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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

**Conditional Approval #312  
May 1999**

**DECISION OF THE OFFICE OF THE COMPTROLLER OF THE CURRENCY  
ON THE APPLICATION TO CHARTER  
NEXTBANK, NATIONAL ASSOCIATION,  
SAN FRANCISCO, CALIFORNIA  
MAY 8, 1999**

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**I. DESCRIPTION OF THE PROPOSAL**

On December 10, 1998, NextCard, Inc., San Francisco, California ("NCI"), filed an application with the Office of the Comptroller of the Currency (OCC) to charter a new national credit card bank as specified in the Competitive Equality Banking Act of 1987, as amended (CEBA). The proposed bank will be headquartered in San Francisco, California, and will be titled NextBank, National Association ("Bank").<sup>1</sup> The Bank has applied to the Federal Deposit Insurance Corporation (FDIC) for deposit insurance and will apply to become a member of the Federal Reserve System. The Bank has also filed an operating subsidiary application with the OCC to own and operate NextCard Funding Corp. ("NFC"), a Delaware corporation that is currently wholly-owned by NCI. The applications have been supplemented from time to time with additional or amended information. No comments were received from the public regarding these applications.

NCI, formerly called Internet Access Financial Corporation, launched the NextCard VISA card in December 1997. The product, which NCI calls the First True Internet VISA, is marketed to consumers exclusively through its Web site, *www.nextcard.com*. The NextCard can be used for both online and offline purchases and offers several product and service enhancements specifically designed for the Internet-enabled consumer. These include a customized application process, Internet-based account management, and online shopping enhancements.

The NextCard currently offers a completely online credit application, authentication, and underwriting process through a proprietary program called RapidResults, a Java-based Internet

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<sup>1</sup>The organizers of the Bank are Jeremy Lent, Timothy Coltrell, Kathleen Fritzsche, John Hashman, and Robert Linderman, all of whom are employees of NCI.

application.<sup>2</sup> The process works as follows. The applicant completes and submits a credit card application online in a secured Internet session. RapidResults then accepts the information submitted by the applicant, electronically accesses credit bureaus, and obtains a credit report from each credit bureau accessed. This information is then scored by the RapidResults' decision engine, applying FICO scorecards and discrete credit-specific criteria. The processing time for an application is generally less than 30 seconds.

Approved applicants are underwritten and presented with several different upgrade opportunities. Currently, the options may include Standard, Gold, or Platinum VISA with different introductory interest rates. The specific upgrade opportunities presented to the applicant are based upon his or her credit profile and the dollar amount of qualifying balance he or she wishes to transfer. The applicant has the option of personalizing his or her card with a variety of pictures and designs, including a personal photograph.<sup>3</sup> Although the approval is granted online, this is only a provisional approval. NCI does not complete the balance transfers or mail the new credit card until back office personnel complete additional fraud checks, including a possible telephone call to the applicant.

Through NCI, the NextCard cardholder has access to Internet-based account management and online shopping and reward programs. This includes online account statements, the ability to download activity into personal financial management software, and online customer service through secure E-mails. The NextCard's GoShopping! service currently includes a bargain finder engine, online shopping guide, and special discounts available only to cardholders. In addition to online services, NCI also offers a more traditional rewards program called Rew@rds Points. Cardholders earn points for each purchase, points which can be redeemed for merchandise at major national retailers and Internet electronic commerce sites. NCI also provides a "100% Safe for Internet Shopping" guarantee which protects cardholders from fraud that may occur in connection with the use of the NextCard on the Internet.<sup>4</sup>

The objective of NCI's charter application is to fund and originate its own receivables. Currently, Heritage Bank of Commerce, an unaffiliated state-chartered depository institution in San Jose, California, originates and funds the NextCard receivables through a contractual

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<sup>2</sup>NCI has filed three patent applications and applied to register several of its trademarks in the United States. The patent applications and some of the trademark registrations have not yet been acted upon; on February 9, 1999, the U.S. Patent and Trademark Office granted service mark registration for "NextCard."

<sup>3</sup>To manage and control reputation risk, NCI has established standards for acceptable card content and reserves the right to decline any image submitted.

<sup>4</sup>Under Regulation Z, the liability of a cardholder in a case of unauthorized use of the credit card is generally limited to \$50.00 with the remainder of any loss borne by the card issuer. Under the "shop safe" guarantee, however, NextBank would be responsible for all losses, from the first dollar, that result from fraud in connection with NextCard usage on the Internet.

arrangement.<sup>5</sup> The Heritage Bank contract is scheduled to expire with the formation of NextBank. The Bank's activities will be limited to activities permissible for credit card banks, mainly generating and financing NextCard credit card loans funded with wholesale certificates of deposit greater than \$100,000.<sup>6</sup> In addition, the Bank will make extensive use of the capital markets to securitize portfolios of receivables, initially through conduit arrangements and eventually through private placements and public offerings.

