April 17, 2003
Audit Report No. 03-029

The Division of Resolutions and Receiverships' Resolution and Management of Credit Card Portfolios

TABLE OF CONTENTS

BACKGROUND	**2**
DRR's Experience with the Resolution and Management of Credit Card Portfolios	**2**
NextBank	**3**
Net First National Bank	**5**
Near Failures	**6**
RESULTS OF AUDIT	**6**
FINDING A: NEXTBANK'S SECURITIZED CREDIT CARD PORTFOLIO	**7**
Valuation of the Credit Card Portfolios	**7**
Resolution of the Credit Card Portfolios	**9**
Assessing the Cost of Resolving the NextBank Credit Card Portfolios	**12**
Conclusion	**13**
Recommendation	**14**
FINDING B: CONTRACT OVERSIGHT OF PORTFOLIO FINANCIAL ADVISOR	**15**
Recommendation	**17**
CORPORATION COMMENTS AND OIG EVALUATION	**18**
APPENDIX I: OBJECTIVE, SCOPE, AND METHODOLOGY	**20**
APPENDIX II: CREDIT CARDS	**25**
APPENDIX III: THE NEXTBANK RESOLUTION	**26**
APPENDIX IV: TIMELINE OF SIGNIFICANT EVENTS—NEXTBANK RECEIVERSHIP	**30**
APPENDIX V: PRE-CLOSING ROLES AND RESPONSIBILITIES FOR CREDIT CARDS	**31**
APPENDIX VI: POST-CLOSING ROLES AND RESPONSIBILITIES FOR CREDIT CARDS	**32**

APPENDIX VII: **FDIC AS RECEIVER FOR NEXTBANK—COMPARISON OF BANK AND TRUST CREDIT CARD PORTFOLIOS** **33**

APPENDIX VIII: **ACRONYMS AND ABBREVIATIONS** **34**

APPENDIX IX: **CORPORATION COMMENTS** **35**

APPENDIX X: **MANAGEMENT RESPONSES TO RECOMMENDATIONS** **37**

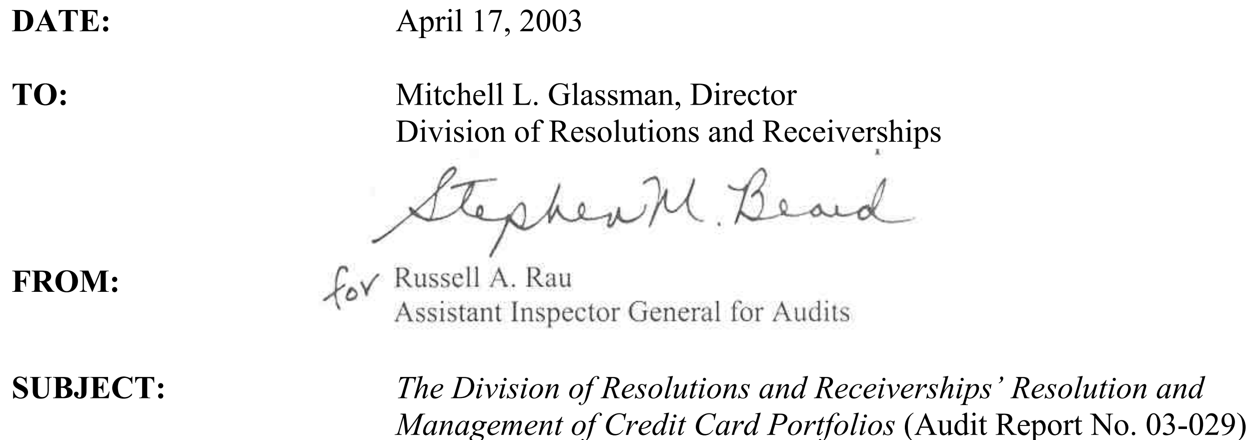
FIGURES

Figure 1: Basic Securitization Process **4**
Figure 2: Credit Card Transaction Flow **10**

FDIC

Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Audits
Office of Inspector General



DATE: April 17, 2003

TO: Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

FROM: for Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *The Division of Resolutions and Receiverships' Resolution and Management of Credit Card Portfolios* (Audit Report No. 03-029)

The Office of Inspector General (OIG) has completed an audit of the Division of Resolutions and Receiverships' (DRR) resolution[1] and management of credit card portfolios acquired from failing insured depository institutions.[2] Credit cards are income-producing assets to the institutions that issue them and consist of receivables from the credit card holders net of allowance for uncollectable amounts. When an insured depository institution fails, the FDIC is appointed receiver[3] and assumes responsibility to maximize returns to the receivership. In doing so, the FDIC is able to limit losses to its deposit insurance funds.[4] In order to carry out this responsibility, the FDIC liquidates failed institution assets, including the bank's interest in credit card portfolios.

Since January 1, 2002, one financial institution with credit card portfolios has failed--NextBank of Phoenix, Arizona (NextBank). Another, the Net First National Bank of Boca Raton, Florida (Net First), issued credit cards, but a third party owned the receivables. Our audit objective was to determine whether DRR developed and applied effective guidance for the potential[5] and actual resolution and management of credit card portfolios. Appendix I of this report discusses our

---

[1] The resolution process involves valuing a failing insured depository institution, marketing it, soliciting bids for the sale of the institution, determining which bid is least costly to the insurance fund, and working with the acquiring institution(s) through the closing process (or paying off insured deposits if there is no acquirer).
[2] An insured depository institution is a financial institution whose deposit accounts are insured by the Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF).
[3] As receiver, the FDIC may collect all obligations and money due to the institution. The receivership process involves performing the closing function at the failed bank, liquidating any failed institution assets, and distributing liquidation proceeds to uninsured depositors and general creditors with approved claims.
[4] The deposit insurance funds consist of the BIF and the SAIF.
[5] There have been several near failures of other financial institutions with credit card portfolios, but these institutions received sufficient infusions of capital to continue operations. In such cases, DRR carries out pre-closing activities to analyze the institution's condition to determine resolution options that the FDIC might offer in the event the institutions become critically undercapitalized or otherwise closed.

objective, scope, and methodology. Appendix VIII contains a listing of acronyms and abbreviations used in this report.

BACKGROUND

The FDIC's roles and responsibilities when serving as a receiver are defined by specific statutory provisions contained in the Federal Deposit Insurance Act (FDI Act) of September 21, 1950, P.L. No. 797, as codified at 12 U.S.C. § 1821(d) "Powers and Duties of Corporation as Conservator or Receiver." Specifically, the power to control an institution's assets includes the power to "conduct all business of the institution;" id. § 1821(d)(2)(B)(i); "perform all functions of the institution … consistent with the appointment as conservator or receiver;" id. § 1821(d)(2)(B)(iii); and "preserve and conserve the assets and property of such institution," id. § 1821(d)(2)(B)(iv). The primary objective of the FDIC as receiver is to maximize the value of the failed institution assets in order to limit losses to the deposit insurance funds and repay uninsured depositors[6] and general creditors.[7] As such, the FDIC has an important role in liquidating these assets in the most cost-effective manner possible. The FDIC can dispose of a credit card portfolio by keeping the cards open for use and selling all or some of the cards to a third party or by closing off the cards from further use and selling the receivables. Appendix II discusses the basics of credit card operations.

As required by the FDIC Improvement Act of 1991,[8] each resolution is to be the least costly possible under the circumstances of the individual failure. To fulfill this requirement, DRR's mission is to continue to develop, refine, and implement resolution policies, procedures, and strategies that minimize losses to the insurance funds. The FDIC also has a strategic objective that receiverships are to be managed to maximize the net return toward an orderly and timely termination. In order to fulfill its mission and the Corporation's strategic objective, DRR monitors troubled banks and plans for resolution activities. Pre-closing efforts focus on valuing an institution's assets to determine resolution options, estimating the liquidation value of the assets, and calculating the cost of a deposit payoff and/or loss to the insurance fund. DRR has developed policies, procedures, and other guidance to cover most aspects of these operations, including how to address bank-owned credit cards as part of a bank closing.

DRR's Experience with the Resolution and Management of Credit Card Portfolios

The BestBank failure in 1998 was the first time that DRR acquired responsibility for the servicing of a credit card portfolio. The FDIC, as receiver, continued using BestBank's credit card servicer and processor while trying to market the portfolio. Ultimately, DRR determined that most of the portfolio had no value to a purchaser and discontinued the servicing and processing operations. The portion of BestBank's portfolio not tainted by fraud was sold and the related servicing transferred. The BestBank loss to the BIF as of January 31, 2003, was reported

---

[6] Uninsured depositors are those depositors whose accounts are over the $100,000 deposit insurance limit.
[7] General creditors include suppliers and servicers of the failed bank who are owed funds.
[8] P.L. No. 102-242, codified throughout title 12, U.S.C.

to be $223.5 million. As a result of lessons learned from BestBank, DRR undertook several initiatives to improve its process for managing and liquidating a credit card portfolio.[9] However, it was not until early 2002 that DRR assumed significant credit card portfolios in the NextBank failure where it could apply what it had learned.

NextBank

The FDIC was appointed receiver of NextBank on February 7, 2002. According to the Department of the Treasury Office of Inspector General's *Material Loss Review of NextBank*,[10] the bank's failure can be attributed primarily to improperly managed rapid growth that led to unacceptably high levels of credit risk, losses, and operational problems. The failing bank case presented to the FDIC Board of Directors indicated that NextBank had total assets of approximately $959 million and total deposits of approximately $611 million. Because no bids for the bank's deposits were received, the FDIC paid off [11] the insured deposits of NextBank. NextBank was a limited purpose national credit card bank[12] and a wholly owned subsidiary of NextCard, Inc.,[13] the holding company. The bank issued credit cards that NextCard originated over the Internet. A large portion of the bank's credit card portfolio was securitized[14] into a Master Trust[15] (Trust) with the Bank of New York serving as the Trustee. NextBank retained an

---

[9] Our August 15, 2001 audit memorandum to the Director, Division of Resolutions and Receiverships, *DRR's Efforts to Enhance its Readiness to Manage and Liquidate Credit Card Portfolios*, cited several initiatives undertaken by DRR staff that were designed to improve DRR's process for managing and liquidating a credit card portfolio. These included an education process that identified lessons learned, external and internal training from industry leaders on the basic business of credit card operations, and the creation of a Credit Card Task Force. DRR engaged credit card consultants to assist with future resolutions. The report concluded that the OIG could not measure the effectiveness of DRR's efforts because DRR had not assumed any significant credit card portfolios in bank failures since the BestBank failure in July 1998.

[10] As mandated under section 38(k) of the Federal Deposit Insurance Act, the Department of the Treasury's Office of Inspector General reviewed the failure of NextBank.

[11] The FDIC as insurer pays off all of the failed institution's depositors with insured funds the full amount of their insured deposits (insured limit is $100,000). Depositors with uninsured funds and other general creditors (such as suppliers and service providers) of the failed institution do not receive either immediate or full reimbursement; instead, the FDIC as receiver issues them Receivership Certificates. A Receivership Certificate entitles its holder to a portion of the receiver's collections on the failed institution's assets.

[12] A limited purpose national credit card bank is a bank that may engage only in credit card operations, may not accept demand deposits, may not accept savings or time deposits of less than $100,000, may maintain only one office that accepts deposits, and may not engage in the business of making commercial loans.

