# MATERIAL LOSS REVIEW
# OF
# NEXTBANK, NA

**OIG-03-024** **NOVEMBER 26, 2002**

## Office of Inspector General

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**The Department of the Treasury**

# Contents



## Abbreviations

| | |
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| ALLL | Allowance for Loan and Lease Losses |
| CEBA | Competitive Equality Banking Act of 1987 |
| DRR | Division of Resolutions and Receiverships |

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## Abbreviations (con't)

| | |
|---|---|
| EIC | Examiner-in-Charge |
| FAS | Financial Accounting Standards |
| FDIA | Federal Deposit Insurance Act |
| FDIC | Federal Deposit Insurance Corporation |
| NCI | NextCard, Inc. |
| OCC | Office of the Comptroller of the Currency |
| PCA | Prompt Corrective Action |
| SEC | Securities and Exchange Commission |

November 26, 2002

John D. Hawke, Jr.
Comptroller
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As mandated under section 38(k) of the Federal Deposit Insurance Act (FDIA), we reviewed the failure of NextBank, National Association, of Phoenix, Arizona (NextBank). On February 07, 2002, the Office of the Comptroller of the Currency (OCC) closed NextBank upon determining that unsafe and unsound practices had substantially dissipated assets and that insolvency was imminent without Federal assistance. NextBank's failure is estimated to cost the Federal Deposit Insurance Corporation (FDIC) between $300 and $350 million, making it the most costly failure in 2002.

The FDIA mandated review primarily requires us to (1) ascertain the cause(s) of NextBank's failure; (2) assess OCC's supervision of NextBank; and (3) where applicable, recommend how such failures might be avoided in the future. We conducted the detailed audit work at OCC Headquarters in Washington, D.C., and the OCC Western District office in San Francisco, California. We also met with FDIC's Division of Supervision supervisory officials in Washington, D.C., and their regional office in San Francisco, California. We reviewed OCC and FDIC supervisory files and interviewed supervisory officials, attorneys, and examiners involved in the examination, enforcement, and or receivership processes. We also met with officials from FDIC's Division of Resolutions and Receiverships (DRR) and the Division of Finance (DOF) personnel in Dallas, Texas; DOF personnel at NextCard, Inc. headquarters, the parent company of NextBank in San Francisco, California. A detailed discussion of the review objectives, scope, and methodology is provided in Appendix 1.

## Results in Brief

In less than two and a half years, NextBank opened as OCC's first Internet-only credit card bank, grew six-fold from $300 million to over $2 billion in managed assets, never turned a profit, and failed. Based on an unproven technology-based business strategy, NextBank's initial capitalization seemingly arose from the widespread dot-com optimism that prevailed at the time. NextBank's principal owners had just previously operated a similar Internet-based business venture that had also lacked earnings. With a national bank charter, NextBank was able to pursue this Internet-only business strategy, leveraging with Federally insured deposits.

Chartered in September 1999, NextBank operated under the provisions of the Competitive Equality Banking Act of 1987 (CEBA).[1] As such, NextBank's product line was limited to credit cards and it could not diversify through commercial loans. NextBank's funding was also restricted to $100,000 or greater time deposits; it was prohibited from obtaining less costly and less volatile transaction demand accounts (e.g., checking), and deposits could only be accepted from a single office. NextBank effectively served as a shell bank gathering deposits and booking the credit card receivables which had actually been marketed, screened, originated, and securitized by its sole owner and parent company, NextCard, Inc (NCI), of San Francisco, California.

Years prior to opening NextBank, the principals of NCI had developed propriety software that evaluated credit card applicants over the Internet. Rather than its own bank, NCI initially applied this technology through a nonaffiliated bank. Under that arrangement, NCI marketed and screened credit card applicants through the Internet, while the unaffiliated bank funded, originated, and booked the resulting credit card receivables with each sharing the associated proceeds. Although the strategy seemed to hold promise as an effective financial service technology application, NCI experienced consecutively increasing operating losses over 2 years prior to opening NextBank, totaling more than $47 million.

[1] 12 U.S.C.§1841(c)(2)(F).

Nevertheless, NCI raised over $299 million through two public offerings in 1999. Discontinuing the relationship with the unaffiliated bank, NCI channeled most of the proceeds from the public offerings to capitalize NextBank.

NextBank commenced operations in September 1999[2] and through its Internet-based platform quickly grew to over $900 million in assets in two years. The bank's actual growth was far larger than that reflected by its balance sheet. NextBank securitized[3] about $1.4 billion in card receivables and retained the servicing (i.e., managed) for over $2 billion in credit cards.

As with other technology-based companies at the time, NCI's stock valuation reflected optimism rather than profitability. In what may have been an attempt to maintain those exuberant valuations, NCI deviated from its business plan as originally conveyed to OCC in 1998. Asset growth more than tripled over plan, and NextBank's targeted customer base shifted from prime to subprime borrowers.[4] Rather than profitability, NextBank's growth into subprime credits resulted in increasing annual losses. In just over 2 years of operation, NextBank incurred an operating loss exceeding $108 million on over $2 billion in managed assets, and fell three regulatory capital levels depleting capital by more than $96 million. FDIC estimates NextBank's failure will cost between $300 and $350 million.

## Causes Of NextBank's Failure

NextBank's failure can be attributed primarily to improperly managed rapid growth that led to unacceptable high levels of credit risk, losses, and operational problems. Supervisory files repeatedly note that NextBank lacked the systems, controls, and expertise to properly support its excessive growth in a safe and sound manner. The challenges and risks associated with being an Internet-only bank were magnified by the shift from the initial plan of prime

[2] Prior to NCI's de novo application, there had been one other application with a business plan that entailed delivering banking products and services by electronic means.

[3] Securitization essentially entailed selling the bank's credit card receivables to investors through a third party which effectively removed the loans off the bank's balance sheet.

[4] Subprime borrowers are generally defined as exhibiting significantly higher default risk than traditional bank customers. Another common description is a borrower with a tarnished credit history.

lending to subprime borrowers ultimately accounting for more than 40 percent of total managed assets by mid-year 2001. NextBank's Internet-based technology also did not effectively control the associated credit risk. Indeed, some card applicants received initial approval within 30 seconds of submitting an online application. According to an OCC examiner, there was limited, if any, verification of the on-line submitted information.

Even the credit risk reduction technique of securitization was partially negated. Although not required under the terms of the securitization agreement, NextBank would replace previously sold credit cards that had defaulted with performing credit card receivables to maintain the market confidence needed to sustain a securitization program.

The severity of NextBank's lending problems was also partly obscured by deficient accounting practices. Contrary to standards, NextBank followed certain accounting treatments which effectively served to understate operating losses by deferring the recognition and reporting of (1) credit losses exceeding $12 million, (2) needed loan loss provisioning expenses of about $13 million, and (3) $35 million in expenses that had been improperly capitalized. NextBank's restricted funding to high cost volatile deposits not only pressured interest margins, but also exposed the bank to a heightened liquidity squeeze to meet depositors' demands. By the end of the second year of operation, NextBank failed to maintain or augment regulatory capital commensurate with its increased risks, or with that needed to operate as a going concern.

## OCC's Supervision of NextBank

OCC conducted two full scope examinations over the life of the bank. OCC was quick to close NextBank once examiners determined the severity of the bank's credit risk problems in the latter part of 2001. In fact, OCC closed the bank before it became "critically undercapitalized," doing so when it became apparent that there were unrealistic prospects of returning to an "adequately capitalized" level without Federal assistance. Nevertheless, we believe there were aspects of OCC's examination and enforcement procedures that warrant closer review and assessment given the rapidity of NextBank's uncontrolled growth and failure.

For the bank's first full scope examination in 2000, the examiner-in-charge (EIC) initially planned for what appeared to be a comprehensive examination based on OCC's prior limited/targeted site visit shortly after NextBank had opened.  However, the actual examination ended up less than planned, and the EIC was only able to focus on the lack of documented controls and risk management systems, and whether the bank had adhered to its original business plan.  Little, if any, in depth portfolio analysis was completed; the actual impact of the absence of controls and management systems was not assessed; and the bank's true financial condition as a result of its rapid growth into subprime lending was not determined.

The less-than-desired examination coverage in 2000 was due to resource constraints in terms of budgeted examination hours, the number of examiners, and the needed specialized experience and knowledge of the credit card business and NextBank's technology based platform.  As a result, we believe the examination results understated the bank's true risk profile and operating problems. Consequently, OCC's enforcement response through a Board Resolution did not appear sufficiently forceful to reasonably effect corrective action.  Further, the Board Resolution was based on a questionable presumption that NCI could provide needed capital support.

A year later, the second full scope examination initially experienced similar resource constraints.  Again, examination coverage was less than needed, but signs of portfolio deterioration had become pronounced.  Asset growth accelerated even faster than before with only marginal management system improvements and doubts arose as to the accuracy of the bank's financial records and supporting management information systems.  Indeed, before the examination was completed, supervision of NextBank was turned over to OCC's Special Supervision and Fraud Division in Washington, D.C. in July 2001.

Shortly thereafter, the examination recommenced but this time with an expanded team including examiners with specialized skills in credit card lending.  The expanded second phase of the examination in 2001 ultimately revealed NextBank's deteriorating financial condition and portfolio, quantified the understated losses due to deficient accounting practices, and effected the restrictions and mandatory enforcement provisions of Prompt Corrective Action.[5] OCC also issued a Temporary Cease & Desist order, but it's unclear how effective these latter enforcement actions served to minimize FDIC's losses in that NextBank was closed 3 months later in February 2002.