The Bank will serve a nationwide market, targeting the segment of banking customers who are comfortable transacting business on the Internet. The primary market segment targeted for the NextCard consists of online revolvers. The secondary market segment consists of online purchasers who are attracted by the ease and convenience of Internet commerce. The Bank will underwrite the NextCard credit card product that is marketed exclusively through Internet direct marketing techniques, including banner advertisements and so-called "affiliate" relationships with other Web sites.

This is the second charter proposal filed with the OCC for a national bank that will deliver products and services to customers primarily through electronic means.<sup>7</sup> The Bank will not have any traditional banking offices and will primarily interact with its customers through the existing NextCard Web site. NCI will operate, maintain, and enhance the NextCard Web site under its name and brand. NCI will license its proprietary technology to NextBank on terms that are at least as favorable as those that would be given to an unaffiliated third party. There are no immediate plans to establish Bank-specific Web pages connected to the NextCard Web

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<sup>5</sup>Prior to January 1999, Heritage Bank of Commerce ("Heritage Bank") funded and held on its books all of the credit card accounts and loans originated on NCI's Web site pursuant to an agreement where NCI charged Heritage Bank for origination and servicing of the accounts and shared 50 percent of the resulting net profits or losses. In January 1999, NCI through NFC began purchasing credit card receivables from Heritage Bank on a daily basis using borrowings from a \$100 million secured lending facility with Credit Suisse First Boston and equity contributions by NCI. Under the current arrangement, NCI earns interest income, fee income, and VISA interchange fees. NCI will contribute the stockholder's equity of NFC to NextBank upon its formation.

<sup>6</sup>As a limited purpose national credit card bank, the Bank will be subject to the following restrictions on its activities: (1) it may engage only in credit card operations; (2) it may not accept demand deposits or deposits that the depositor may withdraw by check or similar means; (3) it may not accept savings or time deposits of less than \$100,000 (except as security for loans); and (4) it may maintain only one office that accepts deposits; and (5) it may not engage in the business of making commercial loans. See 12 U.S.C. § 1841(c)(2)(F).

<sup>7</sup>See Decision of the Office of the Comptroller of the Currency on the Application to Charter CompuBank, National Association, Houston, Texas, Conditional Approval #253, August 20, 1997; available for viewing or download at <http://www.occ.treas.gov/interp/sep97/ca253.pdf>.

site.<sup>8</sup> Bank customers will also be able to conduct banking business through the mail and the 24-hour automated telephone response system and customer service line.

The Bank will have a physical presence in two primary locations. The Bank's main office, which will serve as the principal executive offices, will be situated in an office suite in downtown San Francisco, California. In addition, the Bank will have a non-branch operations and customer service office in San Ramon, California. NCI currently has 145 employees, most of whom will become Bank employees upon its formation.

The Bank, similar to other national credit card banks, will perform some key operational functions internally while contracting with third-party service providers for the provision of other functions. Bank staff will perform business and strategic planning, investment, funds management, cashier, loan underwriting, marketing, operations support, legal, internal audit, and regulatory compliance functions. In the near term, Bank staff will share operational duties with a third-party service provider for telephone customer service and new account processing. Completely outsourced functions will include card issuance, online customer service, balance transfers, credit reports, fraud detection, collections, billing, and payment processing. As volumes necessary for economies of scale are achieved, NextBank plans to bring in-house those functions where it can add value, especially those involving customer contact. Many of these changes could occur by the end of 1999.

## **II. LICENSING FACTORS**

### **A. Policy Considerations**

Under its Corporate Activities regulations (12 C.F.R. § 5.20), the OCC considers whether the proposed bank: (A) has organizers who are aware of, and understand, national banking laws and regulations; (B) has competent management, including the board of directors, with ability and experience relevant to the types of services to be provided; (C) has capitalization that is sufficient to support the projected volume and type of business; (D) can reasonably be expected to achieve and maintain profitability; and (E) will be operated in a safe and sound manner.

In evaluating this charter proposal, the OCC performed a thorough analysis of the proposed operating plan. This included a field investigation comprised of interviews with the proposed organizers, officers, and directors; in-depth review of NCI's existing credit card operations,

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<sup>8</sup>The NextCard Web site currently provides customer access, via hyperlinks, to other third party products and services. The OCC expects that NCI and the Bank will take reasonable steps to clearly distinguish between products and services that are offered by the Bank and those offered by NCI or a third party. Bank customers should be able to tell when they are dealing with the Bank and when they are not. For example, a third party may have different standards than the Bank with respect to security, privacy, etc. for information provided over the Internet. Internet technology provides multiple methods to provide such clarity to potential customers. Examples include simple text and dialogue boxes. See also "Technology Risk Management: PC Banking," OCC Bulletin 98-38, p. 17 (August 24, 1998); available for viewing or download at <http://www.occ.treas.gov/bullst98.htm>.

policies, procedures, and controls; and evaluation of existing and proposed information system architecture and approach to security and controls. We also conducted a detailed financial and business plan analysis using regulatory and rating agency data and analysis techniques.