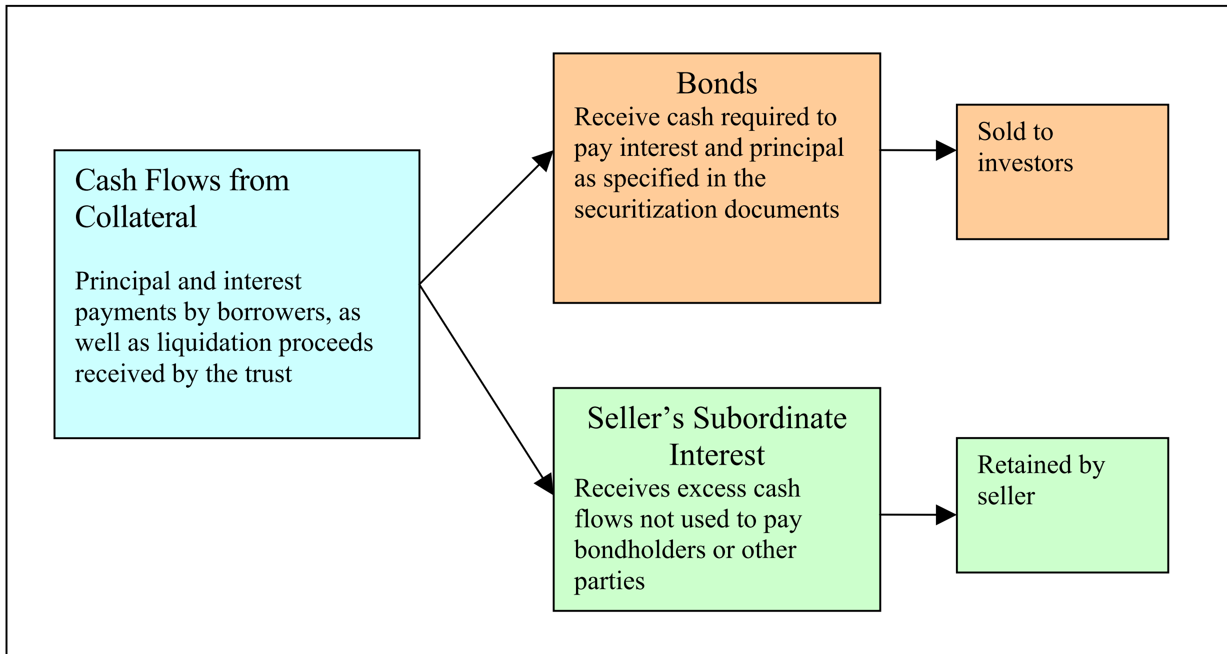
[13] Pursuant to a Service Agreement dated September 16, 1999, NextCard agreed to perform servicing functions for the bank's credit card portfolio. NextCard provided the software used to service the accounts. NextCard entered into numerous third-party contracts to support its servicing obligations to the bank. The bank reimbursed NextCard's expenses that were incurred on behalf of the bank as a result of these contracts and employees.

[14] A credit card securitization is when a financial institution sells its credit card receivables to a special purpose trust, which pays for the receivables by selling securities to the public. The securities sold to the public are backed by the cash flows generated from the receivables. The seller usually retains a subordinate interest or share in the trust as further protection to the owners of the securities.

[15] Master Trust - a special purpose vehicle that houses more than one securitized issue. The Master Trust structure is designed to provide flexibility and a cost-effective means of securitizing credit card receivables. In a Master Trust arrangement, all issues within the trust share the same rights to a common pool of receivables.

approximate 9 percent seller's interest in the Trust receivables.[16] (See Figure 1 below for a diagram of the basic securitization process.) NextBank held the servicing rights for the underlying credit card securities and NextCard, the parent, serviced the portfolio under a subsequent agreement.

Figure 1: Basic Securitization Process



Source: FDIC

In marketing and attempting to sell its interest in NextBank's credit card portfolio, DRR sought to preserve the assets and property of the institution and maximize the value of the institution's assets in order to limit the losses to the BIF and unsecured creditors. DRR acted to avoid early amortization[17] and to preserve and dispose of NextBank's credit card portfolios. It accomplished this by reimbursing NextCard for certain expenses incurred on behalf of NextBank that were outstanding. With this assistance, NextCard postponed declaring bankruptcy, and the FDIC was able to continue uninterrupted the NextCard's credit card servicing operation and market the credit card portfolios. DRR engaged a credit card consulting firm (First Annapolis Consulting, Inc.) effective December 12, 2001, to analyze and help direct the continuation of servicing with

[16] NextBank retained the seller's or transferor's interest, which represents the difference between total securitized credit card receivables and the outstanding debt issued by the trust. According to DRR officials, the actual dollar amount of the seller's interest, and the percentage interest in the trust receivables, fluctuates daily based on purchases, payments, chargeoffs, and other portfolio activity affecting the total outstanding credit card receivables.

[17] An early amortization is an unplanned liquidation of the assets generally due to deterioration in the credit quality of the assets. In this scenario, cash flow is insufficient to meet financial obligations to the owners of the securities backed by the credit card receivables, and the seller or transferor (FDIC) becomes "subordinate" in the proceeds received from the liquidation of assets and subsequent distribution of any cash distributions to meet these obligations.

NextCard. Also, DRR retained a financial advisor (Bank One Capital Markets, Inc.) effective January 11, 2002, to help value and liquidate the bank's credit card portfolio and related interests in securitizations. The FDIC sold the bank-owned credit card portfolio on July 1, 2002 to Merrick Bank Corporation (Merrick). As part of the sales agreement, the FDIC continued servicing Merrick's credit card portfolio until September 20, 2002.

On June 13, 2002, DRR staff informed the Board that the FDIC had received no positive bids for the seller's interest in the securitized credit card portfolio. The reason for the negative bids was that the debt in the Trust was greater than the current market value of its receivables. Two bidders did propose offers where the FDIC would pay the acquirer to assume NextBank's interest in the Trust. The FDIC considered these proposals unacceptable. The FDIC went back to the final bidders and explicitly offered the Trust assets to them at no cost, but no bidder was willing to take the Trust assets without a payment from the FDIC.

On July 8, 2002, the high rate of charge-offs[18] triggered an early amortization for the Trust-owned credit card portfolio. As a result, the receivership, as holder of the seller's interest, would receive a rapidly dwindling portion of the cash flow. Consequently, the FDIC decided immediately to close the "open-to-buy"[19] and thereby limit the receivership's loss to the amount of NextBank's interest in the Trust. The FDIC, by letter dated July 10, 2002, formally repudiated[20] substantially all contracts with the Trust. As a result of the repudiation, the trustee appointed a successor servicer effective August 1, 2002. A servicing conversion to the successor servicer began at that time and was concluded effective September 30, 2002. As of January 31, 2003, the estimated loss[21] to the BIF from the failure of NextBank was estimated to be $300 million. See Appendixes III – VII for further details regarding the NextBank resolution, including FDIC's actions; a timeline of significant events; diagrams depicting the pre- and post-closing credit card responsibilities; and a comparison of the two credit card portfolios.

Net First National Bank

The FDIC was appointed receiver of Net First on March 1, 2002. According to the failing bank case, Net First had total assets of approximately $38 million and total deposits of approximately $32 million. Bank Leumi USA agreed to assume the insured deposits and to purchase a portion of the failed bank assets. The FDIC, as receiver, retained the remaining assets for later disposition. Net First's main source of income was a secured credit card[22] program. The bank issued the credit cards, but Key Financial Systems owned the receivables. The credit card

[18] Charge-off - The balance on a bank cardholder account that a bank no longer expects to be repaid and writes off as a bad debt. A charge-off is generally recorded by a debit to the reserve for possible credit losses and a credit to the loan balance.
[19] Cards are active and available for holders to use to buy goods and services.
[20] According to the FDIC, repudiation is a controlled breach of contract. With repudiation, the FDIC will become liable for the trust's actual direct compensatory damages resulting from the repudiation. These damages will be payable by General Credit Certificates.
[21] Estimated losses represent the FDIC's current estimate of the cost of an individual failure to the insurance fund. Estimated losses are derived, in large part, from estimates of future asset disposition proceeds, which are estimated by determining, via statistical sampling or recent disposition activity, the recovery rates for similar assets across all receiverships. Accordingly, the losses ultimately realized by the BIF will likely vary from amounts estimated.
[22] A secured credit card is one that a cardholder secures with a savings deposit to ensure payment of the outstanding balance if the cardholder defaults on payments.

accounts were charged both an annual fee and an application-processing fee. Solicitations of the credit cards were primarily aimed at the subprime market.[23] According to DRR's Failing Bank Case memorandum, the failure of Net First was not related to its credit card operations, but was due to poor lending practices involving Small Business Administration loans. The FDIC closed down Net First's credit card operation and paid off the secured accounts. The FDIC reported that Net First was a no cost resolution as of October 31, 2002.

Near Failures

There have also been several near failures where the FDIC performed work in preparation for a possible failure associated with credit card portfolios. In the case of one institution, the FDIC and its credit card consultant performed review work at the bank and produced a formal product addressing receivership issues and considerations. In the case of another institution, the FDIC's consultants produced an on-site two-phase report. The first-phase report discussed the initial assessment of the bank during an on-site review conducted by the consultants, the FDIC, and other regulators. The second-phase report documented the consultant's review of the credit card servicing and processing operations. DRR did not perform any additional resolution work on these portfolios because both institutions were able to obtain additional capital and continue operations.

RESULTS OF AUDIT

Overall, DRR developed and applied effective guidance related to credit card portfolios. Specifically, DRR adequately resolved and managed smaller credit card portfolios that did not involve securitizations. DRR retained several credit card consultants to assist with pre-closing efforts on near failures and advise on operational matters related to credit card servicing functions. DRR formulated and implemented credit card guidelines to facilitate bank-closing actions. DRR has also increased staff awareness of the credit card industry through training. Finally, DRR has developed credit card expertise through the repeated use of key staff on potential and actual institution failures.

However, DRR's resolution of large securitized credit card portfolios needs improvement. Specifically, DRR was not fully prepared to value and resolve the FDIC's interest in the large NextBank securitized credit card portfolio. As a result, DRR incurred significant obligations with limited assurance, at the time of closing, of maximizing returns to the BIF after pay-off of insured depositors. (See Finding A--NextBank's Securitized Credit Card Portfolio.)

Additionally, DRR did not adequately oversee the contract with its credit card portfolio financial advisor. As a result, the financial advisor was paid for reports it did not complete, and DRR did not have the benefit of information and analysis that those reports would have contained. (See Finding B--Contract Oversight of the Portfolio Financial Advisor.)

[23]A subprime market includes borrowers who make only minimum payments or who are delinquent, borrowers with marginal history of credit usage, and borrowers who can only access credit at exorbitant rates.

FINDING A: NEXTBANK'S SECURITIZED CREDIT CARD PORTFOLIO

DRR's resolution of large securitized credit card portfolios needs improvement. Specifically, DRR was not fully prepared to value and resolve FDIC's interest in the large NextBank securitized credit card portfolio because the division had not developed adequate guidance to value or resolve such portfolios. As a result, DRR incurred significant obligations with limited assurance, at the time of closing, of maximizing return to the BIF.

Valuation of the Credit Card Portfolios

DRR has developed and used valuation models for the liquidation of many types of assets, including mortgage loans and commercial loans. DRR, however, does not have a valuation model for valuing large, securitized credit card portfolios such as the one acquired as the result of NextBank's failure. Consequently, a financial advisor was retained shortly before NextBank's failure to help value and liquidate the bank's credit card portfolios and related interest in securitizations. However, DRR was only able to obtain indications of value for the credit card portfolios at the time the institution closed and when it requested the FDIC Board of Directors' (Board) approval for its resolution strategy.

