

The FDIC and the Nextbank Failure

It was a cold day in February of 2002 when senior FDIC officials from the Western region received notice that Nextcard, Inc., a San Francisco-based consumer lending organization, was calling it quits. The company intended to transfer all assets, including over \$2 billion of outstanding credit accounts, over to the FDIC.

FDIC officials knew that Nextcard was in trouble. In October of 2001, the firm stated that it would be reclassifying certain credit losses as mandated by federal regulators. This move left Nextcard's banking unit, Nextbank, severely under-capitalized and caused the firm's stock price to drop about 80% in one day (see Exhibit 1). At the time, however, the firm still clung to its credit portfolio and innovative strategy of offering consumer credit cards over the internet. The FDIC would need to gather as much information as it could about Nextcard's assets and current situation before a decision was made on how to handle the situation.

Credit Card Industry History

Francis McNamara started *Diner's Club* in 1950 as one of the first "payment" cards. At first, the card could be used as a form of payment at several New York City restaurants. However, when the product proved successful, *Diner's Club* expanded its operation to include hotels and retail stores in other cities as well. Between 1953 and 1954 almost 100 banks introduced "charge cards" that could be used primarily by their own customers within their local areas. However, many banks found it difficult to manage this new line of business, with about half dropping their charge card programs after a short period of time. Instead of using cash, consumers could use charge cards as a form of payment, requiring them to pay the charge by the end of a specified period, usually thirty days. Since no interest or fees were charged to the consumer, charge card operations derived income primarily from merchants who accepted their card as a form of payment by charging participating merchants a percentage of card-based sales.

This gave Diner's Club little competition until 1958, when American Express, Bank of America, and Chase Manhattan Bank all entered the fray. While American Express, like Diner's Club, was a charge product, both Bank of America and Chase Manhattan Bank were considered pioneers of the general purpose credit card, which offered both payment and credit services to consumers to be used at any participating retail location. These "credit" cards were especially appealing to smaller merchants who did not have the means to issue their own credit product. In addition, having a third party manage credit between large numbers of consumers and retailers created significant economies. While these new credit products allowed the issuing companies to draw income from merchant fees, much like a charge card, they also gave opportunities to gain profits from consumers as well. This was achieved by charging consumers interest on credit balances, as well as charging fees to cardholders for various occurrences, such as making a late payment or going over their credit limit.

At first, these new credit programs were difficult to administrate. Banks did not understand how to properly extend unsecured credit to unaffiliated consumers, since it differed so greatly from

standard bank lending practices. By 1962, many banks had exited the fledgling industry, including Chase Manhattan.

Card Associations

Most failures in the immature payment card industry were due to several reasons. First, in order for a new card to be successful, the provider (bank) had to convince merchants and consumers to accept its card simultaneously. This proved to be a difficult and costly task. Second, to quickly establish a payment card's market share, issuers were often lured into dispersing their cards to consumers outside their existing customer base. Information on these "new" customers was not as detailed, causing banks to extend credit to consumers who were unable to pay their debts. Third, payment cards were also an easy target for fraud.

These circumstances made it difficult for smaller banks to compete with alternative products that were more readily acceptable, such as American Express and Diner's Club. However, things changed in 1966, when Bank of America created BankAmerica Service Corporation. This new entity licensed Bank of America's existing payment cards to local banks, allowing them to issue a card that could be used nationally. This new, more efficient structure allowed Bank of America to manage merchant relationships, while the banks themselves licensed the card and signed up local consumers. This new separation of responsibilities was very appealing, and in response, several other banks created the Interbank Card Association in 1966 to compete with Bank of America's new conglomerate. These two card associations eventually evolved into Visa and MasterCard, respectively, and allowed smaller banks to issue cards that were able to compete with national charge cards like American Express. By the end of the 1960's, more bank credit cards had been issued than national charge cards.

The market for credit cards opened even further starting in the mid-1980's. At that time, retailers, insurance companies, automakers and other firms discovered a way to issue their own payment cards through affiliated financial institutions. Using this method, firms like GM and AT&T were able to enter the credit card industry.

Duality

Until 1974, banks could only be associated with one of the two major card associations (Visa or MasterCard). This was due to Visa's strict usury rules which were intended to keep its issuing institutions from handling MasterCard products. However, in 1971 Worthen Bank and Trust Company, a Visa member, filed an antitrust suit claiming that Visa's strict licensing policy was essentially an illegal group boycott. While the case was eventually settled out of court, Visa did turn to the U.S. Department of Justice in an effort to gain approval of its business practices, specifically maintaining rules for merchants and issuers. In 1974, after much consideration, Visa's request was declined. Upon this decision, merchants and issuers alike rushed to sign up with both card associations in an effort to meet a wider audience of consumers. Today, Visa and MasterCard are generally accepted at most credit accepting merchants.