### *Organizers and Management*

The OCC's field investigation concluded that the Organizers are knowledgeable of, and understand, national banking laws and regulations and safe and sound operations. The Organizers are all existing officers and employees of NCI. All the Organizers have served as an officer or mid-level manager of either a national bank, Federal savings bank, or credit card company. Each Organizer, who either will serve or plans to serve in the future as a Bank director, understands the roles and responsibilities of a national bank director, and is knowledgeable of the credit card industry and banking concepts. Although there is no individual with significant technology experience among the Organizers, the Bank is in the process of finalizing selection of the Chief Technology Officer. This individual should have strong technical and leadership skills in the computer and Internet areas to create a vision for future technology needs. OCC review and no objection is a preopening requirement.

The balance of management and directorate for the proposed Bank possess experience relevant to the proposed products and services. Most of the management team previously worked together at Providian National Bank, a monoline credit card bank whose operations are centered in the San Francisco Bay Area. The proposed Chief Executive Officer of the Bank is Jeremy Lent, who is the founder, Chairman, and CEO of NCI. Mr. Lent is a long-time resident, but not a citizen, of the United States. As such, he will not be able to assume the statutory position of President until his pending citizenship application is approved by the Immigration and Naturalization Service (INS).<sup>9</sup> Mr. Lent has extensive credit card and banking experience, previously serving as Providian's Chief Financial Officer. The interim proposed President and Chief Financial Officer is John Hashman. Mr. Hashman served in a wide-array of management positions at Providian, including the second-highest ranking financial officer during Mr. Lent's tenure. The proposed Chief Operations Officer, Timothy Coltrell, has extensive bank operations management experience, most recently serving as President and CEO of GE Capital Consumer Credit Card Company. Similarly, the proposed heads of the legal, credit, marketing, and human resources areas bring valuable and relevant knowledge and experience. Serving as an outside director for the Bank and independent contractor for NCI is Bruce Rigione, who previously led the asset securitization areas at Chase Manhattan Corporation and HongKong Shanghai Banking Corporation.

### *Capital Considerations*

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<sup>9</sup>Twelve U.S.C. § 72 requires that every national bank director be a citizen of the United States throughout his or her term of service. In addition, 12 U.S.C. § 76 requires that the president of a national bank must be a director. Consequently, Mr. Lent must be a United States citizen to hold these offices.

Proposed capital is sufficient to support the projected volume and type of business. NCI plans to capitalize the Bank with \$31.1 million comprised of cash, fixed assets, and all of the equity of the NFC, which currently purchases the NextCard receivables from Heritage Bank. Based upon the Bank's growth and earnings projections, this level of initial capital should ensure that the Bank's Tier 1 leverage ratio will exceed eight percent throughout the first three years of operations. Further, the OCC has imposed an additional capital requirement for the first three years based upon the Bank's total managed assets. During these initial years, the Bank must at all times maintain a ratio of capital-to-managed assets that is at least equal to 6.5 percent.<sup>10</sup> To maintain this ratio and to otherwise ensure "well capitalized" status under the FDIC's Prompt Corrective Action guidelines, NCI represents that it will make subsequent injections to the Bank as needed.<sup>11</sup> Given the unseasoned nature of the NextCard portfolio and Bank's reliance upon securitizations for funding, this capital requirement should help ensure that the Bank's capital base provides adequate protection against potential funding, credit, and other risks from off-balance sheet receivables. At the end of the first three years of operation, the OCC will determine whether any continuing additional capital requirements are necessary given prevailing industry standards and the Bank's condition.

NCI, the parent company, should have the financial capacity to provide additional capital if needed. To date, through private placements, NCI has raised \$55 million in capital from individuals and major venture capital firms. NCI's current capital structure is comprised of common stock and four series of convertible preferred stock. As of December 31, 1998, shareholders' equity totaled approximately \$40 million net of accumulated deficit with an equal amount held in cash and cash equivalents. Further, in March 1999, NCI filed a preliminary Registration Statement with the Securities and Exchange Commission to raise an additional \$65 million in new common stock through an initial public offering. All existing preferred shares will convert to common shares for a pro forma total capitalization of approximately \$105 million based upon year-end 1998 figures.<sup>12</sup> The initial public offering should provide more than sufficient capital to fund any necessary capital injections in the Bank's early years.

### *Earnings Considerations*

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<sup>10</sup>Capital for this purpose is defined as equity, as determined under generally accepted accounting principles, plus the allowance for loan losses. Managed assets is defined as the sum of on-balance sheet assets and off-balance sheet securitized receivables.

<sup>11</sup>See also Section 38 of the Federal Deposit Insurance Act (12 U.S.C. § 1831o), as added by Section 131 of the Federal Deposit Insurance Corporate Improvement Act of 1991 (FDICIA).