**Other Regulatory Matters**

Prior to any OCC supervisory examination or enforcement actions, we believe the circumstances and conditions under which NextBank obtained its operating charter point to a potential vulnerable regulatory area warranting management review. Initially, NCI filed an application with OCC for a new charter in December 1998. FDIC raised concerns over approving Federal Deposit Insurance for the new charter, which would have prevented final approval of the charter. FDIC's concerns centered on the stock options accruing to NCI owners and whether the options would be in NextBank's best interest or its long term viability. In May 1999, OCC conditionally approved the application and included both pre-opening and on-going conditions intended to ensure NextBank would operate in a safe and sound manner.

NCI then, however, pursued a different approach to chartering NextBank. Rather than operate under a new bank charter, NCI instead filed a separate change-in-control application in August 1999 to acquire a dormant existing national bank charter. The targeted charter would have existing FDIC deposit insurance coverage and OCC does not as a practice precondition change-in-control decisions. We believe, however, preconditions could have possibly allowed OCC to more effectively control NextBank's growth and operations early on rather than after its risk exposures had reached critical and costly proportions. For example, preconditions, in addition to those already set against the de novo application, as to how NextBank would control and support its projected growth might have helped OCC examiners assess and prioritize NextBank's risks in response to the resource constraints during the first full scope examination in 2000.

[5] 12 U.S.C § 1831o (e),(f),(h).

Finally, as a CEBA charted bank, NextBank's parent, NCI, was exempt from Federal oversight by the Federal Reserve as normally provided under the Bank Holding Company Act. NCI was licensed in California, but had never been subject to state examinations or oversight. While the OCC had examination authority over NCI as an affiliate and third party service provider of NextBank, OCC examination coverage of NCI was limited to the transactions and operations that directly related to the nationally chartered NextBank. Beyond the legal organizational distinctions between the two entities, NCI and NextBank were substantively the same organization with dual senior managers and managing directors, and NCI clearly controlled NextBank's financial resources. However, OCC examinations did not cover the specific operations of NCI or its financial records.

While possibly a unique situation, we believe this type of organizational structure points to a potential supervisory gap between OCC and a functional regulator. Of concern is when that supervisory gap exists over the non-supervised parent company whose financial condition and operations may adversely affect a national bank. For example, OCC examiners were not aware of a loan NCI made in 2000 to a senior manager who had held dual positions with NCI and NextBank. Months after NextBank failed in 2002, the loan and interest had still not been repaid. Although the associated amount was not material (under $200,000), we are reminded that one of NCI's primary source of funds was NextBank. Moreover, OCC had always viewed NCI as a source of capital support for NextBank.

**Recommendations**

The report contains six recommendations aimed at enhancing certain regulatory matters dealing with credit card banks, refinements to certain examination and enforcement processes, a potential PCA violation, change-in-control applications, and oversight of unsupervised national bank parent companies.

**OCC Response and OIG Comments**

In its November 25, 2002 written response to the OIG's draft report, OCC concurred with the reported findings and agreed that the recommendations, when implemented, may be helpful to avoiding similar situations in the future. Over the next few weeks, OCC plans to formulate action plans detailing the steps they will take to implement the recommendations. The actions will be formally reported and monitored through the Department's Joint Audit Management Enterprise System.

We believe OCC's planned actions are responsive to the intent of the recommendations. The OIG will also continue to monitor OCC's progress in addressing the reported findings and recommendations. The full text of OCC's response is included in Appendix 4.

## Background

In 1996, NCI was incorporated in California and began offering Internet-based consumer financial services. NCI had developed proprietary Internet-based credit card application and underwriting technology. NCI sought new customers only through Internet advertisements and e-mail solicitations rather than the mass mailings used by conventional credit card banks at the time. NCI's Internet-based card system included accepting information submitted by an applicant and applying both credit bureau scorecards and discrete credit-specific criteria. The applicant could receive preliminary approval or disapproval within 30 seconds.

NCI initially applied its Internet-based technology through a partnership with a nonaffiliated bank. NCI solicited and screened the credit card applications over the Internet, whereas the nonaffiliated bank funded and originated the credit card receivables from NCI's website. In return, NCI collected origination and servicing fees plus a percent of the profits. However, NCI never achieved profitability with increasing operating losses totaling more than $47 million. Despite the lack of earnings, NCI was still able to complete two public stock offerings in 1999, raising over $299 million in gross proceeds. Like other technology-based companies at the time, NCI was viewed as an outstanding prospect by investors.

Rather than limiting itself to the technology applications, NCI acquired a dormant national bank charter in September 1999. The acquisition enabled NCI to fund its own credit card operations and retain the credit card receivables. NCI discontinued the business arrangement with the nonaffiliated bank, and channeled most of the proceeds from the 1999 public offerings to capitalize the acquired charter. The bank was named NextBank, National Association (NextBank), becoming OCC's first charted Internet-only credit card bank.

NextBank's charter was also subject to the provisions of CEBA. Under CEBA, NextBank's product line was limited to credit cards, and it could not diversify through commercial loans. Its funding was also limited to large deposits in amounts of no less than $100,000, and it could not gather less costly or volatile transaction deposits such as checking accounts. Although gathering deposits was also restricted to a single office, NextBank's Internet platform allowed it to effectively market and obtain deposits on a nation-wide basis.

Aside from the legal organizational distinctions between the parent company and the banking subsidiary, NCI and NextBank were substantively the same entity. NCI employees staffed most of NextBank's key operations and most of those operations were covered under a fee based service agreement with NCI. NCI, in turn, contracted some of the functions with its subsidiary or another third party service provider. Key operations provided by NCI included deposit gathering, card solicitations, screening, and originations, most of which were performed in California. NCI also maintained NextBank's financial records, support systems, and website. As a result, NCI's sole source of income was NextBank and most of NCI's operating cost was related to supporting NextBank's operations. In terms of key management decisions, many of the senior managers and directors held dual positions at both entities. From 1999 through 2001, NextBank paid NCI over $173 million under the service agreement.

**<u>NextBank Grew Rapidly</u>**

Through its Internet-based platform, NextBank grew rapidly from about $300 million in assets in September 1999 to over

$900 million in September 2001. Besides the Internet technology, other avenues facilitating rapid growth included balance transfers (assuming an applicant's outstanding card debt balance(s)), accepting greater number of applicants with a higher risk of default (subprime borrowers), and increasing cardholders' credit limit.

NextBank's rapid growth was far greater than reflected by its balance sheet. In addition to the booked assets, the bank had sold over $1.4 billion in credit card receivables for securitization. Besides reducing the credit risk, the proceeds from the securitizations also enabled NextBank to fund growth. Indeed, securitizations accounted for as much as 58 percent of total funding by January 2002.

NextBank's growth never reached the critical mass bank management believed was needed to achieve profitability. Instead, the rapid growth only resulted in operating losses totaling over $108 million in just over two years.

The recognition of losses was also delayed due to deficient accounting practices. However, by the fourth quarter of 2001, examiners identified NextBank's true unsafe financial condition due to its rapid growth, subprime loans, and the adverse effect of providing support on loans previously sold through securitizations. NextBank's regulatory capital fell sharply in just a few months, from "well capitalized" to "significantly undercapitalized" by October 2001. As of October 31, 2002, NextBank's failure is expected to cost the FDIC between $300 and $350 million, making it the largest failure of the year, and NextBank may well take on the distinction as one of the quickest bank failures in decades.

## Findings and Recommendations

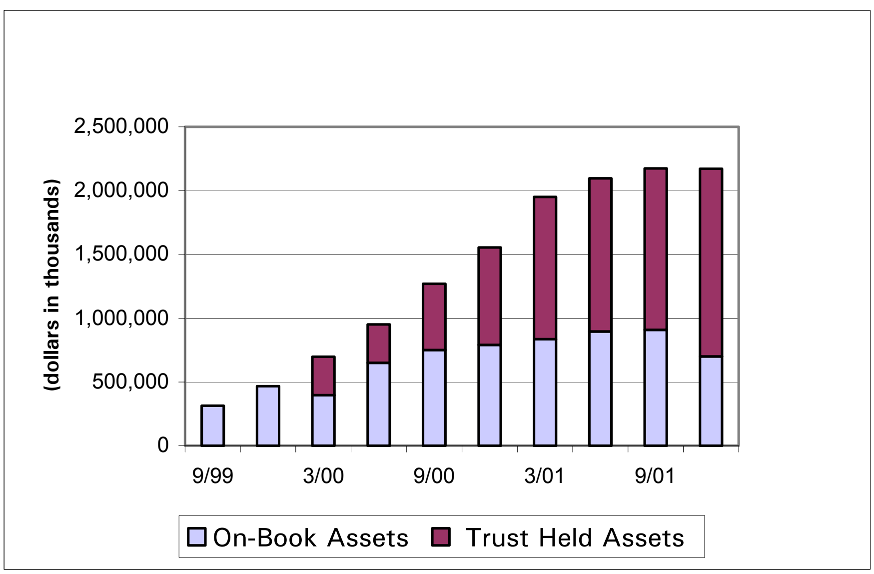
### Finding 1 Causes of NextBank's Failure

NextBank's failure can primarily be attributed to rapid growth that was not properly managed. The accompanying credit risks were magnified with much of that growth involving subprime credits. Operationally, NextBank faced not only the many challenges of Internet banking, but also the added risks of being an Internet-only bank. Under the operating restrictions of its CEBA charter, NextBank was not able to mitigate credit risks through product diversification or avoid the margin pressures given its high cost and volatile funding. Indeed, profitability through NextBank's Internet-based business model was seemingly dependent on exceedingly high asset volume. NextBank pursued this strategy but did not have the systems and controls needed to support growth in a safe and sound manner. As assets grew so did the associated credit risks, losses and operational problems, followed by severe capital depletion and NextBank's failure.