The lack of a valuation model for a large credit card portfolio was cited in the FDIC OIG's previous audit memorandum on *DRR's Efforts to Enhance Its Readiness to Manage and Liquidate Credit Card Portfolios* (01-708). In that audit memorandum, we noted that DRR officials said that they did not have the expertise to value large credit card portfolios, and in the future, a contractor would be used for valuation.

According to DRR officials, the issues and challenges associated with management and disposition of the securitized credit card portfolio at NextBank were unprecedented for both the public or private sectors. In response, DRR assembled a team of internal and external resources. At the time the bank failed, there were indications of potential value in both the bank-owned and the seller's interest in the Trust based on, among other things, work done by the financial advisor, the credit card servicing experts (First Annapolis), discussions with NextCard officials, and an earlier third party valuation report.

In its Failing Bank Case presented to the Board on January 24, 2002, DRR reported that the least costly resolution of NextBank was unknown. The FDIC's estimated cost to liquidate the bank based on the Unanticipated Failure Model, as of September 30, 2001, was $20.2 million. DRR advised the Board that this model was based on average historical loss rates derived from failed financial institutions having comparable asset balances. According to this case, the asset quality and off-book exposure characteristics of this institution would likely cause the actual loss to deviate substantially from the Unanticipated Failure Model's estimate. Additionally, the case stated that a marketing plan for the bank's credit card portfolio was being developed and that a financial advisor had been retained (effective January 11, 2002) to begin an initial assessment of the credit card portfolio.

In DRR's Credit Card Asset Disposition Case, dated February 7, 2002, the FDIC Board was presented with three alternative scenarios that DRR and its financial advisor had identified for

resolution of NextBank's credit card portfolio. The first scenario was an early amortization in which the receiver would allow cardholders to continue to make purchases using their credit cards. The second scenario was an early amortization in which the receiver would not allow cardholders to continue to use the cards for purchases. The third scenario was to avoid early amortization and continue uninterrupted servicing operations of the credit card portfolios. At the time, DRR's financial advisor had prepared an initial assessment of NextBank's credit card portfolios, based on available information that projected losses under the above scenarios. Therefore, DRR, with Board approval, opted to protect the bank's principal assets by continuing uninterrupted NextCard servicing operations of the credit card portfolios. Specifically, the FDIC decided to assist in delaying NextCard's bankruptcy, and, as receiver, continue to receive its monthly share of distributions from the Trust while DRR attempted to market the credit card portfolios.

Contractor Involvement in the Valuation of NextBank Credit Card Portfolios

DRR's financial advisor, Bank One, was hired on January 11, 2002, shortly before the institution's failure, and only had time to perform an "initial estimated assessment of value."[24] The advisor noted that it had little time with the data and that a complete portfolio valuation could take as long as 120 days following receipt of complete and definitive portfolio information and full access to documentation and complete legal, servicing, and basic due diligence. According to DRR officials, critical decisions associated with the credit card portfolios (funding or closing the open-to-buy) had to be made immediately and could not wait 120 days. A delay of the marketing process for 120 days would have provided no benefit. Bank One, according to DRR officials, was unable to complete a portfolio valuation primarily because of the inability of NextCard to provide requested data tapes that were free of errors. Also, Bank One indicated that the prior attempt by NextBank to market the credit card portfolios and servicing operation through Goldman Sachs may have permanently tainted the value of the assets.[25]

Meanwhile, First Annapolis, hired primarily to assist with servicing issues, provided some input on potential portfolio value. In a memorandum dated February 8, 2002, First Annapolis mentioned the feedback from a few, very preliminary conversations with seven organizations with whom First Annapolis had held recent discussions concerning other portfolio acquisitions. Five of the seven banks indicated they would be interested in taking a look at the portfolio. Their interest was mixed between the entire portfolio and pieces of the portfolio. First Annapolis noted that while these were preliminary responses and work needed to be done, the responses gave a positive read on the market potential for the portfolio.

Another indication of the portfolio's potential value was Goldman Sach's valuation of NextCard, which was completed in late 2001. This assessment was part of the NextCard efforts to self- liquidate that failed. The Goldman valuation approach included (a) current FICO scores,[26] (b) key activity, (c) revenue and loss assumptions extrapolated from NextCard performance from

---

[24] DRR's financial advisor used this term to describe its attempt to value NextBank's portfolio.
[25] In the months prior to NextBank's failure, NextCard, the holding company, attempted to self-liquidate. NextCard had retained Goldman Sachs & Company as consultants to help sell the company but the effort failed.
[26] Fair Isaac Company Score (FICO) is a formula for credit risk assessment that is believed to be highly predictive of future payment risk.

October 2000 through October 2001, and (d) FICO scores aggregated into "buckets" to reflect potential market interest. The presentation stated that the information provided was for indicative purposes only and was being supplied in good faith based on information believed, but not guaranteed, to be accurate or complete.

In a February 28, 2002 memorandum to the Board, DRR outlined its contract requirements for the resolution of NextBank and asked the Board to approve up to $99 million to maintain the credit card operations.[27] DRR expected the expenses would be funded by the cash flow generated by the credit card portfolios (those held on the bank's balance sheet and the seller's interest in the securitizations). Specifically, DRR indicated in the memorandum that the bank's credit card operations generated a positive cash flow of $60 million before expenses of approximately $11 million for January 2002. Based on this information, the Board approved the $99 million in funding requested by DRR to maintain the credit card operation. [28]

Resolution of the Credit Card Portfolios

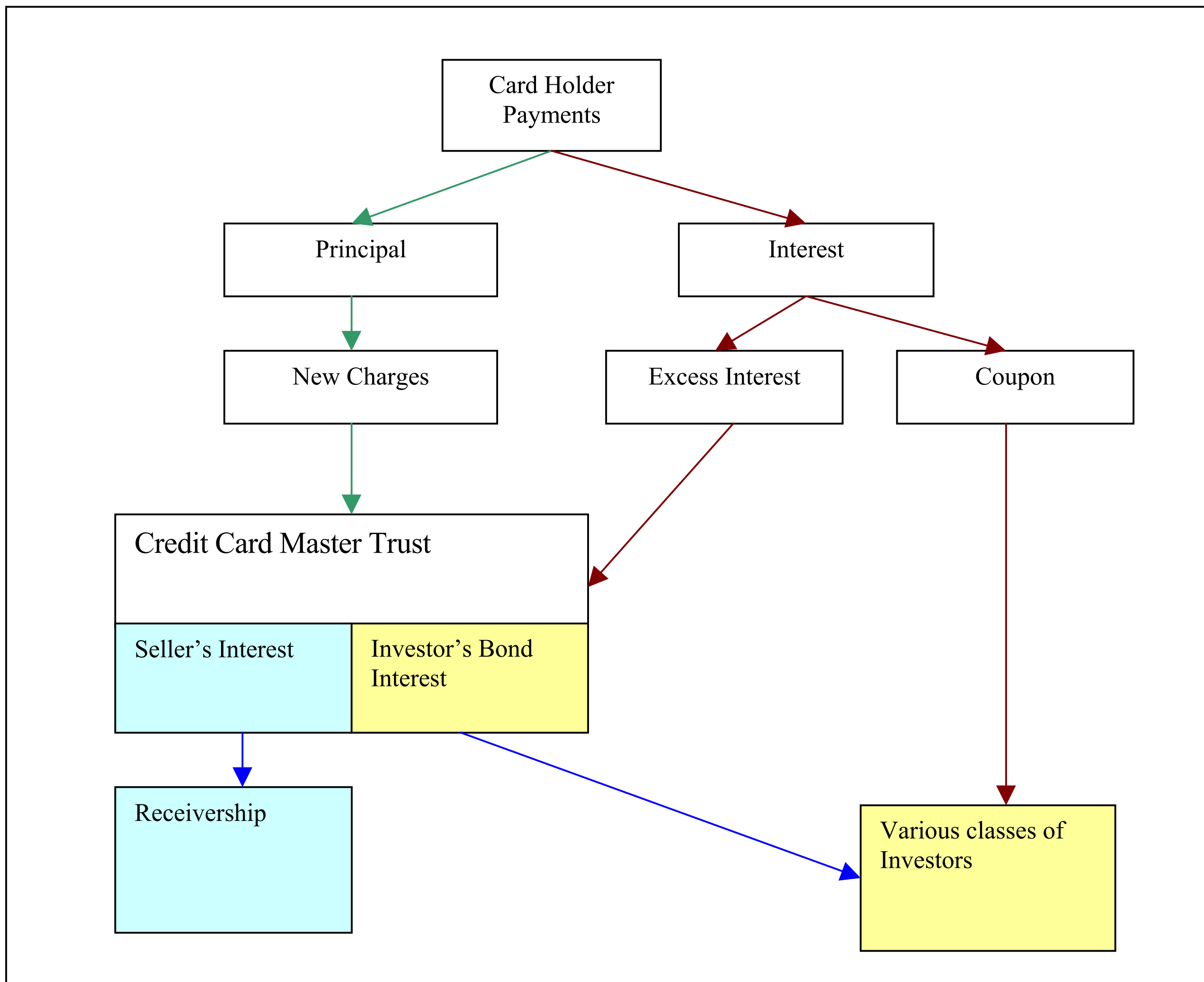
DRR had substantial experience in dealing with troubled mortgage and asset-backed securitizations, but the NextBank resolution was the first time that DRR staff had managed trust relationships for securitized credit cards. According to DRR officials, it was entering uncharted territory with respect to early amortization, interim servicing, and servicing transfer issues. The Trust transactional documents were voluminous, contained contradictory provisions in some instances, and were unclear in others. Past work with credit cards generally focused on the bank-owned portfolio. DRR was proactive in performing some work in preparation for several near failures involving securitized credit cards. However, with limited experience and no formal guidance for resolving large securitized credit card portfolios, DRR had difficulty in managing and liquidating NextBank. To help compensate, DRR solicited the expertise of consultants, outside counsel, and certified public accountants.

Calculating Credit Card Cash Flows

DRR controlled the risk to the BIF by monitoring cash flows associated with the credit card portfolios on a daily, weekly, and monthly basis, to ensure that retained payments on the credit card portfolios exceeded purchases and other cash outflows. DRR planned to shut down the open-to-buy status of the credit card accounts if the cash flows turned negative. In fact, at a February 7, 2002 Board meeting, limits were set on the amount that the receivership could fund "out-of-pocket" in maintaining the securitizations and on-book portfolio.[29] Throughout the period that the credit card operation remained active (February 7, 2002 through July 8, 2002), net cash flows were positive. (Figure 2 shows the credit card transaction flow.)

[27] The February 28, 2002 DRR memorandum to the Board of Directors stated that 9 months was a conservative estimate of the length of time it would take to sell the assets and transfer the servicing of those assets. It typically takes 3 months or more to transfer the processing and servicing of a credit card portfolio.
[28] As of October 31, 2002, the FDIC had spent $72,736,590 of this budgeted amount.
[29] In the event that either (1) a monthly projection concerning the bank-owned portfolio showed the receivership having to fund out-of-pocket over $20 million on a net cumulative basis or (2) a monthly projection concerning the Trust credit card portfolio showed the receivership having to fund anything out-of-pocket on a net cumulative basis, DRR was obligated to return to the Board for further direction.

Figure 2: Credit Card Transaction Flow



Source: FDIC

DRR understood the ramifications of early amortization on its allocable cash flows from both principal collections and finance charge collections. In July 2002, the high rate of charge-offs and rising delinquencies triggered a clause in the securitizations that required early amortization. With early amortization, the distribution of cash flows changed wherein the entire flow of principal payments would be directed to investors, requiring the receivership to fund receivables into the Trust at its own cost. As such, DRR closed the open-to-buy on the credit cards when early amortization occurred and undertook a balance transfer program.