<sup>12</sup>Prior to the proposed offering but adjusted to reflect the conversion of all outstanding shares of preferred stock to common stock and the exercise of all vested stock options and warrants, the principal shareholders of NCI are Brentwood Venture Capital (20.66%), Jeremy R. and Molly Lent (10.75%), and Moore Capital Management, Inc. (9.98%). Other major stockholders include Kleiner Perkins Caulfield & Byers (7.99%), Forrest Binkley & Brown (7.44%), Trinity Ventures (7.34%), and St. Paul Venture Capital (7.24%). As a group, NCI's officers and directors control 56.46%.

The Bank's financial projections show a positive net interest margin that is in line with current industry performance. It is reasonable to expect that the proposed Bank can achieve and maintain profitability in line with these projections. The majority of the Bank's revenues will be generated by the interest income and fees received from outstanding balances.<sup>13</sup> Similarly, interest paid on deposits and other borrowings will be a major expense item. While the Bank will be exposed to interest rate risk, it plans to manage and control this risk using interest rate hedging techniques, an area where management is well-versed. Through its Internet direct marketing strategy, the Bank should be able to realize lower customer acquisition costs than competitors using direct mail. Further, through its high underwriting standards and software that optimizes balance transfers for new applicants, the Bank has the potential to continue building a portfolio of quality revolvers. The financial projections show the Bank becoming profitable within three years using reasonable growth assumptions.

Although growth in credit card receivables has moderated in the late 1990s, the credit card business line remains profitable with recent improvements in asset quality and earnings. While the number of credit card banks has declined from a high of 77 in 1996, the remaining 68 banks reported an average ROAA for 1998 of 2.89 percent, above the 2.66 percent average for the trailing 5-year period.<sup>14</sup> Moody's Investor Service and Fitch IBCA, bond rating agencies that track the performance of credit card issuers and related securitizations, have both reported improving asset quality trends with charge-off rates at an 18-month low of approximately 6 percent and principal repayment rates approaching historical highs.<sup>15</sup> The improved results stem from tighter underwriting standards, lower consumer debt burdens due to mortgage refinancing and debt consolidation, and strong domestic economic conditions. Further, in its most recent comprehensive report on the U.S. credit card industry, Moody's predicts:

The dramatic consolidation of the last few years will continue, as more smaller credit card issuers conclude that without sufficient scale, the long-term profitability of credit cards no longer meets their own internal profit goals. Ultimately, this will result in an industry dominated by a small handful of mega-issuers, although the strongest independent niche players are likely to survive.<sup>16</sup>

There are reasonable prospects that the Bank will attract its proposed customer base notwithstanding the highly competitive and consolidating nature of the credit card industry.

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<sup>13</sup>Other important sources of revenue include late fees, over-limit fees, and VISA system fees.

<sup>14</sup>Figures are based upon information provided by the FDIC. A credit card bank is defined here as a bank with a loan-to-assets ratio greater than 50% and a credit card loan-to-total loans ratio greater than 50%.

<sup>15</sup>See "Credit Card Credit Indexes," Moody's Special Report, March 30, 1999; and "Credit Card Movers & Shakers," Fitch IBCA, March 1999.

<sup>16</sup>See "U.S. Credit Cards, Industry Outlook," Moody's Investor Service, April 1999, p.5.

The NextCard is uniquely positioned as the first completely Internet-based credit card. It has already achieved a brand identity among Internet-active adults as a result of its aggressive online advertising campaign over the last year. In its first 15 months of operations, the NextCard Web site received one million "hits" resulting in 40,000 active accounts and \$125 million in receivables. NCI management is adapting for the growing Internet market, database analysis and direct marketing skills from their previous experience at credit card companies. NCI's basic strategy is to contract with financial and nonfinancial Web sites and portals (e.g., Netscape NetCenter, Yahoo, etc.) for frequently appearing banner advertisements, or billboard-like space, on the sites. In addition, NCI is developing so-called affiliate relationships with other Web sites that meet its quality standards. Affiliates post a NextCard logo on their site, providing a direct link to the NextCard Web site and receiving payments for each new NextCard customer gained via their Web site. NCI performs extensive analysis on the quality, characteristics, and behavior of customers acquired from each source and constantly adjusts its advertising strategy.

Direct Internet marketing of credit cards appears to be an attractive and untapped area compared to the more traditional direct mail techniques. Although the credit card industry mailed a record 3.45 billion pieces last year, according to a recent study by BAIGlobal, the response rate hit an historical low of 1.2 percent.<sup>17</sup> The online market and customized products offer the Bank a marketing and technology advantage over its offline competitors. In addition, its unique and proprietary online application process offers the Bank an advantage over its online competitors. A relatively untapped marketplace, the same BAIGlobal study reported that online applications accounted for only 2.0 percent of new card accounts. The Bank clearly has a marketing and technology advantage on the Internet at this time, but will need to continue to enhance this niche position to remain competitive in the future.