By the early 21st century, credit and charge cards became ubiquitous. The number of cards had grown dramatically both in the U.S. (see Exhibits 2 and 3) and globally (see Exhibits 4-5). The

industry had become intensely competitive with many banks involved in the industry (see Exhibit 6).

Nextcard, Inc.

Nextcard, Inc. offered internet-related credit card products through its website starting in December of 1997. The company was the first to offer instant, online credit approval and offered several products, including the popular Amazon Visa, which gave points with every purchase that could be redeemed for merchandise at Amazon.com.

Initially, the company seemed to be a success. By mid-1999 the firm had signed up over 100,000 customers and was drawing nearly 10,000 credit applications a day. Their approval rate of about 20% was in line with the industry average and their average balance of \$2,500 was much higher than its competitors.

Nextcard was co-founded and led by CEO Jeremy Lent, a Cambridge educated executive who was formerly CFO of Provident Financial Corp. Lent founded the company on the belief that he could create marketing efficiencies by identifying and targeting websites that were the most lucrative marketing partners. To do this, Lent hired about 20 PhDs to track and analyze data from all the sites where the firm advertised. Business Week summed up the process as follows:

“By tracking their target customers from the time they click on an ad to the time they actually apply for credit, the company can figure out quickly which sites and promotions deliver the right customers. The sites that hit NextCard's sweet spot not only receive more targeted advertising but also might get a long-term deal in which NextCard becomes the site's exclusive credit-card advertiser. NextCard is able to figure all this out by doing continuous testing of how ads are performing. Because of the Web's ability to track results, NextCard can basically tell within two hours how ads on specific sites are performing. Overall, this marketing approach has led to a 70% decrease in the cost of acquiring customers since the beginning of 1998.”

--Business Week Online, 3 August 1999

Nextcard coupled its steady pipeline of new customers with a wide array of personalized services, such as an anti-fraud guarantee to allay internet shopping fears and a cyber wallet to help consumers search for and buy products online.

The good news stopped, however, in October of 2001. At that time, The FDIC and OCC (Office of the Comptroller of the Currency) had just finished a regulatory investigation of Nextbank N.A., Nextcard's wholly-owned finance institution. The investigation yielded several things. Regulators found that Nextbank had high loan losses, possibly from loose lending criteria, that had not been correctly accounted for. Once the firm was forced to appropriately re-classify these losses, the FDIC found Nextbank and Nextcard to be severely under-capitalized. (See Exhibit 7 for latest available financials.) In addition, the Company was required to further tighten its underwriting criteria, which limited new account originations.

These new restrictions not only left Nextbank crippled, but severely hampered Nextcard's ability to compete. It was under these conditions that Nextcard's hold on the internet credit card market began to unravel. First, the company retained Goldman Sachs to explore the sale of the firm to a larger and better-capitalized entity. About a month later a class-action lawsuit was announced against Nextcard and some of the company's officers.

The Decision

The quandary for FDIC officials centered around what to do with Nextcard. They could simply liquidate the company, which would likely cost the FDIC close to \$500 Million in reimbursements to Nextbank depositors, not to mention dealing with the repercussions of shutting down Nextcard's large credit portfolio. Another option would be to try and sell the firm to another bank. This would also be difficult. Nextcard itself had hired Goldman Sachs to locate a buyer for the firm in October 2001 with no success. Could the FDIC succeed where the firm itself had failed? Finally, the FDIC could provide assistance to Nextcard by helping the bank to find suitable financing in order to bolster its weakened capital position. This option was not preferable, but officials knew that they may have to consider the possibility if nothing else panned out.