After early amortization occurred in early July 2002, almost all of the proceeds from the Trust securitized credit cards transferred to the Trust to pay off the investors. According to DRR officials, beginning in the second month (August), the receivership would receive no allocation of principal payments that were collected. However, the receivership was entitled to receive its

allocation of financial charges collected monthly, independent of the pay-off of the investor notes. DRR reported that the actual July collections that were paid to the receivership on August 15, 2002, totaled about $31.8 million.[30]

On July 3, 2002, DRR initiated a balance transfer program[31] to have cardholders transfer their balances to other banks' credit cards. By arranging for other banks to accept balance transfers, DRR officials expected that the total number of outstanding accounts would be reduced and credit card holders would create an inflow of cash to the NextBank receivership. The balance transfer program was introduced earlier to the Board in a June 13, 2002 memorandum. DRR indicated to the Board that the program would minimize customer inconvenience. Also, this action was expected to create an inflow of cash from large principal payments to the Trust to pay off card debt. The cash would pay down the outstanding principal balance of the investor's certificates, and a portion would eventually flow to the FDIC through its seller's interest. Effectuating a balance transfer would increase the rate of principal payments to the bondholders, who would receive 91 percent of the principal generated by the balance transfers. According to DRR officials, the volume expectations for the program were speculative.[32] The balance transfer program brought in $31,127,483 from CompuCredit and $4,180,033 from Fleet, for a total of $35,307,516.

Disposing of and Transferring the Service Function

DRR officials spent considerable time and effort negotiating with the Trust for interim or successor servicing after the FDIC repudiated its original service agreement with the Trust. According to DRR officials, dealing with the trustee at this point was difficult because the trustee was unprepared to deal with servicing. Efforts to negotiate an interim servicing agreement focused on recovery of the actual servicing costs of the receivership for the remaining time that it would service the portfolio and the orderly transfer of servicing without a deterioration in servicing quality. Without prior notice to DRR, the Trustees (Bank of New York) abruptly broke off negotiations and formally hired the First National Bank of Omaha (FNBO) as servicer and notified the FDIC that they wanted to transfer the servicing of the trust-owned credit card portfolio to FNBO effective August 1, 2002. The actual transfer was not completed until September 30, 2002, because there were issues involving the coordinated transfer of many complex systems and operational functions. There was also an issue regarding the handling of cash receipts via the same lockbox accounts for both the on-book and securitized portfolios.

---

[30] The figure was composed of about $15.1 million for the sellers' interest in principal collections, about $2 million for the seller's interest in finance charges and recoveries, and about $2.1 million for servicing fees. Another $13 million was for investor allocation of principal for the revolving period. There was also a deduction from the total of about $383,000 for principal collections to a note.

[31] The process of moving an unpaid credit card debt from one issuer to another. Card issuers sometimes offer initially low introductory rates to encourage balance transfers coming in and balance transfer fees to discourage them from going out.

[32] Standard and Poors, in a February 4, 2003 article on NextCard, stated that the FDIC, with assistance from VISA, contacted approximately 10 potential card issuers to partner with for the balance transfer effort. The FDIC signed agreements with two financial institutions. The balance transfer program was not as successful as had been hoped.

Assessing the Cost of Resolving the NextBank Credit Card Portfolios

DRR has not yet finalized the financial information associated with the resolution of the NextBank credit card portfolios but estimated that the net cumulative cashflow from the credit card portfolios will exceed receivership operating costs through September 30, 2002, when all servicing transfers were completed and the on-site operation was substantially concluded.[33] Nevertheless, DRR incurred significant obligations with limited assurance, at the time of closing, of maximizing returns.

DRR officials, in an effort to forestall NextCard's bankruptcy and to allow for the opportunity to market and/or sell the large, securitized credit card portfolio, made a business decision to pay NextCard approximately $11 million for expenses incurred by NextBank before it failed. The FDIC budgeted $99 million for resolution purposes based on its decision to continue to fund the credit card operation. The budget included retention bonuses for keeping NextCard employees, payments for expensive leased office space, and the funding of all servicing costs for both the bank-owned and the Trust credit card portfolios. The budget did not include consulting services or FDIC employee- related expenses.

The budget allocated $9 million for retention bonuses. The retention bonuses were higher than the amounts the credit card advisors recommended, but were according to DRR officials, a necessary step as part of an incentive program to retain NextCard staff in a competitive workforce environment. The office space, especially in San Francisco, was expensive ($82.00 per square foot) and much of it was not used. The receivership inherited what NextCard had set up, and relocating the technology would have disrupted servicing the cards. Additional expenses included the cost of First Annapolis's services for operations (approximately $2.5 million) and FDIC staff salaries (approximately $2 million) and travel costs (approximately $600,000) associated with work on the receivership activities for more than 8 months.

The FDIC's actual servicing costs from date of failure through September 2002 well exceeded the servicing fees it received from the deal with the Trust. The Service Agreement By and Between NextCard, Inc. and NextBank, N.A., dated September 16, 1999, set terms whereby the holding company was entitled to reimbursement of expenses for services and expenses incurred on behalf of the bank by the holding company. The bank was the named servicer of the credit card receivables in the Trust for which it received an annual servicing fee of 2 percent of the outstanding credit card receivables. In the process of continuing uninterrupted NextCard servicing operations and avoiding early amortization, the FDIC had to accept ongoing agreements. The FDIC agreed to pay all actual servicing costs, with the Trust continuing to pay to the receivership a reimbursement servicing fee of 2 percent of its outstanding credit card receivables. The deal in effect capped the servicing cost reimbursement from the Trust until the FDIC repudiated all agreements in July 2002. According to DRR's Field Operations Branch, Accounting Operations staff, if the overall service costs were prorated by size and number of accounts, the Trust should have been paying about 84 percent of the $70 million in expenses paid as of October 10, 2002, or about $58.8 million. Instead, the Trust reimbursed the receivership about $17 million for servicing expenses during this time frame. The effect was that the FDIC

---

[33] DRR's *Receivership Status Report and Action Plan* is dated September 30, 2002. However, the financial information in the report was updated and finalized on December 11, 2002 to reflect the current status.

significantly subsidized the servicing costs for the Trust, a situation it attempted to rectify later in negotiations.[34]

The FDIC sold the bank-owned credit card portfolio (200,000 accounts with a book value of about $197 million) with a loss share provision[35] capped at about $21 million. The sale closed on July 1, 2002, and generated net proceeds of $128,019,956. The receivership, as part of the sales agreement, serviced the portfolio on an interim basis until September 20, 2002, and billed the buyer interim servicing fees of $2,262,727. Cumulative shared losses for the 5 months ended December 31, 2002, were $14,407,571. The FDIC was unable to sell its approximate 9-percent seller's interest in the Trust credit card portfolio. DRR officials attribute not receiving positive bids for the seller's interest to the high degree of leverage in the Trust and heavy discounting for uncertainty associated with the long-term performance of the Internet-originated portfolio. The performance of the securitized portfolio steadily deteriorated beginning in the latter half of 2001 and continued during the period the portfolios were being marketed.

During the revolving period when the FDIC did service the Trust credit card portfolio, the receivership benefited from servicing fees, principal reductions, finance charges, and the sale proceeds for the bank-owned credit card portfolio. Through September 30, 2002, the credit card portfolio income, including the cash from the balance transfer program, generated a net positive cashflow to the FDIC of approximately $127.5 million (excluding disposition proceeds) compared to approximately $95 million in total receivership expenses, including sales costs, operational expenses, consulting services, FDIC employee costs, and pre-closing reimbursement costs to NextCard.

According to DRR officials, the FDIC is entitled to continue to receive its allocation of finance charge collections monthly, independent of the pay-off of the investor notes from the seller's interest. Initially, DRR, in its *Receivership Status Report and Action Plan,* estimated that the seller's interest would yield approximately $71 million more to the receivership. However, in February 2003, DRR officials, based on continued deterioration in Trust performance and updated projections, revised this estimate to $40 million. Meanwhile, the Trustee and certain investors have submitted legal claims totaling $733 million against the receivership that may adversely impact the FDIC's collection of the seller's interest.

Conclusion

At the time that the FDIC closed the institution and sought the funding to support the uninterrupted NextCard servicing operation, DRR did not have a completed valuation report from its financial advisor for the bank-owned or the seller's interest in the securitized trust portfolio. There was not, among other things, a value of the securitized residuals, overall and by transaction; a determination of the seller's interest; and a valuation of the portfolio by delinquency status, performing and non-performing. Instead, critical decisions associated with the securitized credit card portfolio were made quickly, with only indications of potential value, an expectation that positive cashflows would continue from the credit card receivables, and the

[34] According to a Moody's Investor Service article published on January 31, 2003, below market servicing fees are rampant. Servicing fees are one of the most contentious issues concerning servicing transfers.
[35] The loss share arrangement states that for a period of time expected to be at least one year, the FDIC will be liable for the extra losses, up to about $21 million.

presumption that the risk to the BIF could be controlled by monitoring the cashflows and closing the open-to-buy status of the credit cards if the cashflows were negative.

The NextBank resolution process has presented the FDIC with unique challenges and opportunities for lessons learned. For example, there were the inescapable obligations associated with uninterrupted NextCard service, the uncertainty associated with a continued deterioration in securitized portfolio performance, and the unpredictability of service commitments if and when early amortization occurred or when a credit card portfolio sold. FDIC learned a lot about the mechanics of credit card cash flow and the need for early access to trust documents.

While net cashflows were positive throughout the period the card operation remained active, keeping the NextCard credit card servicing operation active for the marketing effort has been costly, labor intensive, and time consuming, with a large degree of uncertainty surrounding minimizing losses. There were interim servicing and servicing transfer issues. DRR was able to sell the bank-owned credit card portfolio with a loss share provision, but the FDIC received no positive bids for the seller's interest in the securitized credit card portfolio. According to DRR officials, ultimately, the market provided a valuation through the bid process. To better prepare itself for future resolution activities, DRR needs to develop pre-closing guidelines specifically for the valuation and resolution of large securitized credit card portfolios.

Recommendation

We recommend that the Director, DRR:

(1) Develop pre-closing guidance for securitized and other large, complex credit card portfolios. This guidance should address, among other things:

- (a) determining the timing and degree of consultant involvement in the process;
- (b) obtaining a reasonable and supportable value for both bank-owned and trust-owned credit card receivables;
- (c) assessing trust relationships promptly;
- (d) calculating the present and anticipated credit card cash flows;
- (e) disposing and transferring of the service function to a third party; and
- (f) assessing the costs associated with assuming existing service operations and agreements.

FINDING B: CONTRACT OVERSIGHT OF PORTFOLIO FINANCIAL ADVISOR

DRR's financial advisor did not provide valuation and disposition strategy reports for the NextBank credit card portfolio as required by the contract. Specifically, DRR's Franchise and Asset Marketing Branch, Marketing Section, did not adequately oversee the contract under which the financial advisor was providing services. As a result, the advisor was paid for work that it did not complete.

The FDIC contracted with the financial advisor to provide financial and sales advisory services to assist with the potential disposition of two failing financial institutions' credit card portfolios (NextBank and another institution that has not failed). Contract #02-00003-C-AF, executed on February 1, 2002, contained a Statement of Work (SOW). Section 2.3 of the SOW, titled "Valuation," tasked the contractor to perform an asset valuation of the NextBank credit card portfolio and provide a Valuation Report no later than 45 days after contract execution date. Additionally, Section 2.4 of the SOW, entitled "Disposition Strategy," stated that the contractor was to develop a disposition strategy for the NextBank credit card portfolio and provide a Disposition Strategy Report within 20 days after delivery of the Valuation Report but no later than 45 days after contract execution date. The contract is for a firm fixed fee of $5 million for the initial assessment, valuation, and disposition of NextBank and another institution's credit card portfolios. As of December 17, 2002, the FDIC had paid the contractor $1,789,338 for services regarding NextBank.