### *Safety and Soundness Considerations*

The OCC is satisfied that the Bank will be operated in a safe and sound manner. Based upon preliminary review, NCI management has established a good foundation of personnel, policies, and controls which will be adopted by the Bank. The OCC will confirm this during the preopening examination. Particular focus areas include funding risk, technology risk management, Year 2000 compliance, credit risk management, fraud management, and customer privacy.<sup>18</sup>

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<sup>17</sup>American Banker, pp. 1 and 13, April 8, 1999.

<sup>18</sup>At the preopening examination, the OCC will review the Bank's policies, procedures, and controls for ensuring customer privacy and compliance with consumer protection laws and regulations. This review will include confirmation that adequate policies have been implemented in these areas and that supervisory recommendations made during the field investigation have been satisfactorily addressed. The OCC also expects that the Bank's policies and procedures will comply with guidance issued by the OCC and the Federal Financial Institutions Examination Council (FFIEC) with respect to customer privacy, consumer protection, and electronic banking, including OCC Bulletin 98-31 (FFIEC Guidance on Electronic Financial Services and Consumer Compliance) and

As a monoline organization and national credit card bank under CEBA, the inherent liquidity risk will be relatively high. Funding alternatives for the Bank will be limited primarily to jumbo institutional and jumbo retail certificates of deposit, asset-backed conduit facilities, bank lines of credit, and term securitizations, both private placements and public offerings.<sup>19</sup> The Bank anticipates that it will be able to manage and control this liquidity risk by diversifying across sources, limiting concentration from a single source, establishing and maintaining back-up credit lines and conduit facilities, and limiting exposure to brokered funds. Securitizations will be a major funding source, and the Bank's projected securitization levels are consistent with those at other monoline credit card banks. The OCC is requiring that the Bank develop and integrate into its funds management policy and system a comprehensive contingency funding plan. The objective of the plan, which should be updated periodically, is to help ensure that the Bank can prudently and efficiently manage potential liquidity fluctuations.

For the first three years of operation, the OCC is limiting the Bank's securitization activity to the level specified in the Bank's current operating plan, 73 percent of its aggregate receivables. This condition is designed to ensure that the Bank limits funding concentration and has sufficient receivables on hand to manage outstanding asset-backed securities. The Bank must seek prior OCC approval to engage in securitization activities in excess of this percentage limitation.

As part of the operating plan submitted to the OCC, the proposed Bank has outlined the existing information systems architecture and proposed changes. This includes a description of the system and discussion of the technologies used and key elements for the security controls, internal controls, and audit procedures. Based upon our review of the plans, the OCC is satisfied with the plans to date, but will review further during the organizational phase of the Bank. Prior to receiving final charter approval, we are requiring the Bank to submit the final information system and operations architecture plans for the OCC's review and approval. In addition, before implementation, the Bank's computer system must successfully undergo a comprehensive security review by an objective and qualified source, including adequacy of protection against unauthorized external access. Going forward, the Bank will be expected to adhere to current and future OCC issuances on technology risk management.<sup>20</sup>

The proposed Bank has represented that its internal systems are Year 2000 compliant and that it is performing sufficient due diligence and testing to ensure that third-party data processing

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OCC Bulletin 98-38 (Technology Risk Management: PC Banking), and the Bank will carefully consider OCC Advisory Letter 99-3 (Fair Credit Reporting Act); <http://www.occ.treas.gov/bullst98.htm> and <http://www.occ.treas.gov/ftp/advisory/99%2D3.txt>, respectively.

<sup>19</sup>The Bank recognizes that the NextCard portfolio must sufficiently season for an additional one or more years before the Bank can successfully conduct a private placement or public offering of a term securitization.

<sup>20</sup>See "Technology Risk Management: PC Banking," OCC Bulletin 98-38 (August 24, 1998); <http://www.occ.treas.gov/bullst98.htm>.

services or purchased applications and systems from software vendors will also be Year 2000 compliant. The Bank believes that it is in satisfactory compliance with all OCC and FFIEC guidelines and timeframes for Year 2000 project management. The satisfactory Year 2000 status will be confirmed at the preopening examination.<sup>21</sup>

Bank management and staff appear to have significant knowledge and experience in the credit underwriting and risk management area. The Bank will use NCI's proprietary underwriting algorithms in its credit scoring model. NCI has developed a conservative set of underwriting criteria based upon risk models in conjunction with decision rules developed internally. The Bank will periodically re-evaluate each credit line to determine whether an increase or decrease is appropriate given line utilization, usage patterns, and behavioral risk scores. The Bank will regularly audit the algorithm and closely monitor it for accuracy.

The proposed Bank intends to minimize potential fraud losses by applying sophisticated fraud management techniques. This includes computer-based and manual procedures for identity verification and 24-hour account monitoring for suspicious activity. NextCard also subscribes to an extensive fraud prevention database that captures all transactions processed by First Data Resources (FDR), or approximately 68 percent of all credit card activity nationally.