Exhibit 1 – Historical Nextcard Inc. Stock Prices (from WRDS database)



Exhibit 2

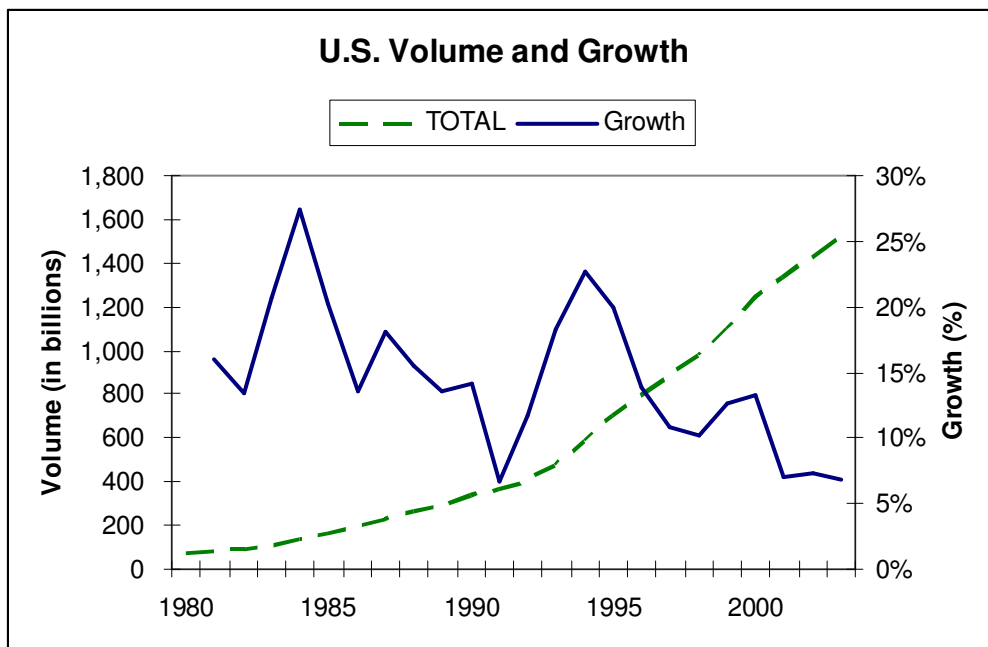


Exhibit 3

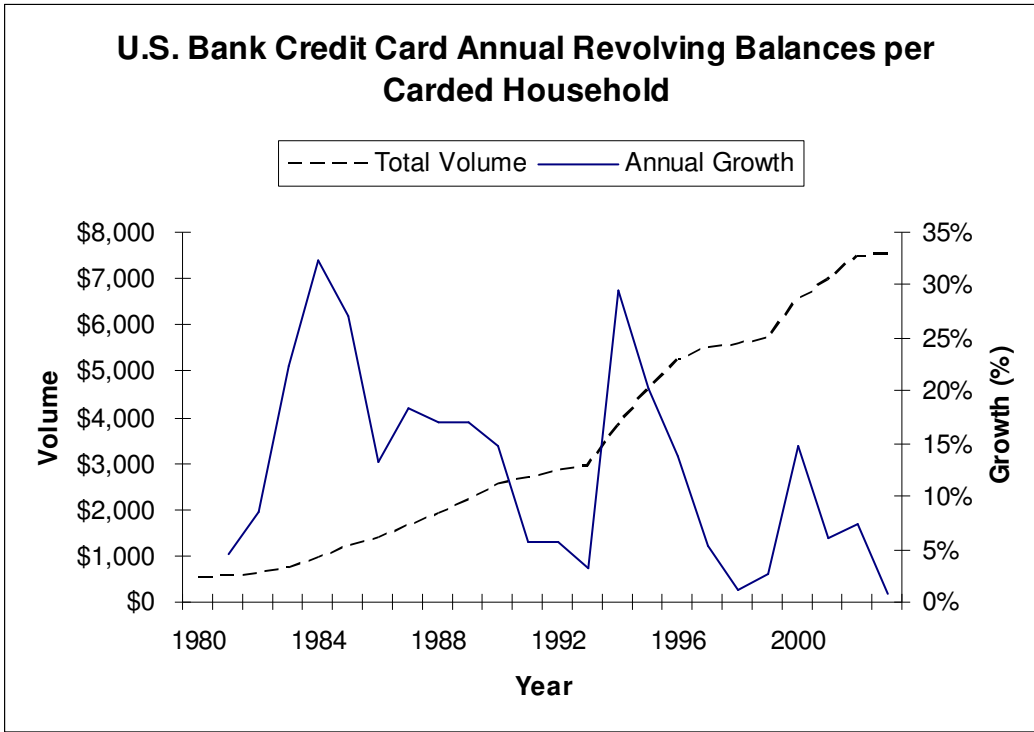


Exhibit 4

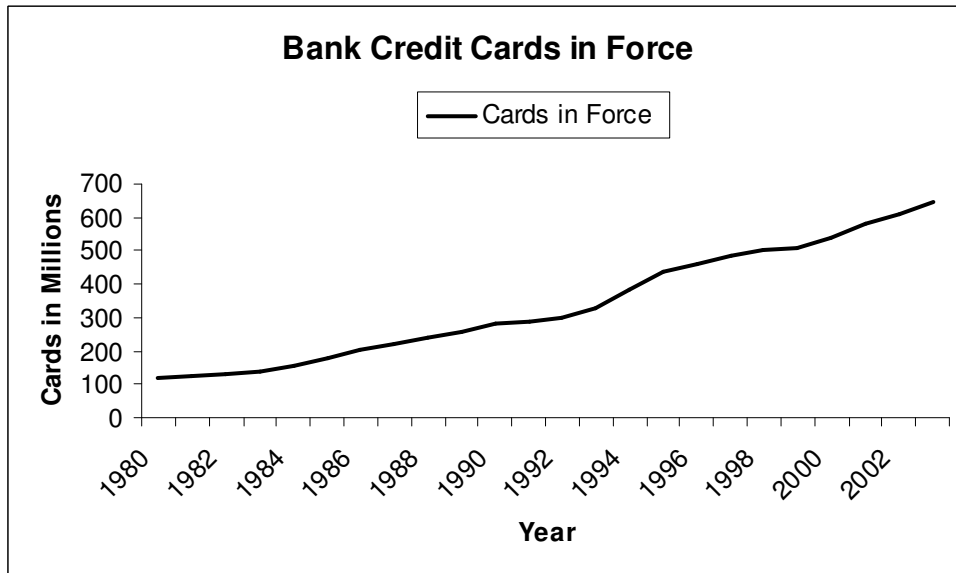


Exhibit 5
Global Annual Payment Card Charge Volume by Brand (trillions)

NETWORK	2000	2001	2002
VISA	\$1.93	\$2.30	\$2.64
MasterCard	0.86	0.99	1.14
American Express	0.30	0.30	0.31

Exhibit 6

TOP TEN U.S. VISA/MASTERCARD CREDIT CARD ISSUERS
2001 YEAR-END
STATISTICS

#	Issuer	Outstanding (billions)	YTD Volume (billions)	Total Accounts (millions)
1	Citibank	108.9	218.5	92.9
2	MBNA America	74.9	142.3	50.9
3	Bank One/First USA	68.2	140.4	39.4
4	Chase Manhattan	40.9	71.9	24.0
5	Capital one	38.4	50.6	38.9
6	Providian	32.9	30.5	19.1
7	Bank of America	27.2	48.9	14.5
8	Household Bank	16.1	34.9	17.9
9	Fleet	15.6	22.4	7.1
10	Direct Merchants	<u>11.9</u>	<u>9.9</u>	<u>8.5</u>
	Totals	435.0	770.3	313.2

Exhibit 7

NEXTCARD, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands, except per share data) UNAUDITED

	SEPTEMBER 30,	DECEMBER 31,
ASSETS	<u>2001</u>	<u>2000</u>
Cash and cash equivalents	\$ 121,868	\$ 151,850
Cash and cash equivalents, restricted	8,078	38,876
Loans held for securitization	167,000	