## Rapid Growth In Subprime Loans

NextBank's business strategy depended on asset growth to achieve profitability. In 1999, management projected that more than $800 million in total assets would be needed to break even, and this growth was initially targeted at low risk prime borrowers. NextBank grew its managed assets by more than six-fold in just over 2 years as shown in Chart 1 below.

**Chart 1**
**Total Managed Assets**
**September 30, 1999 – December 31, 2001**




Source: Call Reports

As previously shown, by March 2000 managed assets included both credit card receivables retained by NextBank (henceforth referred to as on-book loans) plus card receivables sold for securitization (henceforth referred to as trust-held loans)[6], where the bank retained the servicing. NextBank earned a fee by servicing the sold assets. Securitizing credit card receivables facilitated NextBank's growth. Total managed assets peaked to over $2.17 billion by September 2001. NextBank's growth was rapid and greatly exceeded the initial growth projections conveyed to OCC. For example, planned growth was to reach $597 million, but actual was $1.5 billion in December 2000, and planned growth was to reach $1.2 billion, but actual exceeded $2 billion in December 2001.

Besides asset securitizations, excessive growth was also achieved by increasing the origination of subprime loans. One industry and regulatory accepted measure used in defining subprime borrowers is the "FICO score."[7] From September 1999 to December 2001, the average FICO score for the combined managed loan portfolio fell from 704 to 655. The regulatory benchmark for subprime is 660. In July 2001, 72 percent of the Bank's on-book loans, and 38 percent of the trust held loans had FICO scores below 660. Not only had total credit risk increased, but NextBank had retained the brunt of the increased credit risk associated with subprime borrowers. NextBank's credit risk exposure grew worse as the average FICO score for on-book loans continued to fall to 526 by December 2001.

While FICO scores only reflect the risk of default, NextBank's actual delinquency and default rates illustrate the adverse impact from the subprime loans. More than 19 percent of the on-book loans, and more than 9 percent of the trust-held loans were at least 30 days past due as of July 2001. The annualized charge-off rate at the time was more than 22 percent and 8 percent, respectively. The examination files reflected a clear correlation between FICO scores and charge-off rates, with loans with the lowest FICO

[6] Typically, when a bank securitizes loans, the assets are held by a trust on behalf of the investors.

[7] FICO score refers to a test developed by Fair, Isaac, and Company, which is widely used to evaluate the credit worthiness of borrowers. Industry guidance published by the Federal Financial Institutions Examination Council in January 2001 defines a FICO score of less than 660 as subprime.

scores having the highest charge-off rates. NextBank's cumulative credit losses exceeded $41 million by December 31, 2001.

Besides increased credit risk associated with growth, there were also signs of higher credit risk seemingly unique to the Internet platform. Examination files noted that Internet applicants were much more likely to be credit seekers who were beginning to experience financial problems that had not yet been reflected in their credit bureau reports. As a result of this informational lag, Internet applicants resulted in an observed phenomenon known as adverse selection. That is to say for any given FICO score, applicants obtained over the Internet tended to have higher default rates than applicants through traditional channels.

Increased Liquidity Risk

Due to the operating limitations of CEBA, NextBank faced high liquidity risk.[8] NextBank funding was limited to deposits of $100,000 or more. Deposits at this high level generally command not only above market rates, but also attract "rate chasers" who are prone to moving their deposits to any bank offering higher rates. Under CEBA, NextBank could not accept lower cost demand deposits such as checking accounts or less volatile deposits of under $100,000. The liquidity risk associated with these large dollar deposits heightened due to regulatory restrictions imposed after NextBank's regulatory capital levels had fallen in the third quarter of 2001. A severe liquidity crisis loomed based on projections of net deposit outflows for the subsequent quarters with high prospects of not being able to meet depositors' demands.

Ineffective Risk Management

If properly managed, rapid growth and subprime lending does not necessarily subject a bank to undue risk. However, the supervisory files repeatedly indicated that NextBank had not established an effective risk management program needed to support these activities in a safe and sound manner. The bank lacked adequate management information systems, risk analysis procedures and

[8] Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due without incurring unacceptable losses.

skills, and risk measurement capabilities. Even fundamental risk management planning was deficient.

According to examiners, the bank's management information systems could not produce the information needed to measure and monitor the bank's activities. For example, in mid-2001 the bank increased the credit limits of existing customers by an aggregate of about $250 million, without adequate management information systems. The bank's existing system could not provide management the information needed to determine the impact of the credit limit increases on delinquency and default rates. The reports generated were generally done on an ad hoc basis, rather than regularly scheduled basis. As such the bank was less likely to identify developing problems on a timely periodic basis through regularly scheduled reports.

NextBank's management systems also did not produce accurate or complete information. Examiners found that certain risk management reports did not reconcile to the general ledger, and portfolio data did not differentiate between the trust-held and on-book loan performance. The latter prevented management from routinely tracking or analyzing the two portfolios separately. Consequently, the deteriorating condition of the on-booked loans were obscured by the generally better performing trust-held loans. This situation would eventually have significantly adverse effects on the bank.

Examination records also revealed that bank management implemented new initiatives without adequate testing, measurement, and analysis. For example, in mid-2001 the bank implemented a credit card repricing plan to increase interest rates for cardholders whose FICO score had fallen 75 points after the bank had originally approved the card applicant. It observed the performance of a test population of accounts for only 21 days before deciding to expand the repricing plan to the entire loan portfolio. Normal industry practice would be to base such decisions on a *minimum* test period of six months. The repricing plan affected $350 million in receivables. The initiative, however, adversely impacted NextBank. In response to the increased rates, the lower risk cardholders left the bank and the higher risk cardholders experienced higher delinquencies.

Relaxed Underwriting Standards

May 2000 loan portfolio data indicated that the bank experienced substantial levels of downward FICO drift as existing cardholders' updated FICO scores fell after being approved for a credit card. For example, the average portfolio FICO score at September 1999 was 704 and 675 for May. In May 2000, more than 18 percent of the managed loan portfolio had ***updated*** (added for emphasis) FICO scores below 650. However, only 3 percent of these same loans had FICO scores this low at origination.[9] FICO drift contributed to an overall decline of the managed portfolio. As of May 31, 2000, 33 percent of the managed portfolio was below 660, which is below the regulatory definition of subprime. Rather than tightening underwriting in response to the increased credit risk, NextBank management relaxed the underwriting standards. From January 2001 to July 2001, the applicant approval rate remained constant but approvals comprised of an increasing number of applicants with even lower FICO scores from 620 to 659.

## Operational Problems

Compounding the risk of improperly managed growth and subprime lending, NextBank's Internet-based platform suffered from two other problems that contributed to its failure: high operating cost and deficient accounting practices.

High Operating Costs

NextBank's Call Reports reflected increasing operating costs averaging $14 million per quarter in 2000, growing to an average of $37 million in 2001. Operating costs consisted mostly of the fee service agreement with the parent NCI, and far exceeded what NextBank had projected in its original business plan. Moreover, there were indications that NextBank's operating costs were actually higher than reported, which would have the effect of understating the bank's losses.

The bank's reported operating costs consisted primarily of payments to NCI under a fee for service agreement. NCI provided

[9] Both percentages are based on the receivable balance owed.

most of the bank staffing, facilities, technology, and equipment. NCI also subcontracted portions of the functions to various third party service providers, such as collections and information technology. NextBank's payments to NCI under the service agreement exceeded 75 percent of NextBank's total operating expenses. Also, the bank's actual operating expenses far exceeded the levels projected in NCI's original charter application. For example, actual operating expenses exceeded planned for 2001 by more than 2.3 times, i.e., $148 million vs. $62 million.

As noted previously, bank operations were largely conducted by NCI and NCI's operating costs relate mainly to services provided to NextBank. Based on NCI's Securities and Exchange Commission (SEC) 10-K reports, there were indications that NextBank's true operating expenses may have been understated. As Table 1 shows, NCI operating expenses significantly exceeded that of the bank.

**Table 1**
**NextCard and NextBank**
**Total Operating Costs**
**($000)**

| Year | NCI Consolidated | NextBank | Difference |
|---|---|---|---|
| 2000 | $146,249 | $59,057 | $87,192 |
| 2001 | 175,055 | 148,024 | 27,031 |
| Total | $321,304 | $207,081 | $114,223 |

Source: Call Reports and SEC Forms 10-Q

The difference column suggests that NextBank may have understated by more than double its operating expenses in 2000, in turn, understating its operating losses. In so doing, NextBank may have delayed regulatory attention from the magnitude of actual losses, as well as NextBank's longer-term prospects.

Deficient Accounting Practices

In addition to the aforementioned operating costs, NextBank also followed certain accounting practices that further served to understate its losses, mask its true financial condition, and possibly delayed regulatory triggers that would have called for large capital augmentation.