NextCard has developed and implemented a privacy policy.<sup>22</sup> The policy, which will be adopted by the Bank upon its formation, informs the customer what information is being gathered and tracked, how this information is used, and with whom the information is shared. The privacy policy, along with the linked data security policy, is easily accessed from all areas of the Web site, including during the online application process. The privacy policy states that NextCard collects confidential customer data to determine whether it can offer credit and to generate a customized credit card offer. The information is shared with national credit bureaus to conduct a credit check. NextCard also tracks the hyperlink that the customer used to find the NextCard site for marketing analysis purposes. It also shares aggregated customer and hyperlink tracking data for the purpose of securing discounts and incentives for customers; the proposed Bank represents that aggregated data does not include personally identifiable customer information. The Bank further represents that its management will be integrally involved in policy development and planning in this area and that the Bank will develop and implement processes to ensure employee understanding and adherence to its stated policy.

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<sup>21</sup>See "Year 2000 and Systems Integration Considerations in Corporate Application Decisions," OCC Advisory Letter 98-1 (January 20, 1998); <http://www.occ.treas.gov/advl98.htm>.

<sup>22</sup>On May 4, 1999, the OCC issued guidance for national banks on examples of effective practices for informing customers over the Internet about bank policies for the collection and use of personal information. The guidance discusses examples of effective practices for the development of bank privacy policies and measures for ensuring adherence to those policies.

Finally, the Organizers represent that the Bank will not indicate in any of its marketing efforts or materials that the OCC has approved or endorsed the security, functionality, or effectiveness of the Bank's products or services.

Inclusive of the preopening requirements and ongoing conditions outlined below, the OCC believes that the Bank has a reasonable chance for success and can be adequately supervised using established safety and soundness and bank information system examination procedures. Before the Bank receives its final charter approval, the OCC will first conduct a thorough preopening examination of the Bank, including its information systems environment, Year 2000 compliance status, policies, procedures, controls, and compliance with all standard and special preopening requirements.<sup>23</sup>

## **B. Community Reinvestment Act Considerations**

Under the Community Reinvestment Act (CRA) regulations, the OCC must take into account a proposed insured national bank's description of how it will meet its CRA objectives. (See 12 C.F.R. Part 25). The Bank's operating plan includes such a description. Since the Bank proposes to focus exclusively on credit card products, it has requested to be designated as a limited purpose bank for evaluation under the CRA. Under the CRA regulation (12 C.F.R. § 25.12(o)), a limited purpose bank is defined as "a bank that offers only a narrow product line (such as credit card or motor vehicle loans) to a regional or broader market. . . ."

The OCC assesses a limited purpose bank's record of helping to meet the credit needs of its assessment area under the community development test through its community development lending, qualified investments, and services. (See 12 C.F.R. § 25.25). The Bank plans to delineate the San Francisco-Oakland-San Jose CMSA as its assessment area, and to serve this community by making qualified investments and providing community development services as defined in the CRA regulations. The proposed Bank has already performed initial reviews of its assessment area to determine availability of qualified investment opportunities. The Bank represents that it will also evaluate community development service opportunities upon its formation. This large, diverse assessment area should present numerous qualified investment and community development service opportunities for the Bank.

Based upon a review of the proposed operating plan, the OCC has determined that the proposed Bank will only offer a narrow product line to a regional or broader market, and, accordingly, has approved the Bank's request for designation as a limited purpose bank for

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<sup>23</sup>The Bank's operating plan, including any future additions or revisions, will provide the context for the supervisory review during the preopening examination. Major deviations from the operating plan or changes in the composition of the board of directors, ownership, or executive officers that the OCC has not approved may result in withdrawal of preliminary conditional approval.

evaluation under the CRA.<sup>24</sup> The OCC believes that the Bank's plan for meeting its CRA objectives is consistent with preliminary approval for this charter application.

### **C. Legal Considerations**

The OCC charters a national bank under the authority of the National Bank Act of 1864, as amended, 12 U.S.C. § 1 *et seq.* There is no impediment under the National Bank Act to granting this preliminary charter approval.<sup>25</sup> Similarly, there is no legal impediment to ownership of the Bank by NCI, since NCI will not be a bank holding company under either federal or state law. See 12 U.S.C. § 1841(c)(2)(F) and Cal. Fin. Code § 3700 (West Cum. Supp. 1999), respectively.

The Bank has indicated in its application that certain core functions of its internal operations, as well as the operation of the computer interface with customers, will be contracted out to various vendors. The process of subcontracting activities which the Bank would otherwise perform itself implicates the requirements of the Bank Service Company Act, 12 U.S.C. § 1861 *et. seq.* In particular, 12 U.S.C. § 1867(c) states, in part, that

[n]otwithstanding subsection (a) of this section, whenever a bank that is regularly examined by an appropriate Federal banking agency, or any subsidiary or affiliate of such a bank that is subject to examination by that agency, causes to be performed for itself, by contract or otherwise, any services authorized under this chapter, whether on or off its premises - (1) such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the bank itself on its own premises . . . .