The written work products that the contractor provided included an initial assessment of the credit card portfolio, general information on NextBank and its credit card portfolios from a bidder prospective, and a final bid analysis. The initial assessment of the NextBank credit card portfolio was entitled "Elf Receivership Issues and Considerations" and conformed to the requirements in Section 2.2 of the SOW entitled "Initial Assessment." The Initial Assessment document, dated February 7, 2002, also included a qualified, estimated initial valuation assessment[36] of the portfolio. The second work product, a "Confidential Descriptive Memorandum" dated February 2002, was prepared for prospective bidders for the portfolio. It contained general financial, operational, and other information about the portfolio and NextBank in order to facilitate each prospective bidder's independent analysis. The third work product was a "Final Bid Analysis of the NextBank Portfolio" dated May 13, 2002.

The contract's SOW specifically stated that the contractor was to perform asset valuation on the NextBank portfolio and provide a Valuation Report. The specific items that the Valuation Report was supposed to address were delineated in Section 2.3 (i), (ii), (iii) and (iv) of the SOW and included, among other things, establishing a value of the securitized residuals, overall and by transaction, and determining the seller's interest. Also, it mentioned valuing the portfolio by delinquency status, performing and non-performing.

The SOW also stated that the contractor was to develop a disposition strategy for the NextBank portfolio and provide the Disposition Strategy Report. Other tasks associated with the

[36] The estimated initial assessment covered four separate portfolio scenarios. The consultant qualified it by saying that it was impossible to give a definitive portfolio valuation given the time allotted and the information delivered by NextCard.

development of the disposition strategy are delineated in Section 2.4 (i), (ii) and (iii) of the SOW and include, but are not limited to, identifying viable disposition options for the marketing and sale of the portfolio, and identifying advantages and disadvantages of the options, including a cost benefit analysis for each.

DOA's Oversight Manager Job Aid, issued in October 2000, summarizes the Oversight Manager's roles and responsibilities set forth in the Acquisition Policy Manual (APM), Section 7.B, and indicates that an Oversight Manager:

- Ensures work is performed satisfactorily in accordance with contract terms and conditions,
- Understands contractual requirements to successfully monitor contractor performance (e.g. delivery schedule, etc.), and
- Inspects and accepts deliverables.

The FDIC did not receive a Valuation Report or Disposition Strategy Report prepared in accordance with the SOW. The Oversight Manager did not hold the financial advisor accountable for the difference between what was received and what was specifically called for in the SOW. As discussed previously, DRR's Credit Card Asset Disposition Case was presented to the Board on February 7, 2002, and the case included the financial advisor's estimated initial valuation assessment of the portfolio. According to DRR officials, the inability of NextCard to provide clean data was the underlying cause for Bank One's inability to complete the valuation. NextCard was unable to provide requested data tapes that were free of errors and consistent with other reported portfolio information.

Using the financial advisor's estimated initial assessment of value, DRR requested and the Board approved the $99 million in funding to keep the credit card operations open. However, DRR did not have the benefit of all the information that would have been included in the Valuation Report. Additionally, DRR did not have the benefit of the information that would have been included in the financial advisor's Disposition Strategy Report in marketing and selling the NextBank portfolio, such as all viable disposition options for the marketing and sale of the NextBank portfolio and potential bidders that DRR could consider.

When we asked the Oversight Manager about the Valuation Report, we were advised that the work products that the financial advisor provided met DRR's needs. While that may be the case, the financial advisor agreed to the contract terms and did not subsequently request that the SOW be revised to reflect any reduced level of effort or change in deliverables.

As noted previously, the financial advisor was working under a fixed price contract. Under this type of contract, the advisor was required to perform services and provide deliverables at a specified fixed price. The financial advisor should not have been paid the full contract price unless it provided all services and deliverables required under the SOW.

The FDIC can pursue a contractual change that revises the rights of the parties. Such a change will generally require a written bilateral modification to the original contract. An example of a contract modification that affects the rights of the parties includes a change in the amount of fees to be paid to the contractor and a change in the quantity and nature of deliverables. The

Contracting Officer must determine whether a proposed modification is within the scope of the contract and should consult as necessary with the Legal Division in making the determination. In making such determination, the Contracting Officer should consider what was reasonably anticipated by the parties to be within the scope of the contract when it was first entered into.

Under the circumstances surrounding this contract, the deliverables will no longer benefit the FDIC. Thus, the most appropriate course of action would be a contract modification or a commensurate price adjustment that recognizes the advisor's failure to deliver the valuation report and disposition strategy.

Recommendation

We recommend that the Director, DRR:

(2) Work with the Division of Administration's Acquisition Services Branch to modify the SOW for contract #02-00003-C-AF to reflect actual deliverables or to seek an appropriate adjustment to the price of the contract for the products contracted for, but not delivered. Future contractual agreements with outside credit card consultants for resolution assistance associated with securitized credit card portfolios should reflect or mirror the items addressed in the pre-closing guidance.

CORPORATION COMMENTS AND OIG EVALUATION

On March 24, 2003, the Director, DRR provided a written response to the draft report. The response is presented in Appendix IX of this report. DRR concurred with both recommendations. DRR plans to complete corrective actions by September 30, 2003. The following summarizes DRR's response to each recommendation.

(1) Develop pre-closing guidance for securitized and other large, complex credit card portfolios. This guidance should address, among other things, (a) determining the timing and degree of consultant involvement in the process, (b) obtaining a reasonable and supportable value for both bank-owned and trust-owned credit card receivables, (c) assessing trust relationships promptly, (d) calculating the present and anticipated credit card cash flows, (e) disposing and transferring of the service function to a third party, and (f) assessing the costs associated with assuming existing service operations and agreements.

DRR concurred with the recommendation. In its response, DRR indicated that based on the work performed resolving NextBank and the experience gained in managing and liquidating NextBank's credit card portfolios, DRR staff will issue written guidance for managing and selling interests in credit card securitizations, other asset backed securities, and large complex credit card portfolios. The written guidance will be included in the next update of the Asset Disposition Manual. The estimated completion date is September 30, 2003.

Management's planned action is responsive to the recommendation. The recommendation is resolved but will remain undispositioned and open until we have determined that agreed-to corrective action has been completed and is effective.

(2) Work with the Division of Administration's Acquisition Services Branch to modify the SOW for contract #02-00003-C-AF to reflect actual deliverables or to seek an appropriate adjustment to the price of the contract for the products contracted for, but not delivered. Future contractual agreements with outside credit card consultants for resolution assistance associated with securitized credit card portfolios should reflect or mirror the items addressed in the pre-closing guidance.

DRR concurred with the recommendation. DRR staff used a financial advisory SOW that, although specific to credit card portfolios, was not specifically designed for NextBank. Nevertheless, Bank One did provide a valuation that enabled the ordinal ranking of the four basic alternative strategies available to the FDIC. DRR noted that although the actual valuation did not technically meet the valuation deliverable contained in the SOW, it met DRR's needs and helped DRR staff make the appropriate decisions regarding strategies for the resolution of NextBank's assets. DRR noted that Bank One also developed a disposition strategy in close and constant consultation with DRR program staff that was reflected in the offering memorandum, bid form and instructions, and draft purchase agreement. DRR stated that while the form of

deliverable may technically vary from the description in the SOW, Bank One provided the substance of the deliverable.

DRR staff will work with the Division of Administration's Acquisition Services Branch to modify the SOW for contract #02-003-C-AF to reflect actual deliverables by April 30, 2003.

Management's planned action is responsive to the recommendation. The recommendation is resolved but will remain undispositioned and open until we have determined that agreed-to corrective action has been completed and is effective.

A summary chart showing management's responses to both recommendations is presented in Appendix X.

APPENDIX I

OBJECTIVE, SCOPE, AND METHODOLOGY

Our audit objective was to determine whether DRR developed and applied effective guidance for the potential and actual resolution and management of credit card portfolios. The resolution and management functions for receiverships reside in DRR's Receivership Operations Branch and the Franchise and Asset Marketing Branch. Staff from DRR's Field Operations Branch in Dallas, Texas, perform the actual management and accounting oversight activities. Our audit scope included pending and actual failed insured depository institutions for the year 2002. The sample included two banks that contained credit card portfolios and were categorized as potential failures in 2002. The sample also included two banks with credit card portfolios that failed during 2002: Net First National Bank of Boca Raton, Florida, and NextBank of Phoenix, Arizona. We performed our work from May 2002 through February 2003 in accordance with generally accepted government auditing standards.

Methodology

The FDIC's roles, responsibilities, and activities associated with the resolution and management of failed insured depository institutions are outlined in pertinent governing legislation and the FDIC's policies and procedures. To gain an understanding of the legislation, policies, and procedures regarding this subject, our audit methodology included reviewing the:

- Federal Deposit Insurance Act;
- Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA);
- Government Performance and Results Act of 1993 (GPRA);
- Workers Adjustment and Retraining Notification Act (WARN);
- FDIC's *Failed Financial Institution Closing Manual*;
- DRR's *Asset Disposition Manual;*
- DRR's *Resolution Policy Manual;*
- DRR's *Resolution Handbook*;
- DOA's *Acquisition Policy Manual;*
- FDIC Circular 7000.1, *DOS/DRR Information Sharing for Failing Institutions*, dated December 1999; and
- DRR's *Best Practices in the Management, Administration, and Disposition of a Failed Bank Credit Card Portfolio,* dated February 8, 2001.

Our methodology also included interviewing:

- Management and staff from DRR's Franchise and Asset Marketing and Receivership Operations Branches in Washington, D.C.;
- Closing team personnel, asset oversight officials, and accountants from DRR's Field Operations Branch in Dallas, Texas;
- Attorneys from the Legal Division in Dallas, Texas, and Washington, D.C.; and
- DOA contracting officials in Dallas, Texas, and Washington, D.C.

To test whether DRR developed and applied effective guidance for the potential and actual resolution of credit card portfolios, we reviewed the bank closing records for two failed

institutions in our sample. We compared the actions taken during the resolution of the credit card portfolios from these two institutions with the applicable guidance. We also obtained the Estimated Loss Report showing the estimated loss to the insurance fund for these two failed institutions.

Additionally, we reviewed the Basic Ordering Agreements, Statements of Work, and task orders for the FDIC's credit card consultant and financial advisor. We reviewed the credit card consultant's and financial advisor's work products relating to management and disposition of credit cards. These work products included training materials, pre-closing reports on potential failures, memorandums on post-closing credit card operations, and reports related to the marketing of credit card portfolios. Finally, we obtained a schedule of amounts paid to the contractors for the various task orders.

Government Performance and Results Act[37]

To determine whether DRR had any performance measures that we should consider in this audit, we reviewed the 2002 Strategic and Annual Performance Plans. We identified two strategic goals related to the resolution of credit card portfolios. First, DRR has a goal to identify potential bank failures representing significant losses to the insurance fund at least 12 months in advance of failure and obtain access to the institution for resolution at least 90 days prior to failure. Second, DRR has a goal to market at least 85 percent of the book value of a failed institution's marketable assets within 90 days of failure. According to reports and interviews with officials, DRR had access to NextBank on October 26, 2001, or 105 days before failure. DRR was able to market the NextBank's credit card receivables and seller's interest in the Trust within 90 days. However, DRR received no cost-effective bids for its seller's interest in the trust-owned credit card portfolio.