Table 2 shows the accounting adjustments that OCC required which totaled over $88 million.

**Table 2**
**Amount and Nature of Required Accounting Adjustments**

| Description | Amount ($000) |
|---|---|
| Write down of deferred loan acquisition costs | $35,718 |
| Write down of seller's interest from securitizations | 21,899 |
| Increase loan loss provision expense | 13,197 |
| Reclassification of fraud losses | 12,047 |
| Establish Reserve for Uncollectible Interest & Fees | 5,598 |
| Total required adjustments | $88,459 |

Source: OCC examination files

Deferred Loan Acquisition Costs

Fees paid for accounts opened by the parent NCI were incorrectly recorded as an asset (deferred loan acquisition costs), to be amortized over a 12-month period. According to Financial Accounting Standards (FAS) No. 91, loan acquisition costs may be capitalized only if paid to an independent third party. Since NCI was not an independent third party, these costs should have been expensed. OCC required the bank to write down capital by over $35 million for the associated fees paid to NCI through September 30, 2001.

*Incorrect Valuation Of Seller's Interests*

The terms of NextBank's securitization trust agreement required the bank to retain a seller's interest in the trust. NextBank accounted for this as a receivable and recorded it at par. Because the seller's interest was "certificated," the bank should have recorded the seller's interest as a security rather than a receivable. OCC required the bank to reclassify the asset as a security as well as write down its recorded value by about $22 million to reflect current fair market value, in accordance with FAS 115.

*Inadequate Loan Loss Provisioning*

NextBank's basis for provisioning the Allowance for Loan and Lease Losses (ALLL) account provided for 9 months of losses. OCC determined that a more appropriate period would have been 12 months given the bank's deficient underwriting, account management, and collections practices. The additional provision required by OCC amounted to $13.2 million.

*Establish Reserve for Accrued Interest and Fees*

Given the subprime nature of the assets held by NextBank, the collectibility of some portion of the associated accrued interest and fees were likely in doubt. Accordingly, OCC required the bank to establish a $5.6 million reserve for uncollectible interest and fees. Though required by FAS 5, the bank had not previously provisioned for this contingency.

*Misclassification Of Fraud Losses*

From the first quarter of 2000 through the second quarter of 2001, the bank accounted for certain types of losses as a fraud rather than a credit loss. The basis for this accounting treatment did not conform to industry practice, and examiners also noted several operating inconsistencies that did not support this accounting treatment. These inconsistencies included: the lack of associated filing of Suspicious Activity Reports; charging off the losses after 180 days instead of the 90 days to be in line with bank's fraud policy; and the lack of involvement by the Bank's Fraud Department.

The required accounting reclassification totaled $12 million. The affect of this incorrect accounting was twofold. By understating the amount of credit losses, the ALLL was likely inaccurate (under provisioned), and regulatory capital was deficient given how NextBank responded to those "fraud losses" that were associated with the trust-held loans. The latter problem is discussed in further detail below "Implicit Recourse."

## Implicit Recourse

As previously discussed, NextBank decreased its credit risk by selling its loans for securitization. However, OCC examiners determined that the bank would replace certain sold loans that had defaulted with its own performing loans[10]. In so doing NextBank effectively retained the credit risk. Although they were not obligated to provide this backup support, it appears NextBank did so to maintain market confidence in its assets for future securitizations.

The terms of the securitization agreement provided for NextBank to give backup support for losses arising from fraud but not normal credit losses. As previously discussed NextBank had incorrectly accounted for over $12 million in fraud losses. Aside from the accounting adjustments, there were even larger implications for regulatory capital purposes for providing backup support on losses improperly accounted as fraud losses.

Regulatory guidance over assets sales with recourse requires the recognition of the retained credit risk for calculating capital adequacy.[11] OCC's Capital Steering Committee determined that NextBank's had provided full implicit recourse on the securitized receivables in light of the practice of replacing loans misclassified as fraud losses. Accordingly, OCC required the bank to include $1.2 billion in securitized assets in determining how much regulatory capital would be needed to support the additional risk. As a result, NextBank's risk-based capital ratio fell from 17.02 percent to 5.38 percent. In so doing, NextBank's regulatory capital dropped three PCA capital levels to the "significantly undercapitalized" category. NextBank was unable to restore capital to sufficient levels, and many of the previously cited problems cast further doubt that the bank could continue as a going concern.

[10] It was unclear from the supervisory files whether NextBank effected these replacements by reimbursing the trust or actually exchanging loans.
[11] 12 CFR Part 3. Risk-Based Capital Requirements--Low Level Recourse.

## Finding 2 OCC's Supervision Of NextBank

The rapidity of NextBank's growth and failure raises questions as to the adequacy of supervision in terms of detecting problems and responding with appropriate regulatory sanctions. We believe that supervisory performance was mixed. Sanctions taken in late 2001 and early 2002 appeared timely and appropriate. But OCC early examinations were partly hampered by resource constraints, which appeared to have delayed the complete detection of NextBank's actual risk profile, embedded asset problems, and unsafe banking practices. Left without an effective enforcement action, NextBank continued its uncontrolled growth to large and costly proportions. Given NextBank's mere two and a half years of existence, it's unclear how much of a difference earlier detection would have made. However, NextBank clearly illustrates how quickly an institution can accumulate large risk positions to the point that the supervisory response can do little to avert a costly failure.

### Examination History and Enforcement Actions

Table 3 summarizes the results of OCC's examinations and enforcement actions. Also see Appendix 2 for a detailed chronology of significant events regarding NextBank.

## Table 3
## OCC Examination Issues and Enforcement Actions

| Date Started | CAMELS Ratings[12] | Examination Type | Significant Safety and Soundness Issues | Supervisory Response/ Enforcement Actions |
|---|---|---|---|---|
| 12/6/99 | 2/222322 | **Limited scope, initial (60 day) on-site** | • Establish a strategic marketing plan covering growth<br>• Establish a formal and comprehensive capital plan<br>• Enhance credit risk management in three areas<br>• Strengthen Internal Audit function<br>• Establish a Vendor Management program<br>• Establish a formal Strategic Planning process<br>• Enhance liquidity risk management in four areas. | • None |
| 5/8/00 | 2/222322 | Full scope | • Inadequate planning methodology and capital planning process<br>• Inadequate Credit Risk Management<br>• High risk areas not audited<br>• Unfocused Vendor Management program<br>• Problems retaining and recruiting management personnel<br>• High credit risk and increasing due to significant growth and expansion in subprime lending.<br>• Severe deterioration of asset quality. | • 10/00 Board Resolution issued |
| 5/21/01 | Preliminary not rated | Full scope Phase 1 | • Examiners could not conclude on the condition of the bank | • 7/13/01 Supervision turned over to Washington, D.C. Special Supervision Unit |
| 8/20/01 | 5/545554 | Full Scope Expanded Phase 2 | • Insufficient risk, audit, and control systems<br>• Inadequate independent assessment of bank practices and records<br>• Improper accounting practices<br>• Incomplete SARs filing | • 11/01 PCA Directive issued<br>• 2/02 Temp C&D issued<br>• 2/02 Order of Investigation<br>• 2/02 Bank Closed |

**Source: OCC Reports of Examination & Supervisory files**

[12] The CAMELS system grades institutions on 6 factors: capital, asset quality, management, earnings, liquidity, and sensitivity to risk. Performance is rated on a scale of 1 to 5 with 5 being the worst.

Based on the supervisory record, we believe there were three major areas that reflect mixed supervisory effectiveness. One, the large dramatic drop of three CAMELS rating levels in a year's time raises questions whether the earlier examination efforts had fully assessed the bank's financial condition and the emerging problems. Two, the persistent reporting of certain examiner concerns raises questions as to the effectiveness of the enforcement response. Three, the bank's continued phenomenal growth continued despite the lack of adequate controls and systems.

**NextBank's Examinations**

About 60 days after NextBank opened, OCC conducted a limited scope examination to: (1) assess the bank's condition and risk profile and (2) gain an understanding of how management intended to organize, manage, and grow the new bank. The scope was limited given the short time the bank had been operating, and the examination coverage reflected a review of policies and procedures but not detailed testing or analysis. Nevertheless, examiners pointed out several areas warranting management attention and corrective action.

Five months later OCC commenced NextBank's first full scope safety and soundness examination in May 2000. The examination scope memo reflects that the EIC had planned for comprehensive coverage, including Information Technology, consumer compliance, financial trends and credit risk management. However, the number of requested hours, examiners, and experience needed were not available due to higher priorities at other credit card banks at the time. As a result, examiners were able to touch upon most areas but available resources precluded in-depth analysis and testing. For example, about 100 staff days for six examiners had been requested to review asset quality. But only five examiners were provided, two of which had no prior asset quality or credit card experience. Roughly 60 days were spent on this aspect of the examination.

Constraints aside, examiners found that the bank had done little to address their concerns raised in the prior December limited review. Moreover, signs of emerging problems were found, most notably increasing credit risk as reflected by increasing charge-off rates, and the bank's planned expansion into subprime markets despite insufficient progress in addressing prior examiner concerns. The charge-off rates ranged from 9 to 12 percent on the loans that had been transferred from NCI when NextBank originally opened. Of note was that the loans had been underwritten and originated under NCI's Internet-based platform for which current originations were growing. Moreover, actual growth was greatly exceeding original business plan projections. The bank had projected assets would reach $139 million by December, but actual growth had more than tripled at $468 million. As Table 3 previously showed, the CAMELS ratings went unchanged from the prior targeted examination with an overall composite rating of 2.