Pursuant to this statute, services performed for the Bank by contract or otherwise, including the provision of data processing services, Web site support, and fraud detection, will be subject to the examination and regulation of the OCC. The Bank has represented that it will notify potential vendors, in writing, of the OCC's examination and regulatory jurisdiction should they

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<sup>24</sup>The limited purpose bank designation will remain effective until the bank requests revocation or until one year after the OCC notifies the Bank that it has revoked the designation. The Bank would no longer qualify for such a designation if it begins to make loans which are traditionally evaluated under the CRA.

<sup>25</sup>The statutory requirements for chartering a national bank under the National Bank Act are as follows: articles of association and an organization certificate must be drafted and filed with the OCC, 12 U.S.C. §§ 21-23; the required amount of capital must be paid in, 12 U.S.C. § 53; certain requirements relating to directors must be satisfied, 12 U.S.C. §§ 71-73; and the OCC must be notified when these things have been accomplished, 12 U.S.C. § 26. As is typical with new charter proposals, these requirements will be satisfied after the OCC grants preliminary approval.

contract with the Bank.<sup>26</sup> This understanding regarding OCC jurisdiction will be included in all vendor contracts. Accordingly, subcontracting these functions to a vendor will not frustrate the OCC's ability to regulate all aspects of the Bank that could affect its safe and sound operations.

As part of its application to charter the Bank, NCI has also filed an application for the Bank to acquire NextCard Funding Corporation ("NFC") as a wholly-owned operating subsidiary, pursuant to OCC regulations at 12 C.F.R. § 5.34. NFC, a Delaware corporation, is presently a wholly-owned subsidiary of NCI and has its offices in the same building as NCI and the Bank. Upon the formation of the Bank, NCI will contribute its stockholder's equity in NFC, together with all of NFC's assets and liabilities<sup>27</sup>, to the Bank. The transaction will be recorded at book value, consistent with Generally Accepted Accounting Principles (GAAP).

NFC's current activities consist of purchasing on a daily basis all NextCard receivables originated and funded by Heritage Bank, utilizing a revolving credit facility extended by a third party lender.<sup>28</sup> The purchased receivables are then conveyed into a master trust facility which may be used, in the future, to securitize the receivables. Payments by cardholders are used to pay down the credit facility, and in the meantime the trust certificates received from the trust in exchange for the receivables are pledged to the lender as collateral for repayment. It is well settled that these are permissible activities for national banks and their operating subsidiaries. See, e.g., 12 C.F.R. § 5.34(e)(2)(ii)(L) and Interpretive Letter No. 540, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,252 (December 12, 1990). In any event, once NFC is acquired by the Bank, its functions will either no longer be needed or will be performed directly by the Bank. As its existing portfolio is paid down, net revenues will be transferred up to the Bank and NFC will become inactive.

### **III. PREOPENING REQUIREMENTS AND SUPERVISORY CONDITIONS**

In all cases, following review of a new bank charter application, the OCC decides whether to grant preliminary approval, preliminary conditional approval, or disapproval to the request. Preliminary approval indicates permission to proceed with the organization of the bank according to the plan set forth in the application. The organizational steps of a new national bank generally include hiring management and staff, establishing premises, purchasing

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<sup>26</sup>Elements of the services to be provided to the Bank may be performed by third party vendors through NCI. These services will constitute activities pursuant to the Bank Service Company Act (12 U.S.C. § 1861 *et seq.* ("BSCA")). To the extent that third party vendors perform these services for the Bank through NCI, the third party vendors will be subject to federal banking regulation and examination to the same extent as if such services were being performed by the Bank itself. Similarly, to the extent that NCI itself performs services for the Bank, those services will be subject to the BSCA.

<sup>27</sup>None of NCF's liabilities are owed to NCI.

<sup>28</sup>The credit facility covers up to 90% of the book value of the purchased receivables; the other 10% is funded by NFC from capital contributed by NCI.

computers and other equipment, selecting vendors, developing and implementing policies, procedures, and controls, and raising capital. Preliminary approval is not an assurance, however, that the OCC will grant a new national bank charter. Once the OCC grants preliminary approval to a charter proposal, the organizing group must satisfy certain procedural requirements, and in some cases special requirements, before the OCC will grant final charter approval. In addition, the OCC sometimes imposes conditions that will remain in place after the bank opens.

In this proposal, the OCC has decided to grant preliminary conditional approval subject to several preopening requirements and on-going conditions. These supplement the procedural requirements for a new national bank referenced in the transmittal letter to the Bank's spokesperson. The preopening requirements provide a framework for steps that the proposed Bank must successfully complete before the OCC can render a decision on final charter approval. The on-going conditions primarily establish certain checks and safeguards to ensure that the Bank, once open, will appropriately manage and control the relevant risks, maintain adequate capital and liquidity, and operate in an overall safe and sound manner. After the first three years of operations, all but two conditions should expire. The OCC will monitor the Bank's future actions and performance through the normal supervisory process.

