AUDIT OF SECURITIZATION RTC 1992-C4

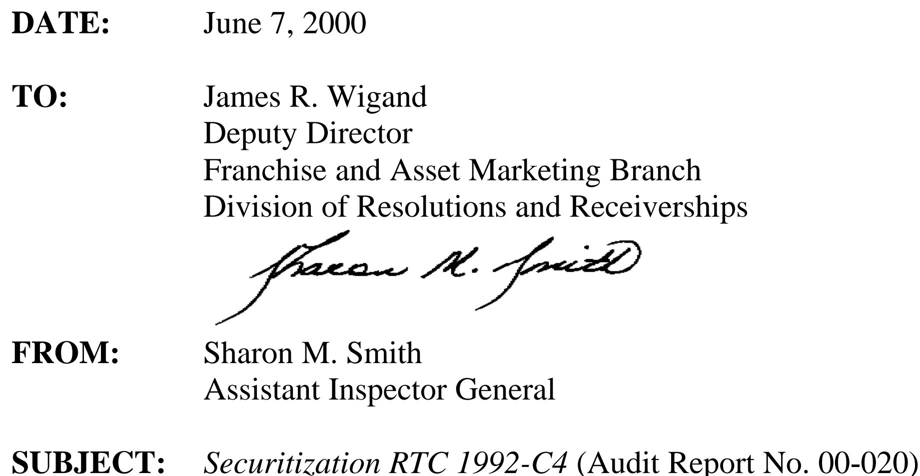
Audit Report No. 00-020
June 7, 2000

OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

DATE: June 7, 2000

TO: James R. Wigand
Deputy Director
Franchise and Asset Marketing Branch
Division of Resolutions and Receiverships



FROM: Sharon M. Smith
Assistant Inspector General

SUBJECT: *Securitization RTC 1992-C4* (Audit Report No. 00-020)

This report presents the results of the Office of Inspector General's (OIG) audit of securitization 1992-C4. Although, generally, the servicing fees were properly calculated, we found problems with realized loss calculations and with interest paid to certificateholders after loan liquidation. This report is the third OIG report issued in the last several years relating to commercial securitizations. The OIG previously issued reports entitled *RTC's Securitization Reserve Fund* (Audit Report No. 96-143), dated December 31, 1996, and *Securitization Credit Enhancement Reserve Fund 1992-CHF* (Audit Report No. 98-083), dated October 7, 1998.

BACKGROUND

From 1991 to 1995 the Resolution Trust Corporation (RTC) created a total of 73 securitized transactions. These transactions were backed by collateral consisting of one-to-four family residential mortgage loans, multi-family mortgage loans, commercial mortgage loans, and other types of mortgage loan pools. The RTC was the designated seller and had few defined responsibilities relative to these securitized transactions after closing. However, the RTC and its successor, the Federal Deposit Insurance Corporation (FDIC), have a substantial financial interest in these securitizations.[1] The FDIC now owns the Class R (residual) certificates from each transaction and the amounts remaining in the credit enhancement reserve funds.

The RTC funded credit enhancement reserves for each securitization. These reserve funds are designed to protect certificateholders by providing funds to cover principal lost by defaulted loans. Any resulting realized losses impact the reserve fund. Realized losses are defined in the securitization's Pooling and Servicing Agreement (PSA) as the unpaid principal balance of a

[1] In accordance with the RTC Completion Act of 1993, the RTC ceased operations on December 31, 1995. Responsibility for all RTC-related work was transferred to the FDIC effective January 1, 1996.

mortgage, plus accrued interest and expenses, minus net owned real estate (ORE) proceeds, net liquidation proceeds, or insurance. After a securitization is terminated, any remaining unused credit reserve funds revert to the FDIC.

Securitization 1992-C4 was initiated on June 24, 1992 and was comprised of 2,683 commercial loans with an aggregate principal balance over $935 million. The four most prominent loan types included in the securitization were office buildings, mixed-use buildings, retail outlets, and industrial/warehouse structures. The credit enhancement reserve fund for securitization 1992-C4 was established with a deposit of $280.8 million, or approximately 30 percent of the aggregate principal loan balances.