The following year's full scope safety and soundness examination experienced similar resource constraints. For the asset quality review portion, about 200 staff days for eight examiners had been requested. But only seven examiners were provided, five of which lacked asset quality or credit card experience. And instead of 200 days, about 80 days were spent on this aspect of the examination.

Again, examiners found that bank management had done little to address concerns raised in the 2000 examination even though the board had formally resolved to address them. Credit risk and losses were more pronounced with charge-offs now at 22 percent on the on-book loans and 8 percent on the trust-held loans. Also, the overall loan portfolio had clearly drifted from prime to subprime borrowers as reflected by the increase in cardholders with FICO scores under 660. However, examiners could not precisely assess the full impact of the observed problems and rapid growth, and greater uncertainty arose as to the bank's true financial condition, given signs of questionable accounting practices.

Supervision of NextBank was then moved from the Western District to the Special Supervision and Fraud Division in Washington, D.C. in July 2001. The second phase of the 2001 examination recommenced in August but this time included issue area specialists from outside the district and no staff day constraints were imposed. By mid-September the gravity of the problems had been assessed, many of the needed accounting adjustments identified, and supervisory determinations (e.g., implicit recourse) that would result in the automatic triggering of the operating restrictions under Prompt Corrective Action (PCA) implemented.

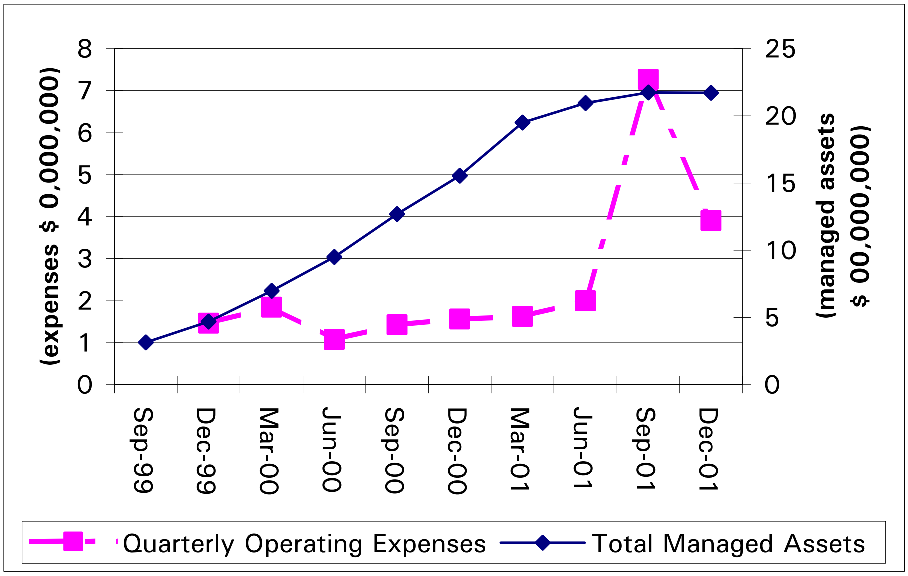
**Areas Warranting Further Examiner Review**

As discussed in Finding 1, two contributing factors to NextBank's failure were its high operating costs and deficient accounting practices. Aside from the possible resource constraints, we believe less than sufficient examiner attention and review had been given in the two areas.

NextBank's operating expenses were largely comprised of the fee service agreement with NCI. Payments to NCI accounted for over 75 percent of the bank's total operating expenses. Actual expenses far exceeded projected expenses under the business plan by more than 2 times in 2001. Expenses which totaled over $222 million likely absorbed the roughly $194 million in capital provided by NCI. From the first site visit in 1999, examiners pointed out the need for a Vendor Management program to oversee the performance of third party service providers. The same concern was raised again in the 2000 examination.

Aside from pointing out the absence of a formal Vendor Management program, examiners did little to assure that the fees were accurate, reasonable, or appropriate, particularly in light of the parent company relationship. The fees were not only large but on a quarterly basis exhibited an unusual trend in that expenses did not parallel the bank's growth as might be expected, and there was an unexplained spike in the third quarter of 2001 as illustrated in Chart 2.

**Chart 2**
**NextBank's Operating Expenses Vs. Total Managed Assets**




Source: Call Reports

Examiners could not recall conducting an extensive review of the operating charges under the service agreement but suggested the fees had been compared to industry standards, and reliance had been placed on the external auditors to surface any problems.

We found no documentary evidence in the examination files evidencing that the operating charges had been reviewed as to compliance with the NCI's service agreement, accuracy or reasonableness, or how the examiner had determined comparability to industry standards.  There were indications that examiners were aware that NCI was in fact subsidizing NextBank's charges, as previously discussed in Finding 1.  We believe that by not fully assessing the accuracy and appropriateness of the fee charges, examiners in 2000 may not have been fully aware of the extent of NextBank's actual operating losses, and thus true risk profile.

As discussed in Finding 1, OCC examiners identified roughly $88 million in needed accounting adjustments, some of which materially affected NextBank's capital.  We found indications of examiners' concerns in this area surfacing around January 2001. However, the concerns were presented as minor and dealing with only two of the five adjustments listed in Table 2. It was not until the second phase of the 2001 examination that the major accounting issues were fully developed.

The 2000 examination scope memo provided for assessing accounting and affiliate transactions. But, it appears from the examination files and discussions with examiners that their focus may have been limited to a general review of policies and procedures, affiliate and intercompany transactions, and associated controls. As to the bank's compliance with standard accounting practices, we found no documentary support of any coverage of the external auditors work as provided under OCC's *Internal and External Audits Comptroller's Handbook* of July 2000. For example, we did not find documentation that the Audit Function Questionnaire had been completed which would have provided the basis for assessing whether additional examination coverage would have been needed.

Examiners acknowledge that some of the questionable accounting practices started in early 2000, but said the associated amounts were likely too small to have been of concern at the time. We suspect that some level of reliance may have also been placed on the external auditors' work under NCI's consolidated financial statements. We did not expand our work as to the reliability of the external auditors' work given SEC's on-going investigation of NCI at the time of this report.

Although we believe examiners could have expanded their coverage over the service fee agreement and accounting practices in 2000, it's unclear whether earlier detection by a year would have materially impacted the supervisory response, the bank's failure, or its cost to the FDIC. Again we are reminded how quickly the bank grew and increased its overall risk profile.

**Enforcement Actions**

To address the concerns identified in the 2000 examination, OCC requested that the board officially commit through a resolution to address the identified weaknesses. The enforcement action is viewed as an informal action but of lesser severity than OCC issuing other informal enforcement documents such as a commitment letter or memorandum of understanding. Certain types of issued enforcement documents are subject to public disclosure as a regulatory enforcement sanction, whereas a Board Resolution is not. Table 4 shows the areas that OCC required the institution to address.

**Table 4**
**NCI Board Resolution**
**October 26, 2000**

| **NCI's** Board Resolution Commitments | Established Timeframes |
|---|---|
| • Curtail growth of managed subprime receivables originated to 5 percent. | 25 days |
| • Maintain Total Risk Based Capital greater than 12 percent of risk weighted assets, and equity capital plus ALLL of at least 6.5 percent of total managed assets. | 25 days |
| • Modify the 3-year strategic plan to provide for reasonable growth rates, adequate capital and adherence to the plan. | 60 days |
| • Develop a Credit Risk Management program including limits on the degree of risk incurred, systems to measure and control risks, and skilled employees managing the risks. | 60 days |
| • Develop monthly & quarterly risk management reports for management review. | 60 days |
| • Ensure the risk manager was independent of credit decision-making activities. | 60 days |
| • Develop a Marketing Plan to carry out the strategic plan. | 60 days |
| • Develop a 3-year Capital Plan, including a Capital Assurance Agreement between NextBank and NCI. | 60 days |
| • Enhance the Internal Audit program. | 30 days |
| • Implement a Vendor Management program governing outsourcing of banking functions | 30 days |

**Source: OCC Supervisory files**

We believe that the 2000 examination had established sufficient basis for using a more forceful enforcement action than a Board Resolution to effect corrective action. NextBank had not substantively addressed the concerns raised in the prior 1999 site visit, such as a establishing a plan covering growth and vendor management. Moreover, NextBank clearly exhibited a higher risk profile given its accelerated growth above the original business plan, its planned expansion into subprime credits, and the unproven Internet platform for controlling credit risk as evidenced by the 9-12 percent charge-off rates of the older loans. In addition, operating losses were not stabilizing and the bank's revised projections indicated that profitability could be achieved through higher than planned growth. Given the absence of fundamental bank risk management systems, we believe an appropriate response would have been an issued enforcement document rather than continually relying on bank management commitments.

Besides the type of enforcement action, there were also certain aspects of the Board Resolution that seemingly could have been enhanced, specifically those aimed at growth and capital coverage. The Board Resolution only attempted to curb subprime growth with a set limit beyond a capital limitation even though the bank lacked systems and controls to support prime loan growth as evidenced by the increasing charge-off rates of prime credits.

The requested capital support of 6.5 percent to total managed assets can be traced to the original charter application in 1998. However, that capital level was in support of projected volume and the type of business (i.e., prime creditors) at the time. As previously noted, those two basic assumptions materially changed with actual growth more than doubling planned, and the shift from prime to subprime credits.