Credit card loans receivable	554,193	528,110
Less allowance for loan losses	(71,598)	(25,136)
Net loans	<u>482,595</u>	<u>502,974</u>
Interest receivable	3,563	7,546
Equipment and leasehold improvements, net	25,035	19,414
Due from securitizations	85,469	75,857
Prepaid and other assets	60,736	52,070
Total assets	<u><u>954,344</u></u>	<u><u>848,587</u></u>
 LIABILITIES AND SHAREHOLDERS' EQUITY:		
Liabilities:		
Deposits	607,513	380,248
Accounts payable	9,028	10,558
Accrued expenses and other liabilities	43,032	38,040
Other borrowings	2,127	4,117
Secured borrowings	174,000	214,734
Total liabilities	<u><u>835,700</u></u>	<u><u>647,697</u></u>
 Shareholders' equity:		
Common stock, par value \$.001 per share (authorized: 87,433 shares; issued and outstanding: September 30, 2001 - 53,837 shares; December 31, 2000 - 53,373 shares)	53	53
Additional paid-in capital	383,899	382,573
Deferred stock compensation	(1,442)	(2,006)
Accumulated deficit	(261,137)	(177,001)
Treasury stock, at cost (359 shares)	(2,729)	(2,729)
Total shareholders' equity	<u><u>118,644</u></u>	<u><u>200,890</u></u>
Total liabilities and shareholders' equity	<u><u>\$ 954,344</u></u>	<u><u>\$ 848,587</u></u>

Exhibit 7 (Continued)