RTC, the master servicer, the special servicer, and the trustee signed a PSA at closing that described the obligations of the trustee and servicers. GE Capital Asset Management Corporation (GE Capital), as the master servicer, had primary responsibility for servicing the mortgage loans. GMAC Commercial Mortgage Corporation purchased the master servicing rights and began servicing on November 14, 1997. The master servicer maintained a collection account for deposits of principal and interest payments, all insurance proceeds relating to loans, income from loans that became ORE, and borrower expense reimbursements. The master servicer also deposited money to the collection account for late payments on specially serviced loans, assumption fees, modification fees, and other similar fees.

Each month, Chase Manhattan Bank (Chase), the trustee, calculated the amounts to be distributed to certificateholders. The trustee used a mathematical model to combine data supplied by the master servicer with various certificate classes, as described in the PSA, to determine distributions to the various certificate classes. Chase maintained its model on a computer spreadsheet that incorporated PSA information such as certificate rates and payment priority. The trustee used the funds wired from the master servicer's collection account to the distribution account for payments to the certificateholders. The trustee also maintained the reserve fund. The trustee replenished any collection account shortages with funds withdrawn from the reserve fund.

J.E. Robert Companies, Inc. (J.E. Robert), the special servicer, was responsible for servicing loans that met certain default criteria and required special servicing. The master servicer classified loans as special serviced loans and transferred them to the special servicer. Special serviced loans included loans with a past due balloon payment, loans over 60 days delinquent, delinquent loans that were expected to be cured by the borrower within 60 days, and loans involving court actions against the borrowers.

In addition to the ordinary servicing of loans, the special servicer was also responsible for calculating pool value reductions resulting from the discounting of mortgage loans when loans were modified or foreclosed. Under these circumstances, the special servicer performs a net present value calculation to determine the discounted principal balance of the modified loan. If the discounted principal balance is less than the scheduled principal balance, the trustee withdraws the difference from the reserve fund and the difference is distributed to the certificateholders as a payment of loan principal, or pool value reductions.

As compensation for its various responsibilities under the PSA, the special servicer receives monthly fees of (1) 150 basis points on the specially serviced loan unpaid principal balances, (2) an additional 50 basis points for supplemental servicing fees, and (3) a workout fee varying between 130 and 245 basis points (a basis point is equal to 1 hundredth of 1 percent).

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of the audit were to determine whether J.E. Robert correctly calculated realized losses and special servicer fees. We selected securitization 1992-C4 for audit because the securitization was scheduled to terminate in 1999. Our audit covered the period June 1992 through March 1999.

To accomplish the audit objectives, the OIG interviewed mortgage-backed securities (MBS) specialists from the FDIC's Division of Resolutions and Receiverships (DRR) and personnel from GMAC Commercial Mortgage Corporation; J.E. Robert; and Chase Manhattan Bank. The auditors reviewed the prospectus, the prospectus supplement, and the PSA for securitization 1992-C4. The OIG also reviewed the most recent Agreed-Upon Procedures Reviews, conducted at the FDIC's request, for GE Capital , the former master servicer (November 1994); the special servicer (October 1994); and the trustee (July 1999 draft).

J.E. Robert's special servicer portfolio manager provided us a universe of 503 realized losses totaling $56,288,302 for securitization 1992-C4. To determine whether realized losses included pool value reductions on Discounted Mortgage Loans (DMLs), we requested the universe of DMLs and received a list of 160 with $35,226,053 in pool value reductions. We matched the realized losses and DML universes to ensure that some of the sampled realized losses also had pool value reductions. We judgmentally selected nine realized losses of various disposition types and dollar amounts, representative of the universe, totaling $8,287,969. Six of the selected losses included pool value reductions. Our sample of nine realized losses included six ORE sales, two loans sold at foreclosure, and one abandoned apartment complex.