Reliance on Computer-Processed Data

We did not assess the reliability of computer-processed data because, according to DRR officials, the FDIC does not have a specific management information system devoted to the recording and tracking of information on credit card portfolios. Also, not assessing the reliability of the computer processed data does not impact the results and recommendations of the audit because our focus was on DRR's credit card resolution and management efforts. We did not use or rely upon any of the NextCard internal system information. For example, NextBank uses NextCard's internal system and First Data Resources' processing system. However, DRR asked First Annapolis to perform security reviews on the systems used by NextCard to service the credit card portfolio. The contractor reviewed 18 systems that process cardholder level data. The contractor found three systems to have high-risk potential and recommended some specific steps for these systems, including access restrictions and reviews of suspicious usage patterns.

---

[37] The Government Performance and Results Act of 1993 (P.L. No. 103-62, codified at titles 5, 31, and 39, U.S.C.) requires agencies to develop strategic plans, align programs and activities with concrete missions and goals, and manage and measure results. An agency is to prepare annual performance plans that establish connections with strategic goals and day-to-day activities and report on the extent to which the agency is meeting its annual performance goals.

Internal Management Controls

DRR has primary responsibility for liquidating failed institution assets, including credit card portfolios. The process requires DRR to coordinate with other FDIC divisions from the point of obtaining access to the failing institution through asset liquidation and receivership termination. Generally, DRR conducts on-site analysis to prepare for the closing and to determine a resolution strategy for the receivership. DRR management is responsible for developing controls to ensure transactions are properly documented and approved and assets are adequately safeguarded.

To assess whether transactions were properly documented and approved, we reviewed:
- FDIC Board cases and minutes documenting decisions made relating to the resolution of the receivership;
- FDIC legal opinions regarding the structure of the trust; and
- Pertinent sales agreements and case approvals for the liquidation of credit card portfolios in our sample.

To assess whether assets were adequately safeguarded, we:
- Interviewed accounting officials from DRR's Field Operations Branch regarding the financial controls in place over NextBank's credit card operations;
- Obtained schedules of cash outflows and inflows in the bank account used for NextBank's credit card portfolio; and
- Obtained and reviewed NextBank receivership balance sheet reports that highlighted operational expenses.

We concluded that the oversight activities constituted a positive management control effort, with the exception of inadequate oversight and potential overpayment of the portfolio financial advisor. Additionally, we did not find any guidance relating to large, securitized credit card portfolios. Because our objective focused on resolution guidance, we did not verify the accuracy of the accounting information provided to us. Specifically, we did not perform a billing review of the resolution cost information, such as the income from the seller's interest in the Trust, the financial information for the sales transactions for the bank-owned credit cards, the balance transfer program income, or the NextCard servicing costs. We interviewed DRR accounting officials and accepted the accounting estimates reported in official documents, Income Statement Reports, and Balance Sheet Reports for mention in this report. We did not audit these numbers.

Summary of Prior Audit Coverage

FDIC OIG Audit Memorandum 01-708 ***DRR's Efforts to Enhance Its Readiness to Manage and Liquidate Credit Card Portfolios.*** The OIG found that DRR's efforts enhanced its readiness to manage and liquidate credit card portfolios acquired from a failed bank. However, the OIG reported that there were two areas where DRR could do more: valuing significant portfolios and fraud detection.

General Accounting Office/GGD-94-23 Report: ***U.S. Credit Card Industry: Competitive Developments Need To Be Closely Monitored.*** GAO found there was no compelling evidence to confirm or reject the viewpoint that the credit card industry's structure limits competition.

Pertinent Laws and Regulations

Federal Deposit Insurance Act, as amended (codified at 12 U.S.C. §§ 1811-1835)
Pertinent sections include:
12 U.S.C. §1821(d) "Powers and duties of Corporation as conservator or receiver" at paragraph (2) "General powers", subparagraph (A) "Successor to institution", states:

> The Corporation shall, as conservator or receiver, and by operation of law, succeed to -(i) all rights, titles, powers and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer or director of such institution with respect to the institution and the assets of the institution; and (ii) title to the books, records, and assets of any previous conservator or other legal custodian of such institution.

Subparagraph (B) "Operate the institution", states:

> The Corporation may (subject to the provisions of section 40 of this title), as conservator or receiver-(i) take over the assets of and operate the insured depository institution, with all the powers of the members or shareholders, the directors, and the officers of the institution and conduct all business of the institution; (ii) collect all obligations and money due the institution; (iii) perform all functions of the institution in the name of the institution which are consistent with the appointment as conservator or receiver; and (iv) preserve and conserve the assets and property of such institution.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), (P.L. No. 102-242, codified at title 12, U.S.C.)
Section 143 of this act, "EARLY RESOLUTION", states:

> (a) IN GENERAL.--It is the sense of the Congress that the Federal banking agencies should facilitate early resolution of troubled insured depository institutions whenever feasible if early resolution would have the least possible long-term cost to the deposit insurance fund, consistent with the least-cost and prompt corrective action provisions of the Federal Deposit Insurance Act.

Competitive Equality Banking Act of 1987 (P.L. No. 100-86, codified throughout title 12, U.S.C.) - The Act redefined the term "bank" to include any bank, the deposits of which are insured by the FDIC as well as any other institution that accepts demand or checkable deposit accounts and is engaged in the business of making commercial loans; (see 12 U.S.C. §1841(c)). The Act recognized the specialized nature of credit card lending by exempting an institution specializing in that activity from the "bank" definition.

Fair Credit Billing Act of 1974 (P.L. No. 90-321, codified at 15 U.S.C. §§ 1666 - 1666j) – The Act provides guidance regarding regulation of credit reports, length of billing period, prompt crediting of payments, treatment of credit balances, prompt notification of returns, use of cash discounts, and rights of credit card customers.

Consumer Credit Protection Act (P.L. No. 90-321, codified at 15 U.S.C. § 1601 et seq.) – The Act covers aspects of open-end credit, including finance charges, credit card applications and solicitations, periodic statements, identification of transactions, billing error resolution, determination of annual percentage rate, and advertising.

Workers Adjustment and Retraining Notification Act (WARN Act)(P.L. No. 100-379, codified at 29 U.S.C. §§ 2101-2107) – The Act offers protection to workers, their families, and communities by requiring employers to provide notice 60 days in advance of covered plant closings and covered mass layoffs. This notice must be provided to either affected workers or their representatives (e.g., a labor union); to the State dislocated worker unit; and to the appropriate unit of local government. The WARN Act was enacted on August 4, 1988, and became effective on February 4, 1989.

APPENDIX II

CREDIT CARDS

Credit cards involve open-end or revolving personal unsecured loans that are activated through using the card. The prevailing instrument is a customer borrowing agreement that is generally executed in conjunction with receiving a card from a financial institution. Credit cards are usually subject to a credit limit and are issued for a specified term. The cardholder may use the card to make purchases from participating merchants across the country or world. All purchases are consolidated into one monthly bill that the borrower can pay in full with no finance charge or in part with a finance charge computed on the unpaid balance. Credit card debt can be unsecured or secured. Unsecured debt is debt that is not guaranteed by the pledge of collateral. Most credit cards involve unsecured debt, which is the main reason why their interest rate is higher than other forms of lending, such as mortgages, which utilize property as collateral. Most credit cards offer revolving credit. A revolving line of credit is an agreement to lend up to a specific amount to a borrower and to allow that amount to be borrowed again once it has been repaid.

Participating merchants enter into a formal agreement with the financial institution whereby the merchant agrees to accept the credit card and the financial institution agrees to pay for all purchases up to a stated amount. For purchases above the stated amount, the merchant must receive authorization from the financial institution before accepting the card. The merchant deposits credit card sales slips and immediate credit is given by the financial institution. The sales slips are then centralized and used to generate a monthly billing to the customer. Credit card operations depend upon two things: networks (credit card company) and issuers (the financial arm for the bank that carries the loan).

Card associations play a key role in making credit card transactions possible. Visa and MasterCard are the two national associations. The associations license their members to issue credit cards under their program and bear the association's design. Associations own and operate processing systems. Among other things, the associations serve as the intermediary clearing house between members; generate transaction processing operating rules; and support members with brand investment, technical, financial, and marketing resources.

Banks provide merchant acquiring and card issuing services as part of a large service offering to commercial and individual customers. Many large-scale issuers have entire divisions devoted to cards while smaller banks often leverage relationships with outside parties (sometimes even other banks) to make these services available. For example, in a securitization, a financial institution sells its credit card receivables to a special purpose trust, which pays for the receivables by selling securities to the public. The securities sold to the public are backed by cash flows generated from the receivables. In general, the liquidation of a financial institution that operates in the credit card area, either as an issuer or an acquirer,[38] involves the packaging and sale of that piece of the business.

---

[38] Acquirer - Banks and non-banks that sell to merchants, manage or own the merchant relationships, and typically provide customer service, risk management, chargeback processing, and other back office services.

APPENDIX III

THE NEXTBANK RESOLUTION

NextBank was a limited purpose national credit card bank[39] and a wholly owned subsidiary of NextCard, Inc., the holding company. NextBank's failure left NextCard in a tenuous financial position, eliminating the bank's only source of income. NextCard openly contemplated filing bankruptcy[40] as a way to limit its losses. NextBank, without NextCard's servicing, realized it would immediately suffer a loss of value in its portfolio and there would be an event of default in the large securitization Trust. Appendixes IV-VII present additional details concerning the resolution of NextBank.

On October 26, 2001, DRR was advised of the potential failure of the NextBank. A decision was made then to market the failing institution through a secure Web site operated by a contractor. A review of preliminary information reflected that the best transaction to offer to the potential bidders would be a clean Purchase and Assumption[41] with insured deposits. This decision was based on the nature of the assets being securitized credit cards and there was no asset valuation review[42] to determine the total loss at NextBank. Forty-two institutions were granted access to the secure Web site; however, only 29 accessed the site. No bids were received. NextBank was closed and the transaction was a payout.

The FDIC's efforts in resolving NextBank focused on two areas--the closing process and the disposition of the bank's assets. DRR's objective was to protect the bank's principal asset by continuing uninterrupted NextCard servicing. To accomplish this, the FDIC had to prevent NextCard from declaring bankruptcy, an event that would render an early amortization of the credit card portfolios. DRR contracted with First Annapolis Consulting for advice on a resolution strategy and the continued operation of the NextCard servicing under FDIC oversight.[43] Also, according to DRR officials, First Annapolis Consulting had deemed that the customer service area was a quality operation and servicing was adequate. DRR officials also knew the average monthly cost of servicing by NextCard and that the cash flows from the credit card portfolios were positive.

---

[39] NextBank was a limited purpose national credit card bank as specified by the Competitive Equity Banking Act of 1987 (CEBA) (P.L. No. 100-86, codified throughout title 12, U.S.C.). A CEBA bank may only engage in credit card operations, may only accept deposits at one office, and may not accept demand deposits of less than $100,000, or deposits that a depositor may withdraw by check or similar means.

[40] NextCard actually filed for Chapter 11 bankruptcy protection on November 11, 2002.

[41] A purchase and assumption transaction is a closed institution transaction in which a healthy institution purchases some or all of the assets of a failed bank and assumes some or all of the liabilities, including the insured deposits.

[42] When an institution is failing and there is no time to perform an asset valuation review, the unanticipated failure model, also referred to as the "Research Model," is used. It uses data from the bank's Call Report (quarterly report to FDIC) and historical loss percentages provided by the FDIC's Division of Insurance and Research, to calculate the loss to each asset category. The results are incorporated into the least cost test (LCT) which is used to determine the least costly resolution of a failing institution as required by the Federal Deposit Insurance Corporation Improvement Act of 1991.