Another aspect of the Board Resolution was a required capital assurance agreement between the bank and NCI. The agreement called for an assurance from NCI to provide additional capital if the bank's capital ratios fell below certain regulatory thresholds. Although it was reasonable to look to the parent and sole owner for needed future capital support, NCI had demonstrated that any capital support would not come from operations given its consecutive years of net operating losses, even prior to owning NextBank. NCI's March 31, 2000, 10-Q reported cumulative operating losses continued to increase and now exceeded $112 million since it began in the Internet credit card business.

These increasing losses were dissipating NCI's financial base and funds obtained from the 1999 public offerings.

The Board Resolution proved to be ineffective in getting the bank to take corrective action. Most of the milestones were not met, and there was also uncertainty arising as to the interpretation of a key provision. Each month OCC was to monitor the bank's progress towards meeting the 5 percent subprime loan restriction. However, the monthly reports filed by the bank were taken on face value; the examiner did not verify these reports. It was not until the second phase examination in 2001, some 9 months later, that examiners determined the reports had been inaccurate. Rather than control subprime growth to 5 percent, actual subprime loans were 34 percent for the quarter ending March 2001, and 27 percent for the following quarter. Bank management attributed this to a misunderstanding of the Board Resolution. OCC officials acknowledge that the Board Resolution had been ineffective, and pointed out that under the revised enforcement policy, *PPM 5310-3*, July 2001, Board resolutions are no longer available as an informal action.

**Prompt Corrective Action**

Prompt Corrective Action (PCA) provides Federal banking regulators an added enforcement tool to promptly address "undercapitalized" banks and thrifts. PCA consists of a system of progressively severe regulatory intervention that is triggered as an institution's capital falls below prescribed levels. PCA does not replace or preclude the use of other available enforcement tools (e.g., cease and desist orders) that address unsafe and unsound banking practices before capital becomes impaired. PCA aims to minimize losses to the FDIC by providing for a quick regulatory response to troubled institutions.

When OCC had determined in October 2001 that NextBank had provided implicit recourse on the trust-held loans, the resultant additional bank assets effectively dropped the bank's regulatory capital level from "well capitalized" to "significantly undercapitalized." At that point, NextBank was automatically subject to the restrictions of PCA. Additional restrictions were imposed by OCC in November 2001 through a PCA Directive, containing 12 provisions.  Some key provisions required NextBank to: develop a capital restoration plan due in 45 days; file amended Call Reports; restrict new credit card account originations to FICO scores above 680; prevent dividend payments; and restrict asset growth, management fees, and brokered deposits.

By December 2001, NextBank advised OCC that it would not be able to address its capital deficiency.  In January 2002, NCI and NextBank filed with the OCC an Asset Disposition Plan detailing plans to liquidate the bank.  Notwithstanding the attempts made during numerous subsequent meetings to resolve the bank's financial condition, OCC appointed FDIC as receiver on February 7, 2002.

<u>Brokered Deposit Restrictions</u>

PCA restricts the use of brokered deposits and the rates paid on deposits when regulatory capital falls below the "well capitalized" category.  These restrictions are intended to slow or reverse growth, and thus risk, by limiting a troubled institution's funding sources.  For NextBank these restrictions were automatically triggered on October 31, 2001.

Call reports show a net outflow of about $56 million in deposits from September 30, to December 31, 2001.  However, brokered deposits increased roughly $135 million from $55 million to $190 million during this timeframe.   Because we were unable to determine the actual dollar amounts of brokered deposits and bank deposits on the day the PCA directive was issued, we spoke to an OCC analyst about the apparent increase in brokered deposits.

The analyst opined that the apparent increase could have been due to the bank's definitional interpretation as to what constituted a brokered deposit.  Prior to the deposit restriction, the bank had not reported certain fiduciary deposits as brokered deposits.  The analyst believed that NextBank might have reclassified a portion of their fiduciary deposits as brokered deposits for the December 2001 Call Report.  We could not determine or estimate how much of the $135 million in additional brokered deposits could have been due to the reclassified fiduciary deposits versus how much may have actually been due to the use of brokered deposits contrary to the restriction.

PCA Effectiveness

PCA's effectiveness in NextBank's situation is difficult to assess given the short time period of about 85 days from the time the PCA Directive was issued to the bank's closure. The implicit notion that PCA provides prompt and progressively severe enforcement action based on a bank's capital position appeared irrelevant in NextBank's situation. By the time Nextbank's true financial condition had been determined in the later part of 2001, it had already accumulated critically, if not irreversible, large proportions of risk. Coupled with the CEBA operating and funding restrictions, the bank had few, if any, realistic options to survive PCA. Rather than prompt enforcement action, NextBank's situation points to a need to quantify uncontrolled growth so that risk and not just capital levels triggers supervisory action. Conventional enforcement actions had not been effective.

## Finding 3 Other Regulatory Matters

One of the mandated review objectives of a material loss review is to bring to regulators' attention any issues which might assist in avoiding bank failures in the future. Although not directly related to the examination of NextBank, we believe the circumstances and conditions under which NextBank obtained its operating charter point to potentially vulnerable regulatory and supervisory areas warranting OCC's review.

**Potential Vulnerability in the Application Process**

NCI initially applied to OCC for a new credit card bank charter in December 1998. NCI's application clearly disclosed the planned Internet-based platform and delivery channel, its targeted prime customer base, planned funding, and basic organizational structure. In reviewing such applications, OCC considers (1) the organizers' familiarity with national banking laws and regulations, (2) competencies of the managers and directors, (3) capital adequacy relative to projected volume and type of business activity, (4) profitability prospects, and (5) the safety and soundness issues.

OCC's final approval of a bank charter also depends on the bank obtaining FDIC deposit insurance. Although FDIC had reached favorable determinations for most of the insurance considerations, the FDIC March 1999 field investigation recommended that the Washington FDIC office deny deposit insurance. The denial was based on the factor "General Character of Management," specifically over the planned compensation to insiders. The FDIC field investigative report concluded that the stock options accruing to NCI owners did not appear to be in the best interest of NextBank or its long-term viability. Aside from the FDIC concerns, OCC granted NCI "preliminary conditional approval" in May 1999. However, OCC's approval included 12 conditions, which collectively were designed to better ensure that once opened, NextBank would operate in a safe and sound manner.

NCI then, however, pursued a different approach to chartering NextBank. Rather than operate under a new bank charter, NCI instead filed a separate change-in-control application to acquire a dormant existing national bank charter in August 1999. In so doing, the targeted charter would already have existing FDIC deposit insurance coverage, and OCC does not as a practice precondition change-in-control applications. NCI opened NextBank under the change-in-control application in September 1999.

OCC's authority to precondition a change-in-control application appears unclear and subject to interpretation. When we initially asked OCC why NextBank's change-in-control decision had not been subject to the same conditions as its prior new bank charter application, we were told that OCC lacked clear legal authority to do so. We brought to their attention the OCC Corporate Manual[13] for chartering an Internet Bank, which specifically states, in part: "…OCC may approve or conditionally approve *any* (emphasis added) filing after reviewing the application…" OCC officials indicated that the manual reference applied only to new charters and not a change-in-control application. Furthermore, OCC officials were not certain if such preconditions would be legally enforceable even though they were aware that the Federal Reserve preconditioned change-in-control applications and believed such preconditions were enforceable under 12 U.S.C §1818.

[13] *The Internet and the National Bank Charter, Comptroller's Corporate Manual,* January 2001

We believe NextBank was, in substance, a new bank given the dormant status of the acquired bank charter. Accordingly, we believe preconditions were not only prudent but also could have possibly allowed OCC to more effectively control NextBank's growth and operations early on rather than after its risk exposures had reached critical proportions. For example, one precondition OCC had invoked under the new bank charter, which could have been expanded, was a minimum 6.5 percent capital to managed assets ratio. Such a precondition seemed appropriate given NextBank's unproven Internet-based technology, and the unknown risks at the time of Internet banking, let alone being an Internet-only bank. NextBank was clearly not to be just another credit card bank. Besides the added capital cushion, preconditions may have also provided examiners an added basis to assess risk and prioritize examination tasks during the first full scope examination in 2000.

**Parent Company Lacked Sufficient Regulatory Oversight**

Finally, as a CEBA charted bank, NextBank's parent, NCI, was exempt from Federal oversight by the Federal Reserve under the Bank Holding Company Act. NCI was licensed in California but had not been subject to state examination or oversight. While the OCC had examination authority over NCI as an affiliate and third party service provider of NextBank, OCC examination coverage of NCI was limited to transactions and operations that directly related to NextBank. Distinguished only by legally separate organizational structures, NCI and NextBank were substantively the same organization with dual senior managers and managing directors. NCI also controlled NextBank's financial resources and operations, the latter through a fee-based servicing agreement. In substance, NextBank was a shell bank that booked insured $100,000 time deposits and credit card receivables. But those assets, transactions, and liabilities were essentially created by NCI, a NCI operating subsidiary, or a third party service provider contracted by NCI. NCI's financial condition and operations clearly could impact NextBank and its Federally insured depositors.

OCC examinations of NextBank did not cover NCI's specific operations as the parent company or its financial records. In effect, NCI was not subject to Federal oversight or sufficient oversight by the state functional regulator, certainly not to the level normally provided over an equivalent bank holding company.