We reviewed special servicer's asset files for each of the nine realized losses in our sample. From these files we reviewed the settlement statements and other disposition documents to confirm the amount of the net proceeds. We reviewed loan histories and amortization schedules to verify the proper amount of principal and interest, the unpaid principal balances, and the inclusion of pool value reductions in the realized losses. We reviewed the adequacy of the documentation supporting the expenses charged to the realized losses. We also looked for any proceeds other than sale amounts, such as insurance premium refunds, utility deposit refunds, additional judgments, and real estate tax refunds.

For two of the sampled realized losses, we traced ORE net proceeds wired from the special servicer to the master servicer's collection account, the trustee distribution account, and finally to the certificateholder distribution. We selected only two realized losses because of the complexity in tracing the information through several entities. We verified that the master servicer's documentation and files agreed with the special servicer's records. We then traced the master

servicer's wire of the collection account funds to the trustee's distribution account and finally to the certificateholders.

In addition, we performed limited testing of the model the trustee used to calculate the distributions to the various certificate classes. We input additional payoffs and principal reductions into the model to determine whether the model correctly changed the distribution amounts and adjusted the reserve fund withdrawals accordingly.

For the review of special servicer fees, we judgmentally sampled 15 of the 84 months covered by our audit to determine the accuracy of the initial booking and removal dates for billing specially serviced assets. We then examined 4 of the 15 months in detail to determine the accuracy of the special servicer's computerized billings. We compared the special servicer's beginning balance on the database of loans for these 4 months, by group, with the master servicer's ending balance, giving consideration to loans added to the special servicing pool. We confirmed the accuracy of the special serviced asset receipt date and removal date by tracing the assets to the disposition receipt/removal report obtained from the master servicer. We compared the applicable special servicing rate and basic fee rate to the approved contracted rate within the PSA. In addition, to determine the accuracy of receipt dates and billing removal dates for the sample realized losses, we compared the dates on the special servicer disposition receipt/removal reports to the dates supported by the loan files.

We also judgmentally sampled 12 specially serviced assets within the universe of realized losses to determine the accuracy of workout fee calculations and rates. To do so, we compared month-end collection balances and final proceed balances with J.E. Robert account summaries and traced related expenses and invoices to J.E. Robert's expense roll-up report. We compared the workout fee rate to the applicable contract rate within the PSA.

The OIG did not perform a comprehensive review of J.E. Robert's internal controls. Instead, we relied on substantive testing to achieve our audit objectives. We performed our work primarily at the special servicer's office in Dallas, Texas; the trustee's office in New York, New York; the master servicer's office in Horsham, Pennsylvania; and the FDIC's offices in Washington, D.C. The audit was conducted from February 1999 through October 1999 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

Generally, J.E. Robert calculated its special servicing and workout fees for securitization 1992-C4 in accordance with the PSA. For calculating special servicing fees, the special servicer took the necessary steps to ensure that asset receipt and disposition data was correct and that the correct PSA servicing fee was applied for each month. For workout fees, the special servicer maintained accurate collection and final proceeds balances and applied the applicable contract rate per the PSA.

Although J.E. Robert billed for its services in accordance with the PSA, we identified problems associated with its realized loss calculations. First, the special servicer did not always complete realized loss computations in a timely manner. Consequently, the master servicer continued to schedule principal and interest payments to the certificateholders for five of our nine realized

losses in our sample, thereby unnecessarily paying certificateholders an average of 4 months of interest from reserve funds. Second, the realized loss calculations related to the six DMLs in our sample included pool value reductions already taken on the same loans, thus overstating the amounts in the trustee's reports to certificateholders and the FDIC.

THE SPECIAL SERVICER'S REALIZED LOSS CALCULATIONS WERE NOT COMPLETED TIMELY

For five of the nine realized losses sampled, the special servicer completed realized loss calculations more than 1 month after the sale or liquidation of the assets. When the special servicer delayed the realized loss calculations, the master servicer continued to treat the loans as delinquent and continued scheduling principal and interest payments on the remaining principal balances. Thus, the certificateholders continued to receive interest on loans that had been liquidated months earlier. For the five realized losses, the average delay between the actual loan liquidation and the date the special servicer calculated the realized loss was 4 months.