[43] Between January 1, 2002 and December 31, 2002, the FDIC paid First Annapolis $2,534,857 for services related to NextBank. DRR officials are pleased with First Annapolis's overall performance.

Negotiations were entered into with NextCard to delay bankruptcy. NextCard was not willing to suffer any financial deterioration for the bank's sake and took a position that it needed reimbursement of certain expenses incurred on behalf of NextBank that were outstanding as of the bank closing date if NextCard were to remain solvent. To prevent termination of employees and a filing of bankruptcy, the FDIC reimbursed NextCard $11.4 million for past expenses and agreed to reimburse it for all costs directly connected with maintaining the servicing. In return, NextCard agreed to delay its bankruptcy for not less than 90 days and to provide servicing during the forbearance period and beyond. Moreover, NextCard also wanted assurances of "indemnification" from employees' possible lawsuits if employees filed against NextCard for dismissal under the WARN Act.[44] Although the FDIC was not bound by the WARN Act, DRR officials agreed to offer retention bonuses.

NextBank issued credit cards that NextCard originated over the Internet. A large portion of the bank's credit card portfolio was securitized into a Master Trust (Trust). NextBank was the servicer of the underlying credit card securities. Just prior to closing, NextBank was managing approximately $1.9 billion of credit card receivables, of which approximately $1.7 billion was securitized in the Trust and the bank held approximately $255 million. In addition, NextBank retained an approximate 9 percent seller's interest in the Trust.

The FDIC serviced the Trust portfolio under the terms of the Transfer and Servicing Agreement with the Trust, to which it succeeded upon failure of the bank. During the bankruptcy forbearance or revolving period, DRR's Franchise and Asset Marketing Branch planned to market and sell the credit card portfolio to maximize the return to the Corporation. DRR retained a financial advisor in January 2002 to value and assist in the marketing of the credit card portfolio. Until the credit card portfolio sold, DRR expected that the receivership would benefit from the positive cash distributions received for its monthly share of redistributions from the Trust for the approximate 9 percent seller's interest that NextBank had retained in the trust. After the seller's interest sold, there would be a conversion of the servicing from NextCard to the acquirer's servicer.

In March 2002, the FDIC, as receiver of NextBank, entered into a "Restated and Amended Servicing Agreement with NextCard, Inc." that included an indemnification for limited contingent liabilities. This agreement was executed to ensure NextCard's continuation of critical services to NextBank, including operation of all computer systems and providing office space.

The FDIC Board of Directors authorized a $99.3 million budget to support this Agreement. The Agreement covered a period of 6 months, with a 3-month contingency and acknowledged that the money would not be spent if the transition period to a new buyer was shorter. The Agreement also stated that the receivership would pay the actual interim service costs, with the trust continuing to pay monthly a reimbursement servicing fee of 2 percent of its outstanding credit card receivables. In doing so, FDIC officials knew that the actual cost of related servicing was higher, approximately 3.5 percent.

Also, to keep employees from resigning, the FDIC authorized a retention payment equal to 4 months' base salary, approximately $9.1 million, for NextCard employees who remained until

[44] See Appendix I for a discussion of the WARN Act.

release. The retention bonus of 4 months' salary for everyone was higher than what the credit card consulting firm had recommended--a retention bonus of up to 3 months' salary for key personnel and up to 5 weeks for the service personnel. The FDIC, through a contract with a temporary personnel agency, Automation Management Service Company, also retained some of the former NextCard employees to assist with the servicing and operations of the NextBank credit card portfolio. Those retained were offered salaries and benefits on comparable terms with their past employer together with the retention payment. As of March 8, 2002, approximately 471 employees were successfully retained by the receiver contract to perform credit card servicing functions. The holding company, NextCard, retained approximately 66 employees to support the servicing operation and terminated approximately 76 employees.

Almost all of NextBank's operations were performed by the holding company. The bank itself had no employees or facilities. In accepting the NextCard servicing operation, the FDIC inherited the office space agreements for the sites in San Francisco and Livermore, California. We visited the NextCard office space in San Francisco in June 2002. The Receivership was paying for space on several floors that were devoid of employees. DRR Asset Management officials attempted, during the resolution period, to negotiate for reduced lease costs for empty office space but were unsuccessful because the FDIC was bound to the existing NextCard lease agreement.

DRR's Franchise and Asset Marketing officials initially marketed the entire credit card portfolio--bank-owned and its interest in the Trust's receivables. A best and final round of bids requested on the non-trust assets and Trust assets separately produced a winning bid for the non-trust assets based on a loss-sharing arrangement with the FDIC. The FDIC sold the bank-owned credit card portfolio (200,000 accounts with a book value of about $197 million) to Merrick Bank Corporation (Merrick), a Utah industrial loan corporation, with a loss share provision capped at about $21 million. The sale closed on July 1, 2002, and generated net proceeds of $128,019,956. The receivership serviced the portfolio on an interim basis, as part of the sales agreement, until September 20, 2002 and billed the buyer interim servicing fees of $2,262,727. Cumulative shared losses for the 5 months ended December 31, 2002, were $14,407,571.

The FDIC was unable to sell its approximate 9 percent seller's interest in the remaining 800,000 accounts with more than $1.7 billion in receivables bundled in the Trust with Bank of New York (BONY) as Trustee. On July 8, 2002, the high rate of charge-offs triggered an early amortization for the trust-owned credit card portfolio. Under the terms of the Trust, this meant a change in the distribution of the cash flows. Under the circumstances, the Trust required that principal collections allocated to investors be applied to paying down the outstanding certificate balances. As a result, the receivership, as holder of the seller's interest, would receive a rapidly dwindling portion of the cash flow. These amounts would no longer be sufficient to fund daily card advances, requiring an out-of-pocket expenditure by the receivership that FDIC officials believed it was unlikely to recover. Consequently, the FDIC decided immediately to close the “open-to-buy” and thereby limit the receivership's loss to the amount of NextBank's interest in the Trust. The FDIC formally repudiated, by letter dated July 10, 2002, all or substantially all contracts with the Trust, including the Transfer and Servicing Agreement. The receivership immediately began to forward to the Trust almost all principal and interest payments as required by the Trust.

After repudiation, DRR officials promptly entered into new negotiations with the Trustee (BONY) to continue servicing the Trust assets at least through September 2002 because of DRR's obligation to service the Merrick-owned portfolio. However, BONY opted to hire its own servicer, First National Bank of Omaha (FNBO), effective August 1, 2002, to service the securitized credit card portfolio. The actual transfer of the servicing of the Trust portfolio to FNBO occurred on September 20, 2002, but it was not until September 24, 2002, that FNBO started receiving all cash and responsibility for daily settlements[45]via the lockbox[46] account with the FDIC, the Trust, and Merrick.

According to DRR officials, the FDIC is entitled to receive its allocation of finance charge collections monthly, independent of the pay-off of the investor notes. The receivership received about $31.8 million on August 15, 2002, which included its July service fee from the Trust. The Trust paid FNBO, but not the FDIC, a service fee for August and September 2002. However, prior to the transition to FNBO, the receivership began offsetting against the Trust's daily remittances for credit refunds, insufficient funds checks, and service fees. The servicing fee holdbacks were $1,817,032 and $1,211,354 for August and September, respectively. Although the Trust performance continues to deteriorate, DRR officials projected that the total future cash flows to the receivership with respect to the seller's interest will be $40 million.

The FDIC paid off the insured deposits of NextBank and is in the process of liquidating all assets. The estimated loss to the BIF (the subrogated claims liabilities less income) for NextBank, as of October 31, 2002, was reported to be about $300 million.

On October 7, 2002, the Trustee and certain investors submitted legal claims totaling $773 million. The claims fall into 4 major categories--failure to begin early amortization upon FDIC receivership, failure to begin early amortization on July 1, 2002, improper servicing of receivables, and breaches of representations and warranties. It is unknown at this time what effect this action will have on the receivership.

[45] Money must be wired out daily to cover settlements with VISA and MasterCard for charges processed. Settlement is the process by which merchant and cardholder banks exchange financial data and value resulting from sales transactions, cash advances, merchant credits, and the like. These items usually consist of net sales, net cash advances, interchange fees, and net charge-back activity.

[46] A collection system in which a bank or third party receives, processes, and deposits a company's mail receipts. A cash management arrangement designed to reduce delays in depositing funds into the payee's bank account. It is a post office box that is established by a bank to receive checks for its cash management customers.

APPENDIX IV

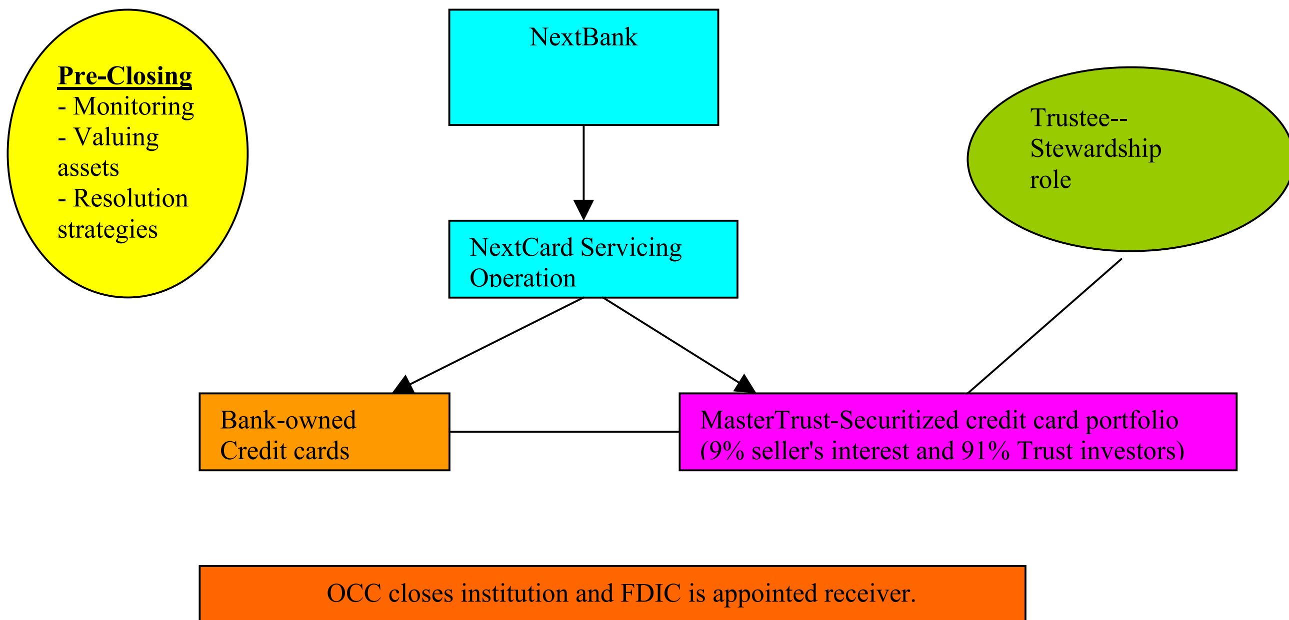
TIMELINE OF SIGNIFICANT EVENTS
NEXTBANK RECEIVERSHIP

Date	Event
10/26/01	After being advised of the potential failure of NextBank, DRR decides to market the failing institution.
01/24/02	DRR's Failing Bank Case to the FDIC Board recommends that staff determine the least cost method of resolution for NextBank.
02/07/02	Office of the Comptroller of the Currency closes NextBank, and the FDIC is appointed receiver. The FDIC Board approves a payout of the insured deposits.
02/07/02	DRR's Credit Card Asset Disposition Case to the FDIC Board recommends that DRR negotiate with the Trustee to avoid an early amortization of the securitized credit card portfolio and continue uninterrupted servicing operations.
02/28/02	DRR's Expenditure Case to the FDIC Board recommends that the FDIC enter into a Restated and Amended Servicing Agreement with NextCard and approve up to $99 million in expenses to continue servicing of the credit card portfolio.
07/01/02	The FDIC closes the sale of the bank-owned credit card portfolio to Merrick Bank Corporation. The FDIC enters into an interim servicing agreement with Merrick Bank Corporation to continue servicing of the credit cards through September 20, 2002.
07/08/02	The high rate of charge-offs in the trust-owned credit card portfolio triggers an early amortization.
07/10/02	The FDIC repudiates substantially all contracts with the Master Trust including the Transfer and Servicing Agreement.
08/01/02	The Trustee hires its own servicer, the First National Bank of Omaha, to service the trust-owned credit card portfolio.
09/20/02	The FDIC transfers servicing of the trust-owned credit card portfolio to the First National Bank of Omaha.
10/07/02	The Trustee and certain investors submit legal claims against the FDIC for delaying early amortization and improper servicing of the credit card receivables.