NEXTCARD, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data) **UNAUDITED**

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>
Interest income:				
Credit card loans	\$ 19,008	\$ 20,980	\$ 47,304	\$ 48,441
Cash, cash equivalents and other	647	3,549	3,941	9,092
Total interest income	<u>19,655</u>	<u>24,529</u>	<u>51,245</u>	<u>57,533</u>
Interest expense:				
Borrowings	875	7,512	4,178	18,075
Deposits	7,488	4,422	21,707	7,977
Total interest expense	<u>8,363</u>	<u>11,934</u>	<u>25,885</u>	<u>26,052</u>
Net interest income	<u>11,292</u>	<u>12,595</u>	<u>25,360</u>	<u>31,481</u>
Provision for loan losses	<u>55,534</u>	<u>16,134</u>	<u>94,092</u>	<u>34,297</u>
Net interest income (expense) after provision for loan losses	<u>(44,242)</u>	<u>(3,539)</u>	<u>(68,732)</u>	<u>(2,816)</u>
Non-interest income:				
Securitization and servicing income	22,990	13,519	76,846	28,258
Credit card fees and other	9,497	7,525	25,273	10,987
Interchange fee	<u>2,404</u>	<u>2,716</u>	<u>6,289</u>	<u>5,715</u>
Total non-interest income	<u>34,891</u>	<u>23,760</u>	<u>108,408</u>	<u>44,960</u>
Non-interest expenses:				
Salaries and employee benefits	17,329	15,606	48,232	36,747
Marketing, advertising and branding	3,429	7,891	12,109	26,212
Credit card activation and servicing costs	9,605	5,628	26,974	14,685
Occupancy and equipment	4,978	3,045	13,015	7,369
Professional fees	518	823	2,583	3,139
Amortization of loan structuring fee	960	774	2,374	1,944
Amortization of deferred stock compensation	604	1,264	1,240	3,696
Other	<u>6,372</u>	<u>5,448</u>	<u>17,285</u>	<u>10,770</u>
Total non-interest expenses	<u>43,795</u>	<u>40,479</u>	<u>123,812</u>	<u>104,562</u>
Net loss	\$ (53,146)	\$ (20,258)	\$ (84,136)	\$ (62,418)
Basic and diluted net loss per common share	\$ (1.00)	\$ (0.38)	\$ (1.58)	\$ (1.19)
Weighted average common shares used in net loss per common share calculation	53,392	53,075	53,254	52,339

Exhibit 7 (Continued)

**NEXTCARD, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands) (Unaudited)

	NINE MONTHS ENDED SEPTEMBER 30,	
	<u>2001</u>	<u>2000</u>
OPERATING ACTIVITIES:		
Net loss	\$ (84,136)	\$ (62,418)
Adjustments to net loss to arrive at cash provided by (used in) operating activities:		
Provision for loan losses	94,092	34,297
Deprecation and amortization	4,749	5,286
Amortization of deferred acquisition costs	12,493	3,202
Amortization of deferred stock compensation	1,240	3,696
Securitization gains	(18,015)	(15,905)
Change in operating assets and liabilities:		
Restricted cash and cash equivalents	30,798	
Prepaid and other assets	(1,530)	(12,545)
Accounts payable	(2,841)	4,048
Accrued expenses and other liabilities	4,992	13,640
Net cash provided by (used in) operating activities	<u>41,842</u>	<u>(26,699)</u>
INVESTING ACTIVITIES:		
Net loan originations	(742,117)	(713,757)
Increase in amounts due from securitizations	(7,588)	(19,344)
Proceeds from securitized loans	504,899	549,266
Purchase of equipment and leasehold improvements	(12,330)	(12,253)
Net cash used in investing activities	<u>(257,136)</u>	<u>(196,088)</u>
FINANCING ACTIVITIES:		
Net increase in deposits	227,264	298,513
Net change in secured borrowings	(40,734)	(80,666)
Payments made on other borrowings	(1,990)	(6,616)
Proceeds from issuance of common stock and other	772	1,243
Net cash provided by financing activities	<u>185,312</u>	<u>212,474</u>
Net increase (decrease) in cash and cash equivalents	(29,982)	(10,313)
Cash and cash equivalents at the beginning of the period	151,850	220,989
Cash and cash equivalents at the end of the period	<u>\$ 121,868</u>	<u>\$ 210,676</u>
SUPPLEMENTAL DISCLOSURES:		
Cash paid during the period for interest	25,649	27,561
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:		
Unearned stock based compensation	676	(2,108)