The net cost to the reserve fund was minimal when the off-set for interest earned by the reserve fund on the principal amount is taken into account. That is, by not writing-off the principal balances timely and distributing the principal to the certificateholders, the principal remained in the reserve fund where it was invested in short-term Treasury securities and earned interest at the U.S. Treasury Bill rate. At the same time, the master servicer calculated interest to be distributed to the certificateholders on the same principal balances but at the higher certificate rate. Therefore, the real loss to the securitization is the difference, or spread, between the Treasury Bill interest received while the principal remained in the reserve fund and the higher interest paid to certificateholders.

When the special servicer was asked why it did not calculate realized losses more timely, special servicer personnel stated that they usually delayed calculating realized losses while they continued pursuing deficiencies from the borrowers. They cited language in the PSA that, they believe, allowed them to hold a loan open after a sale to pursue deficiency judgments. Specifically, the PSA section regarding Final Recovery Determination reads that the asset could be held until "(i) the actual recovery of the full amount of all Insurance Proceeds, Liquidation Proceeds and other payments or (ii) recoveries (including proceeds of the final sale of any ORE property)." We believe that the PSA is somewhat vague regarding exactly when the special servicer is to compute realized losses and this vagueness was a contributing factor leading to the special servicer's delay in computing realized losses.

Although the PSA provision does not clearly indicate that the sale of ORE "must" trigger the final recovery and realized loss calculation, MBS personnel stated that assets should be written off and realized losses should be calculated promptly. Further, MBS advised us that despite some early confusion about loan write-offs for securitizations, in 1994 MBS notified all servicers that they should promptly write off loans after ORE liquidation. Master servicer personnel also stated that the special servicer should have calculated realized losses in a more timely manner. However, the master servicer explained that, under the PSA, the master servicer was not permitted to take any action to write off specific loan balances until directed to do so by the special servicer.

Conclusion and Recommendations

We recognize that the dollar effect of the additional interest paid to certificateholders may be small on a loan-by-loan basis. However, the amount of additional interest could be significant when the total number of loans handled by J.E. Robert and other special servicers are considered.

Accordingly, we recommend that the Deputy Director, Franchise and Asset Marketing Branch, DRR:

(1) Issue a letter to all special servicers reiterating the importance of calculating realized losses in a timely manner.

(2) Ensure that future Agreed-Upon Procedures Reviews include steps for determining the timeliness of the special servicers' realized loss calculations.

THE SPECIAL SERVICER'S REALIZED LOSS CALCULATIONS DUPLICATED PRIOR POOL VALUE REDUCTIONS

The special servicer's realized loss calculations for the six DMLs in our sample included pool value reductions that were already taken on the same loans. Specifically, for the six loans, the special servicer's realized loss calculations did not identify pool value reductions totaling $3,440,190 previously withdrawn from the reserve fund. As a result, the realized losses for the six loans were overstated and inaccurate data was used to develop allowance accounts appearing in the FDIC's financial statements.

In one example, in February 1995, the special servicer reported a $964,772 pool value reduction on a loan to the master servicer. Based on this information, the trustee withdrew that amount out of the reserve fund for distribution to certificateholders. In August 1996, the loan was foreclosed and the underlying property was sold, at which time, the special servicer computed a realized loss of $1,831,070 based on the final principal balance of $1,864,729. However, the special servicer did not reduce the final principal balance by the $964,772 pool value reduction that it had reported earlier. As a result, when the trustee reported the realized loss to the certificateholders and the FDIC, the realized loss was overstated by the $964,772 pool value reduction already taken and reported.

When asked why it did not account for previous pool value reductions when calculating realized losses on the six DML loans in our sample, the special servicer said the master servicer was responsible for maintaining DML balances. We also noted that, although the PSA defines pool value reductions and provides a methodology for calculating realized losses, the PSA does not address the issue of duplicating pool value reductions in realized loss calculations.

It is important to note that there is no dollar effect related to this improper reporting. The impact to the FDIC is limited to its use of pool value reduction and realized loss information in determining allowance accounts in the FDIC's financial statements.