APPENDIX V

PRE-CLOSING ROLES AND RESPONSIBILITIES FOR CREDIT CARDS

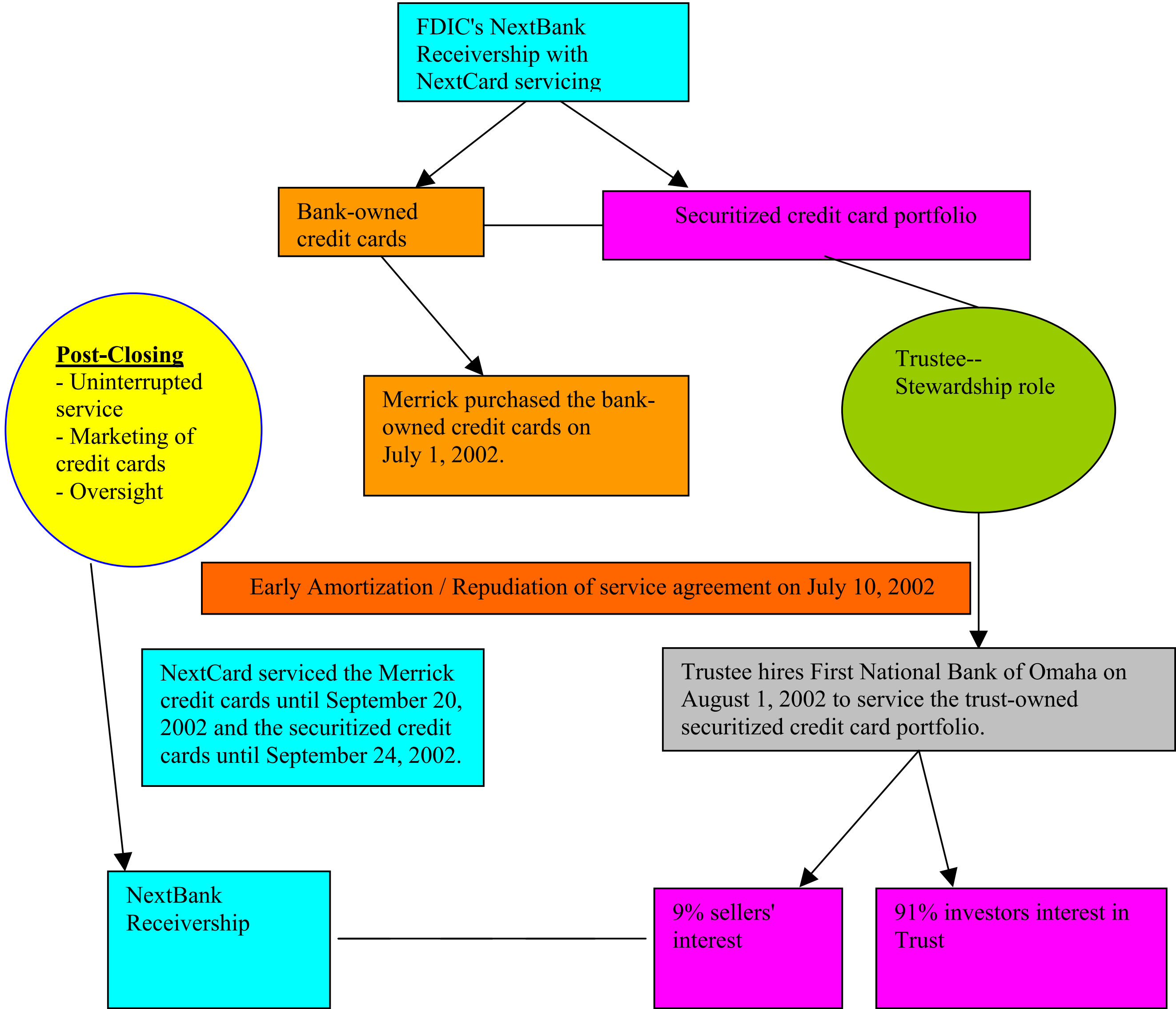
FDIC **Bank of New York**



Source: OIG

APPENDIX VI

POST-CLOSING ROLES AND RESPONSIBILITIES FOR CREDIT CARDS



Source: OIG

FDIC as Receiver for NextBank
Comparison of Bank and Trust Credit Card Portfolios

	Bank Credit Card Portfolio	**Trust Credit Card Portfolio**
Book Value at Time of Bank Closing	$255,000,000 with the receivership owning 100 percent. At the time of sale, the book value had been reduced to about $197 million.	$1,716,000,000 with the receivership owning a 9-percent seller's interest.
Sale	Sold to Merrick Bank for approximately $132,000,000 with a loss share capped at $21 million.	Unable to liquidate the seller's interest.
Cash Inflows to the Receivership	Net proceeds of $128,019,956, service fees of $2,262,727, and a cumulated loss share of $14,407,571 as of December 31, 2002.	About $127.5 million in net cash flow or distributions for the seller's interest, including the servicing fees, financial charge collections, the sale of charge-off loans, and the balance transfer proceeds.
Credit Card Servicing		
Prior to 02/07/02	NextCard under servicing agreement with NextBank.	NextCard under servicing agreement with NextBank.
02/07/02 – 02/28/02	FDIC using NextCard employees under existing servicing agreement.	FDIC using NextCard employees under existing servicing agreement.
03/01/02 – 06/30/02	FDIC using NextCard employees under amended and restated servicing agreement.	FDIC using NextCard employees under amended and restated servicing agreement.
07/01/02 – 09/20/02	FDIC under interim servicing agreement with Merrick Bank.	FDIC transitioning to First National Bank of Omaha (the servicer selected by the Trust) with no interim servicing agreement.
End of Service	Merrick Bank as servicer (09/20/02).	First National Bank of Omaha as servicer (09/30/02).

APPENDIX VIII

ACRONYMS AND ABBREVIATIONS

APM	Acquisition Policy Manual
BIF	Bank Insurance Fund
BONY	Bank of New York
DOA	Division of Administration
DRR	Division of Resolutions and Receiverships
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FDR	First Data Resources
FNBO	First National Bank of Omaha
OCC	Office of the Comptroller of the Currency
OIG	Office of Inspector General
SAIF	Savings Association Insurance Fund
SAVE	Standard Asset Valuation Estimation
SOW	Statement of Work
WARN	Workers Adjustment and Retraining Notification Act

APPENDIX IX

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, DC 20429

Office of the Director
Division of Resolutions and Receiverships

March 24, 2003

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Mitchell L. Glassman *Mitchell L. Glassman*
Director

SUBJECT: Response to Draft Audit
DRR's Resolution and Management of Credit
Card Portfolios (Assignment No. 2002-705)

DRR staff has reviewed the draft report entitled *Audit of DRR's Resolution and Management of Credit Card Portfolios (Assignment No. 2002-705)* and provides the following comments.

Recommendation (1):

Develop pre-closing guidance for securitized and other large, complex credit card portfolios. This guidance should address, among other things,

(a) determining the timing and degree of consultant involvement in the process,
(b) obtaining a reasonable and supportable value for both bank owned and trust owned credit card receivables,
(c) assessing trust relationships promptly,
(d) calculating the present and anticipated credit card cashflows,
(e) disposing and transferring of the service function to a third party, and
(f) assessing the costs associated with assuming existing service operations and agreements.

Response:

DRR staff concurs with the recommendation. Although not currently written as procedures, as noted in the audit report, DRR staff and its expert advisors did address these issues, as well as many others, during the resolution of NextBank. Based on the tasks and analyses performed resolving NextBank and the experience gained in managing and liquidating NextBank's owned credit card portfolio and the interests NextBank held in the NextCard Credit Card Master Note Trust, DRR staff will issue written guidance for managing and selling interests in credit card securitizations, other asset backed securities, and large complex credit card portfolios. This will be completed by September 30, 2003, and will be included in the next update of the Asset Disposition Manual.

Recommendation (2):

Work with the Division of Administration's Acquisition Services Branch to modify the Statement of Work (SOW) for contract #02-00003-C-AF to reflect actual deliverables or to seek an appropriate adjustment to the price of the contract for the products contracted for, but not delivered. Future contractual agreements with outside credit card consultants for resolution assistance associated with securitized credit card portfolios should reflect or mirror the items addressed in the preclosing guidance.

Response:

DRR staff concurs with the recommendation. DRR staff used a financial advisory statement of work that, although specific to credit card portfolios, was not specifically designed for NextBank. The objectives during the first phase of the contract were an initial assessment of the credit card-related assets, a valuation of the assets and the development of a disposition strategy. In response, Bank One provided analyses of credit card asset quality, securitization structures, functional servicing cost estimates, credit card portfolio and retained securitization interests cash flows, and strategies and alternatives for maximizing recovery that included delaying early amortization, credit limit maintenance, monitoring "open to buy" and enhancing the receivership's position by liquidating conduits prior to early amortization. Bank One also provided a valuation that enabled the ordinal ranking of the four basic alternative strategies available to the FDIC. While the actual valuation did not technically meet the valuation deliverable contained in the statement of work, it was the essence of the valuation DRR staff required to make the appropriate decisions regarding strategies for the resolution of NextBank's assets. Bank One also developed a disposition strategy in close and constant consultation with DRR program staff that was reflected in the offering memorandum, bid form and instructions and draft purchase agreement. Again, while the form of deliverable may technically vary from the description in the statement of work, Bank One provided the substance of the deliverable.

Accordingly, DRR staff will work with the Division of Administration's Acquisition Services Branch to modify the Statement of Work (SOW) for contract #02-003-C-AF to reflect actual deliverables by April 30, 2003.

cc: James R. Wigand

APPENDIX X
SEE SEPARATE DOCUMENT

APPENDIX X

MANAGEMENT RESPONSES TO RECOMMENDATIONS

This table presents the management responses that have been made on recommendations in our report and the status of recommendations as of the date of report issuance. The information in this table is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved[a]: Yes or No	Dispositioned[b]: Yes or No	Open or Closed[c]
1	DRR will issue written guidance for managing and selling interests in credit card securitizations, other asset backed securities, and large complex credit card portfolios. This guidance will be included in the Asset Disposition Manual.	September 30, 2003	N/A	Yes	No	Open
2	DRR staff will work with the Division of Administration's Acquisition Services Branch to modify the SOW for contract #02-003-C-AF to reflect actual deliverables.	April 30, 2003	N/A	Yes	No	Open

[a] Resolved – (1) Management concurs with the recommendation and the planned corrective action is consistent with the recommendation. (2) Management does not concur with the recommendation but planned alternative action is acceptable to the OIG. (3) Management agrees to the OIG monetary benefits or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.