In addition to the procedural requirements for all new national banks, the following requirements must be satisfied before the OCC will grant final charter approval:

1. The Bank's initial Tier 1 capital, net of any and all organizational and preopening expenses, must be no less than \$31.1 million.
2. The Bank must submit to the OCC for review and approval a complete description of the Bank's final proposed information system architecture. This should include a schematic drawing and discussion of the following items: vendors; due diligence performed on the third-party vendors; vendor contracts; system and data security mechanisms; internal controls; and internal audit plans.
3. The Bank must name an individual to serve as the Chief Technology Officer. The OCC must review and have no objection to this individual, who shall be deemed a Senior Executive Officer for purposes of 12 C.F.R. Part 5.
4. The Bank must have performed an independent security review and test of its Internet credit card bank platform. The Bank must have this review performed regardless whether the platform is operated in-house or by one or more third-party service providers. This review must be conducted by an objective, qualified internal or external source ("reviewer"). The scope must cover adequacy of protection against unauthorized external access including individual penetration attempts, computer viruses, denial of service, and other forms of electronic access. In addition, the review must assess the adequacy of internal security. By written report, the reviewer must confirm

that the security measures, including the firewall, have been satisfactorily implemented and tested. The report must critique the effectiveness of security policies and controls and confirm, with reasonable certainty, that unauthorized internal or external data and network access or access attempts are detected and recorded. As part of its decision to grant final charter approval, the OCC will consider the results of the report as well as any subsequent actions by the Bank or service provider to implement any recommendations or to remedy any noted security or control deficiencies.

5. The Bank must develop and implement a comprehensive Year 2000 project management program in compliance with OCC and FFIEC interagency guidelines and timeframes.
6. The Bank must develop and integrate into its funds management policy and system a comprehensive contingency funding plan. The objective of the plan is to help ensure that the Bank can prudently and efficiently manage potential liquidity fluctuations. The Bank should update the plan periodically, including as the Bank becomes more complex and industry conditions change. The plan should include administrative matters such as management responsibilities and communication flows during a funding crisis; triggers to alert management to a predetermined level of potential risk; predictions of on- and off-balance sheet changes, quantifying and matching potential cash flow sources and uses; and policies and strategies for critical periods.
7. The Bank must develop and implement a bank-wide disaster recovery contingency plan pursuant to OCC and FFIEC interagency guidelines.
8. The Bank must implement an independent internal audit function that is appropriate to its size and scope of activities. The internal audit function should be supervised and staffed by individuals with sufficient technology and credit card expertise to identify the risks inherent in the Bank's operations and to assess the effectiveness of internal controls.

Final approval will be subject to the following conditions:

1. The limitations of the Bank's activities must be enumerated fully in the Articles of Association. Specifically, the Articles must state:
  - C the business of the association will be limited to that of a national credit card bank as specified in the Competitive Equality Banking Act of 1987; and
  - C the Bank must obtain the prior written approval of the OCC before amending its Articles of Association to expand the scope of its activities and services.
2. In addition to minimum capital requirements established by 12 C.F.R. § 3.6, during the first three years of operation, the Bank must at all times maintain a ratio of capital-to-managed assets that is equal to or greater than 6.5 percent. Capital for this purpose is

defined as equity, as determined under generally accepted accounting principles, plus the allowance for loan losses. Managed assets is defined as the sum of on-balance sheet assets and off-balance sheet securitized receivables. At the end of the Bank's first three years of operation, the OCC may determine that continuing additional capital requirements are necessary based upon prevailing industry standards and the Bank's financial condition.

3. For the first three years of operation, the OCC is limiting the Bank's securitization activity to the level specified in the Bank's current operating plan, 73 percent of its aggregate receivables. The Bank must seek prior OCC approval to engage in securitization activities in excess of this percentage limitation.
4. The Bank must notify all potential vendors in writing of the OCC's examination and regulatory authority under 12 U.S.C. § 1867(c). All final vendor contracts must stipulate that the performance of services provided by the vendors to the Bank is subject to the OCC's examination and regulatory authority.

The above listed conditions of this approval shall be deemed to be "condition[s] imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818(b)(1).

## **V. CONCLUSION**

The charter and operating subsidiary proposals satisfy the applicable statutory requirements of the National Bank Act and the policy standards of the OCC, as set forth in 12 C.F.R. §§ 5.20 and 5.34. For the reasons set forth above, including the representations and commitments made by the applicant, it is my conclusion that this proposed national bank has a reasonable likelihood of success. Accordingly, the applications are preliminarily approved, subject to the requirements and conditions outlined in this Decision Document and the transmittal letter.

If you have any questions regarding this decision, please contact John W. Graetz, Licensing Expert (Financial Analyst), in Bank Organization and Structure at (202) 874-5060.

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/s/  
Julie L. Williams  
Chief Counsel

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05-08-99  
Date

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