Conclusion and Recommendations

Realized losses and pool value reductions are reported to the FDIC on the monthly Statement to Certificateholders. The FDIC uses both pool value reductions and realized losses in its financial statements and maintains allowances for realized losses and pool value reductions based on historical data that is assumed to be accurate and not overstated.

However, to minimize the possibility that realized loss calculations reported to the FDIC duplicate previous pool value reductions, we recommend that the Deputy Director, Franchise and Asset Marketing Branch, DRR:

(3) Ensure that future PSAs make clear that the calculation of realized losses should take into account previously taken pool value reductions.

(4) Issue a letter to the special servicers requesting them to identify, in future realized loss calculations, pool value reduction amounts already taken.

(5) Issue a letter to the trustees requesting them to inform the FDIC and the certificateholders of pool value reductions included in the reported realized loss calculations.

CORPORATION COMMENTS AND OIG EVALUATION

On May 18, 2000, the Deputy Director of DRR's Franchise and Asset Marketing Branch provided a written response to a draft of this report. The Deputy Director's response agreed with the recommendations and provided the requisites for a management decision on each of the five recommendations. The Deputy Director's response is presented as appendix I of this report.

A summary of the Deputy Director's response to recommendation 2 and our analysis follows. The responses to recommendations 1, 3, 4, and 5 are not summarized because the actions planned or completed are identical to those recommended.

Include steps for determining the timeliness of the special servicers' realized loss calculations in future Agreed-Upon Procedures Reviews performed at the FDIC's request by contract auditors (recommendation 2): The Deputy Director stated that "The Agreed Upon Procedures work programs since early 1994 have included steps to verify that the realized loss calculations are prepared accurately and filed on a timely basis." Further, the Deputy Director provided us a copy of the current agreed upon procedures, which clearly include a step to determine whether realized loss calculations are prepared and forwarded timely. Such prior actions address our recommendation. However, although the proper controls were in place, we found in our audit that the contract auditor's procedures did not include a step to verify the timeliness of the realized loss calculation for Securitization 1992-C4. The auditor included steps

to perform the timeliness check for other securitizations covered in its review—just not for Securitization RTC 1992-C4. Accordingly, we will revise our recommendation to read: Ensure that future Agreed-Upon Procedures Reviews include steps for determining the timeliness of the special servicers' realized loss calculations. The emphasis is on ensuring that contract auditors perform the required review steps.

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
Division of Resolutions and Receiverships
Washington, D.C. 20429

Date: May 16, 2000

Sharon M.Smith
Assistant Inspector General
Federal Deposit Insurance Corporation
Office of the Inspector General
801 17th St., N.W.
Washington, D.C. 20429

Re: Draft Audit Report -- Securitization RTC 92-C-4

Dear Ms. Smith:

This letter is in response to the conclusions and recommendations made as a result of the OIG's audit of the subject securitization. The objective of this audit was to determine if the special servicer correctly calculated realized losses and special service fees. Generally, the audit found that the servicing fees were properly calculated. However, the audit did find problems with the realized loss calculations and the interest paid to certificateholders after loan liquidations.

The report was divided into two parts:

Part I - Finding
The Special Servicer's Realized Loss Calculations Were Not Completed Timely

Recommendations

1. Issue a letter to all special servicers reiterating the importance of calculating realized losses in a timely manner.

2. Include steps for determining the timeliness of the special servicers' realized loss calculations in future Agreed Upon Procedures' Reviews performed at the FDIC's request by contract auditors.

Response

The finding states that when the special servicer delayed the realized loss calculations for five of the nine realized losses samples, the master servicer continued to treat the loans as delinquent and continued scheduling principal and interest payments on the remaining principal balances. The finding indicates that this resulted in inappropriate draws from the Reserve Funds for an average of four months to pay scheduled interest due to certificateholders.

We concur that realized losses should be calculated and filed with the trustee on a timely basis. We do not agree that the Pooling and Servicing Agreements (PSAs) give the servicers considerable latitude in determining when a realized loss should be reported to the trustee based on a "Final Recovery Determination". However, since 1994, it has been the express policy of MBS Administration, clearly communicated to the servicers, that realized losses should be filed on a timely basis after liquidation, with subsequent amendments as appropriate. We will continue to emphasize this policy to the servicers.