While possibly a unique situation, we believe this type of organizational structure points to a potential supervisory gap between OCC and a functional regulator.[14] Of concern is when that supervisory gap falls over the parent company whose financial condition and operations may adversely impact a national bank. For example, OCC examiners were not aware of several personal loans NCI made in year 2000 to certain employees, including a senior manager that had held dual positions with NCI and NextBank. According to NCI's 10-K filing, the manager's loan included a stated interest rate and was secured by NCI stock and stock options. Eight months after NextBank failed, the manager's loan and accrued interest had still not been repaid and is currently subject to a collections suit.

The amount of the manager's loan was not material (i.e., under $200,000). But it must be kept in mind that one of NCI's primary source of funds was NextBank And from a supervisory perspective, NCI was also viewed as a source of capital support as reflected in the Board Resolution as requested by OCC after the 2000 examination. OCC's authority to proactively exam NCI, affiliates, and third party service providers is established under 12 U.S.C.§ § 481 and 1867(c). We believe that examiners in 2000 did not fully exercise this authority.

## Recommendations

With respect to NextBank's Internet-based credit card activities, the OIG has no recommendations in light of the Federal Financial Institutions Examination Council's draft *Credit Card-Account Management and Loss Allowance Guidance*, July 22, 2002. While not applicable to NextBank's entire situation, we believe the guidance provides sufficient regulatory expectations that would have mitigated some of the failed bank's risky practices.

[14] A similar supervisory gap was reported by the FDIC OIG involving another bank failure that had resulted in a material loss to the FDIC, *Material Loss Review - The Failure of Pacific Thrift and Loan Company, Woodland Hills, California,* June 7, 2000, Audit Report No. 00-022.

In Finding 2, we noted that examiner resource constraints appeared to have hindered OCC's timely and full assessment of the bank's risk profile and true financial condition until the last quarter in 2001. We are aware that a similar situation had been identified in an OCC Lessons Learned Review for another recently failed bank. One recommendation from that internal review was for OCC to establish a process to allocate specialized examination resources to banks that appear fundamentally sound but have a high or increasing risk profile. This process should be centralized to allow such specialized requests and assigning resources.

1. Accordingly, we support the aforementioned recommendation from the Lessons Learned Review and further recommend that additional steps be taken to proactively expand the pool of examiners with specialized experience based on emerging trends and industry developments.

Also in Finding 2, we noted additional and expanded examiner attention had been warranted in the areas of accounting practices and the service agreement with NCI.

2. With respect to the accounting practice issue, we recommend that the July 2000 *Internal and External Audits* handbook be reassessed for clarity and whether NextBank's situation calls for establishing or increasing mandatory procedures to review the external auditors work covering a bank's accounting practices with respect to compliance with Generally Accepted Accounting Principles.

3. With respect to the service agreement issue, we recommend that examiner guidance be reassessed for clarity or expanding the expected examiner coverage provided under OCC Bulletin 2001-47 *Third-Party Relationships–Risk Management Principles.* The bulletin establishes precise expectations of banks' risk management processes. However, it's unclear as to what examiners are expected to do when a bank's systems are insufficient or absent as in NextBank's case. Specific consideration should be given to examiners

gauging a third party service provider's impact on the bank's condition and operations.

In Finding 2, we also pointed out the possible PCA violation of increased brokered deposits contrary to the associated restriction.

4. We recommend that OCC assess how much of the increase in brokered deposits in the fourth quarter of 2001 was actually due to the reclassification of fiduciary deposits, and assess the need for further sanctions if warranted.

In Finding 3, we point out two potential vulnerable areas dealing with change-in-control applications, and oversight of national bank parent companies that are not subject to Federal supervision or sufficient supervision by the functional regulator.

5. With respect to applications, we recommend that OCC seek legal clarity as to their authority to condition a change-in-control application. If needed, seek legislative authority in concert with the Federal Reserve as to the circumstances allowing OCC to invoke conditions when acting on this type of application.

6. With respect to the second issue, the Comptroller of the Currency should reassess the adequacy of existing examination guidance on how examiners should assess the risks presented by the parent company. Added consideration should be given to the specific supervisory issues presented by entities operating under the Competitive Equality Banking Act of 1987.

**Management Response and OIG Comments**

In its November 25, 2002 written response to the OIG's draft report, OCC concurred with the reported findings and agreed that the recommendations, when implemented, may be helpful to avoiding similar situations in the future. Over the next few weeks, OCC plans to formulate action plans detailing the steps they will take to implement the recommendations. The actions will be formally reported and monitored through the Department's Joint Audit Management Enterprise System.

We believe OCC's planned actions are responsive to the intent of the recommendations. The OIG will also continue to monitor OCC's progress in addressing the reported findings and recommendations. The full text of OCC's response is included in Appendix 4.

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We would like to extend our appreciation to OCC for the cooperation and courtesies extended to our staff during the audit. If you have questions please call me at (415) 977-8810 ext. 222. Major contributors to the report are listed in Appendix 5.

Benny W. Lee /S/
Regional Inspector General for Audit

We conducted this material loss review of NextBank in response to our mandate under Section 38(k) of the FDIA, 12 USC § 1831o(k). This section provides that if the deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the inspector general for the appropriate Federal banking agency shall prepare a report to the agency, which shall:

- Ascertain why the institution's problems resulted in a material loss to the insurance fund;
- Review the agency's supervision of the institution; and
- Make recommendations for preventing any such loss in the future.

As defined by Section 38(k) of the FDIA, a loss occurring after June 30, 1997, is considered material if it exceeds $25 million or 2 percent of the institution's total assets. The FDIA also requires the inspector general to complete the report within 6 months after it becomes apparent a material loss has been incurred. We initiated a material loss review of NextBank based on the loss estimate by the FDIC. In October 2002, FDIC estimated that NextBank's failure would cost the Bank Insurance Fund between $300 and $350 million.

To accomplish our review, we conducted fieldwork at OCC Headquarters in Washington, D.C., and its Western District Headquarters in San Francisco, California. Additionally, we visited FDIC's Division of Supervision in Washington, D.C., the Division of Resolutions and Receiverships (DRR) in Dallas, Texas and Division of Finance (DOF) personnel operating out of NCI's Headquarters in San Francisco, California.

We also met with enforcement officials from the SEC in San Francisco, California to determine the nature and status of any planned or ongoing investigations relating to NCI. At the time of our inquiry, SEC had just filed notice of a formal investigation, and as such SEC was unable to comment. Given the potential breadth of SEC's investigative subpoenas, we did not inquire or seek information surrounding NCI's external auditors with respect to any services provided to NCI or NextBank. Accordingly, our review did not assess what, if any, role the external auditors work may have contributed to NextBank's failure.

Our review covered the period from December 1997 until NextBank's failure on February 7, 2002. We conducted our fieldwork from April 2002 to November 2002. In November 2002, subsequent to issuance of our draft report, OCC issued their Lessons Learned Review of NextBank. Consequently, we were unable to do an in-depth analysis of any information the review might have had with respect to the causes of NextBank's failure or OCC's supervision of the bank. However, reviewing the document shows it is consistent with our audit report.

To assess the adequacy of OCC's supervision of NextBank, we attempted to determine (1) when OCC first identified NextBank's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. Additionally, we attempted to determine whether OCC (4) might have discovered problems earlier, (5) identified and reported all the problems, and (6) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we:

- Assessed OCC actions based on its internal policies and guidance, and various guidance provided by the FFIEC.

- Reviewed supervisory and enforcement files and records for NextBank and its parent from 1997 through 2002 that were maintained at OCC Headquarters, and its Western District Office. We analyzed all examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed this analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess NextBank's condition and the regulatory action used by OCC to compel bank management to address the deficient conditions found. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers, other than those incidentally available through the supervisory files.

- Interviewed and discussed various aspects of the supervision of NextBank with OCC officials, examiners, specialists, attorneys, and an analyst, to obtain their perspective on the bank's condition and the scope of the examinations.

- Reviewed files, workpapers, and examination reports maintained by FDIC's Dallas DRR staff to determine the nature, scope, and conclusions regarding the post closing of NextBank.

- Interviewed the FDIC, DRR and DOF personnel who were involved in the receivership process and in the due diligence reviews, which were conducted prior to and after NextBank's closure and appointment of the conservator.

- Discussed the progress of FDIC's investigative efforts with FDIC DRR investigators in Dallas, Texas.

- We interviewed a FDIC Division of Supervision examiner who had participated with OCC on reviews and examinations at NextBank.

We conducted our review in accordance with generally accepted government auditing standards.