We believe the financial impact of the finding may be less than implied in the report. The PSA requires that liquidation proceeds received during each prepayment period be reported to the Trustee and passed through to certificateholders during the related distribution date. The master servicer should be reducing the scheduled principal balance of liquidated assets accordingly. Thereafter, even if some principal balance remained outstanding, the scheduled interest should be calculated on the reduced scheduled principal balance. Because there was not a finding with respect to timely remittance of liquidation proceeds to the Trust, we assume that this was not an issue.

With respect to the OIG recommendations we will do the following:

1. We will issue a letter to all the commercial and multifamily servicers by July 31, 2000, reemphasizing MBS Administration policy that the final recovery determination should be completed during the month of asset liquidation, with the scheduled principal balance reduced to zero.

2. The Agreed Upon Procedures work programs since early 1994 have included steps to verify that the realized loss calculations are prepared accurately and filed on a timely basis. This step is also included in the current standardized work program, a copy of which is attached.

Part II - Finding
The Special Servicer's Realized Loss Calculations Duplicated Prior Pool Value Reductions

Recommendations

3. Ensure that future PSAs make clear that the calculations of realized losses should take into account previously taken pool value reductions.

4. Issue a letter to the special servicers requesting them to identify, in future realized loss calculations, pool value reductions amounts already taken.

5. Issue a letter to the trustees requesting them to inform the FDIC and the certificateholders of pool value reductions included in the reported realized loss calculations.

Response

Based on the information presented in the OIG report, we concur with the finding, including the statement that there is no dollar effect related to the reporting by the special servicer. It appears based on the information presented that the special servicer's realized loss calculations were

Note: The attachment referred to above is not included.

prepared in accordance with the requirements of the PSA. We believe that the PSA is clear with respect to the inclusion of pool value reductions in the calculation and reporting of realized losses. As we read the finding, the OIG is really questioning whether the information is presented in the Statement to Certificateholders in a manner that is most useful to the FDIC in connection with the its calculation of internal loss reserves.

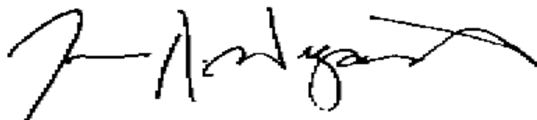
With respect to the OIG recommendations we will do the following:

1. In drafting future PSAs, we will consider the extent to which reporting by the trustee in monthly Statements to Certificateholders can or should be clarified to be most useful to investors, rating agencies and the FDIC.

2. We will issue a letter to the special servicers and trustees by July 31, 2000, requesting that monthly realized losses as reported in the Statements to Certificateholders be footnoted to show the amount of realized loss that resulted from pool value reductions. We will request this be done on a prospective basis, and that cumulative figures be reported if this can be determined without undue expense.

If you have any questions, please contact me at 202-898-6714.

Sincerely,



James R. Wigand
Deputy Director, Franchise and Asset Marketing

cc: Bruce Gimbel, OIG
Dean Eisenberg, Internal Review

MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid. Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report and subsequent discussions with management officials.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	DRR will issue a letter to all the commercial and multifamily servicers re-emphasizing MBS Administration policy that the final recovery determination should be completed during the month of asset liquidation, with the scheduled balance reduced to zero.	August 31, 2000	Letter to commercial and multifamily servicers	$0	Yes
2	Agreed Upon Procedures work programs include steps to verify that realized loss calculations are prepared accurately and filed on a timely basis.	Completed	Current Standardized Work Program	$0	Yes
3	In drafting future PSAs, DRR will consider the extent to which reporting by the trustee in monthly Statements to Certificateholders can be clarified to be most useful to investors, rating agencies, and the FDIC.	Date of next PSA	Appropriate section of future PSA	$0	Yes
4 and 5	DRR will issue a letter to the special servicers and trustees by July 31, 2000, requesting that monthly realized losses as reported in the Statements to Certificateholders be footnoted to show the amount of realized loss that resulted from pool value reductions.	August 31, 2000	Letter to special servicers and trustees	$0	Yes