## Chronology Of Events In NextBank's History

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| 06/96 | Internet Access Financial Corporation, subsequently renamed NextCard, Inc. (NCI) in October 1998, is incorporated in the State of California to offer Internet-based consumer financial services. |
| 12/23/97 | The NCI Visa is first offered to the public, with loans originating through the NCI website. Credit cards are issued solely through a strategic alliance with an unaffiliated bank. |
| 12/10/98 | NCI files a charter application with OCC for a new national bank. |
| 01/12/99 | NCI terminates its Consumer Credit Card Program Agreement with its strategic partner and begins purchasing credit card receivables from the partner using secured lending facilities extended to a subsidiary, NCI Funding Corporation. |
| 02/16/99 | OCC and FDIC conduct charter field investigation. |
| 05/08/99 | OCC grants NCI conditional approval to establish a new national, limited purpose credit card bank. Conditions include minimum capital greater than 6.5 percent of managed assets and limiting securitizations to not more than 73 percent of aggregate receivables for three years. |
| 05/19/99 | NCI completes its Initial Public Offering (IPO) with gross proceeds of approximately $138 million. |
| 07/99 | FDIC's San Francisco Regional Office recommends denial of insurance, based on excessive stock-based compensation to insiders and noncompliance with its statement of policy on stock benefit plans. |
| 08/16/99 | NCI files notice to acquire the charter of Textron National Bank (TNB) of Costa Mesa, California an almost dormant bank, insured by FDIC. |
| 09/15/99 | NCI's change in control becomes effective. TNB is renamed NextBank, National Association, a new limited purpose national credit card bank. Total Assets were about $313 million by September 30, 1999. |

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| 12/06/99 | OCC conducts a 60-day limited scope examination of NextBank as of September 30, 1999. CAMELS 2/222322. |
| 12/14/99 | NCI completes a follow-on public offering with gross proceeds of approximately $161 million. |
| 03/00 | Founder, Chairman and CEO of NCI steps down, retained as Chief Strategy Officer. |
| 05/08/00 | OCC begins first full scope examination based on March 31, 2000 data. Total Assets as of March 31, 2000 were $696 million. |
| 05/00 | NextBank submits a revised business plan for 2000. |
| 07/11/00 | FDIC requests to attend exit meeting due to concerns about rapid growth, increasing risk profile and lack of controls. |
| 7/00 | OCC requested NCI's Board Of Directors to develop a Capital Assurance Agreement between the bank and NCI. |
| 09/06/00 | OCC holds an exit meeting with NextBank on the May 2000 examination. OCC concludes that the bank's condition is satisfactory and assigns CAMELS ratings of 2/222322. FDIC has reservations with OCC's ratings, but concurs, lacking information that would substantiate a lower rating. Total managed assets were $951 million at June 30, 2000. |
| 10/26/00 | Based on the May 2000 examination, NextBank's Board of Directors adopts Board Resolution including a Capital Assurance Agreement. |
| 12/00 | OCC on-site visit to review NextBank compliance with the Board Resolution. OCC finds that NextBank made minimal progress in addressing issues raised in the Board Resolution and asset quality issues. |
| 01/01 | NextBank issues new Capital and Business Plans. |
| 01/02/01 | OCC on-site review of NextBank securitizations and compliance with Board Resolution. OCC considers securitization activity satisfactory. However NextBank is not in full compliance with Board Resolution. OCC asks NextBank management to re-write the Capital and Business Plans. |

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| 03/01 | OCC on-site visit to evaluate NextBank's compliance with Board Resolution. OCC finds only partial compliance. |
| 05/01 | OCC begins a full scope examination, with FDIC participating. NextBank expanding subprime loan market, growing greater than planned, planning and control systems not keeping up with growth, and the bank deviates from original business plan. Total managed assets $1.9 billion as of March 31, 2001. |
| 07/13/01 | OCC transfers NextBank supervision from the Western District to its Washington, D.C. Headquarters Special Supervision and Fraud Division. |
| 08/20/01 | OCC begins Phase 2 of the full scope examination with an expanded team of specialized examiners. |
| 09/30/01 | OCC examiners ascertain NextBank's true financial condition, leading to a reduction of its capital position by $96 million. OCC deems that NextBank is providing implicit recourse on securitized assets. Total Risk Based Capital is reduced to 5.38 percent, placing NextBank in the "significantly undercapitalized" PCA category. |
| 10/04/01 | NCI retains outside investment bank to market the parent and bank for sale, likely indicating that management is unwilling or unable to improve NextBank's capital position. |
| 11/09/01 | OCC asks NextBank's Board of Directors to request in writing that NCI provide capital support as required under the Capital Assurance Agreement. |
| 11/16/01 | OCC issues a PCA Directive requiring NextBank to file an acceptable Capital Restoration Plan with OCC by December 31, 2001, or a plan to sell/merge/liquidate at no cost to the FDIC. |
| 12/31/01 | NextBank files a Capital Restoration Plan with OCC proposing either the sale of NCI to a third party or a liquidation of NextBank's assets and liabilities. |
| 01/12/02 | NextBank files an Asset Disposition Plan with OCC since a Capital Restoration Plan is not feasible. The Asset Disposition Plan is unacceptable to OCC and FDIC because of its high cost, lack of |

assurance that a buyer could be found, and inability to raise enough money to retire the bank's liabilities.

02/07/02 OCC issues a Temporary Cease and Desist Order requiring NextBank to take action to enforce the Capital Assurance Agreement between the bank and NCI.

02/07/02 OCC issues an Order of Investigation requiring NextBank to provide documents needed to assess the financial condition and evaluate the affairs of NextBank and to determine whether any enforcement action is appropriate against directors, officers, or employees of the bank.

2/07/02 OCC closes NextBank and names FDIC as Receiver.

03/02 SEC opens an investigation of NCI.

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| Allowance for Loan and Lease Losses | A valuation reserve established and maintained by charges against a bank's operating income. As a valuation reserve, it is an estimate of uncollectable amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected. |
| Brokered Deposits | Funds, which a bank obtains, either directly or indirectly, by or through a broker, for deposit into a deposit account. Brokered deposits include both those in which a single depositor holds the entire beneficial interest and those in which the deposit broker sells participations to one or more investors. Under 12 Code of Federal Regulations § 337.6, only "well capitalized" banks may accept brokered deposits without FDIC approval. |
| CAMELS | The OCC and other bank regulators use the Uniform Financial Institution Rating System to evaluate a bank's performance. CAMELS are an acronym for the performance rating components: <u>C</u>apital adequacy, <u>A</u>sset quality, <u>M</u>anagement administration, <u>E</u>arnings, <u>L</u>iquidity, and <u>S</u>ensitivity. |
| Implicit Recourse | An implied obligation for the bank to make good all credit losses in accounts sold. |
| Individual Minimum Capital Requirement | OCC may establish the minimum level of capital for an institution it supervises. This enforcement action is a special capital requirement set case-by-case for associations with unacceptably high-risk profiles. |
| Informal and Formal Enforcement Actions | Informal enforcement actions are documents that provide a bank with guidance in addition to that provided by the Report of Examination. Informal actions are those instances where it is desirable to have commitments from a bank's management and board of directors. Formal enforcement actions are reserved for significant safety and soundness or compliance |

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| | problems that, unless corrected, constitute a present or future threat to the survival of the bank or otherwise pose a serious threat to the bank's safety and soundness. |
| Order of Investigation | Orders approved by Washington Supervision Review Committee and the Senior Deputy Comptroller for Bank Supervision Operations, which authorize formal investigations of certain national banks. Once issued the Comptroller's representatives are authorized to subpoena documents and testimony from the entities within and outside the bank under investigation. |
| Prompt Corrective Action | A framework of supervisory actions for insured institutions, which are not adequately capitalized. These actions become increasingly severe as an institution falls into lower capital categories. The capital categories are: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized (12 USC § 1831o). |
| Subprime | The term refers to the credit characteristics of the individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. |
| Temporary Cease & Desist Order | Interim order to impose immediate measures pending resolution of a final cease and desist order. May be challenged in U.S. District Court within 10 days of issuance but effective on issuance. Pursuant to authority under 12 USC § 1818. |

# MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Benny W. Lee, Regional Inspector General for Audit

From: John D. Hawke, Jr., Comptroller of the Currency

Date: November 25, 2002

Subject: OIG Draft Audit Report – NextBank N.A.

We have received and reviewed your draft audit report titled *Material Loss Review of NextBank, N.A.* The Office of the Comptroller of the Currency closed NextBank, N.A. (NextBank) on February 7, 2002 upon determining that unsafe and unsound practices had substantially dissipated assets and that insolvency was imminent without Federal assistance. The Federal Deposit Insurance Act mandated your review of the failure, because the Federal Deposit Insurance Corporation (FDIC) estimated that there would be a material loss to the deposit insurance fund.

Consistent with the purposes of the review, you found that the bank failed because of improperly managed rapid growth that led to unacceptable high levels of credit risk, losses, and operational problems. You also found that there were aspects of OCC's examination and enforcement procedures that warrant closer review and assessment given the rapidity of NextBank's uncontrolled growth and failure.

We concur with your findings and agree that the recommendations, when implemented, may be helpful to us in avoiding similar situations in the future. Over the next few weeks, we will be formulating action plans detailing the steps we will take to implement the recommendations. The actions will be formally reported and monitored through the Department's Joint Audit Management Enterprise System (JAMES).

Thank you for the opportunity to review and comment on the draft report.

## Inspector General, Office of Audit

John A. Richards, Audit Manager

John E. Carnahan, Auditor-in-Charge

Jack Gilley, Auditor

John Mansfield, Auditor

Garrett W. Gee, Auditor

**U.S. Department of the Treasury**

Office of the Under Secretary for Domestic Finance
Office of the Assistant Secretary for Financial Institutions Policy
Office of Strategic Planning and Evaluations, Departmental Offices
Office of Accounting and Internal Control, Departmental Offices
Office of the Assistant Secretary for Public Affairs

**Office of The Comptroller of the Currency**

Comptroller
Deputy Comptroller Western District
Senior Advisor-OIG/GAO Liaison

**Office of Management and Budget**

OIG Budget Examiner

**U.S. General Accounting Office**

Comptroller of the United States

**Federal Deposit Insurance Corporation**

Chairman