AUDIT OF BANK MIDWEST, NA
RTC MORTGAGE TRUST 1995-SN2

Audit Report No. 99-021
April 15, 1999

OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

April 15, 1999

MEMORANDUM TO: John F. Bovenzi, Director
Division of Resolutions and Receiverships

FROM: David H. Loewenstein
Assistant Inspector General

SUBJECT: *Bank Midwest, NA - RTC Mortgage Trust 1995-SN2*
(Audit Report No. 99-021)

The OIG completed an audit of Bank Midwest, NA, the trust servicer for the RTC Mortgage Trust 1995-SN2. The trust, created on September 1, 1995, consists of a Class A Certificate Holder, Chillicothe Properties, Inc., and a Class B Certificate Holder, the Resolution Trust Corporation (RTC).[1] The Division of Resolutions and Receiverships (DRR) is responsible for the oversight of the trust. DRR contracted with Aldridge, Eastman, and Waltch (AEW) to assist DRR in its oversight responsibilities and to oversee RTC's interest in the SN-Series transactions. Bank Midwest, in addition to being the asset servicer for the trust, was controlled by the trustee of Chillicothe Properties, the Dickinson Financial Corporation.

DRR management contacted the Office of Inspector General requesting audits of various trusts. We selected the 1995-SN2 trust for review because of the close relationship between Chillicothe Properties and the trust servicer.

[1] In accordance with the RTC Completion Act of 1993, the RTC ceased to exist on December 31, 1995. Responsibility for all RTC-related work transferred to the FDIC as of that date.

BACKGROUND

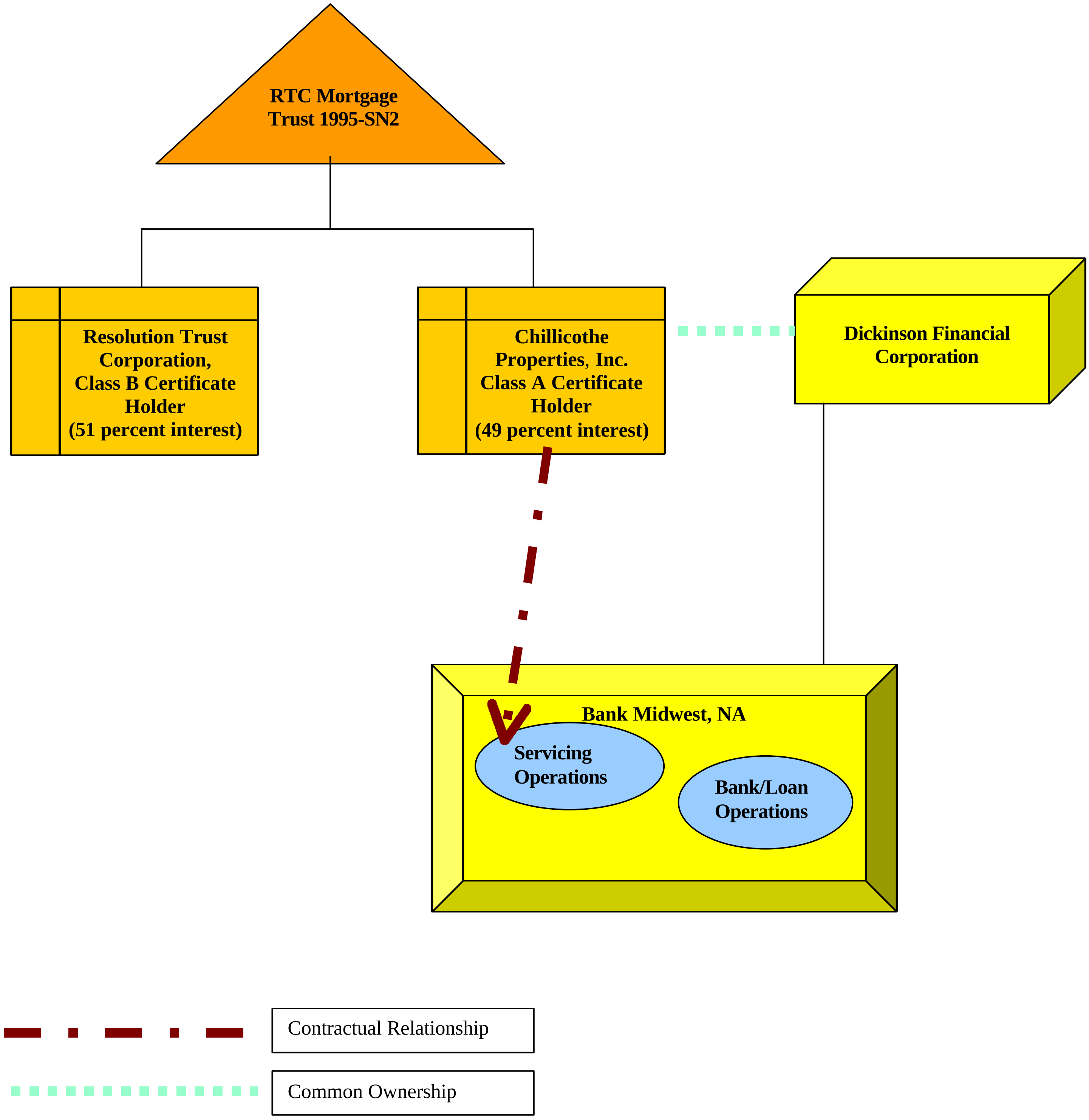
The RTC, acting in its corporate capacity and its capacity as conservator or receiver, had the authority to create a trust that sold, through a competitive bid sale, certificates representing a percentage of beneficial ownership in that trust. The 1995-SN Series consisted of five pools of selected sub-performing and non-performing commercial mortgage loans of several depository institutions.

The RTC Mortgage Trust 1995-SN2 was organized as a limited purpose Delaware trust. One of the purposes of the trust was to dispose of the assets purchased from the RTC as promptly as possible in a manner that maximized economic return. On September 1, 1995, the RTC entered into a deposit trust agreement with the owner trustee, Wilmington Trust Company. The owner trustee is responsible for ensuring that all parties to the transaction fulfill their respective obligations under the deposit trust agreement. In exchange for the assets, the RTC received from the owner trustee two types of equity certificates - the controlling Class A Certificate and the non-controlling Class B Certificate. The RTC, in turn, sold the Class A Certificate to the winning bidder, Chillicothe Properties, Inc. The RTC held the Class B Certificate.

The Class A Certificate entitled Chillicothe Properties to 49 percent of the income generated by the trust and responsibility for the daily operations of the trust. In connection with the purchase of the Class A Certificate, Chillicothe Properties entered into a servicing agreement with Bank Midwest located in Kansas City, Missouri, to service mortgage loans and manage, market, and dispose of the trust assets.

It is important to note that the Class A Certificate Holder, Chillicothe Properties, and the trust servicer, Bank Midwest, are related entities. That is, Bank Midwest is a subsidiary of Dickinson Financial Corporation. The founder of Dickinson Financial Corporation also created Chillicothe Properties as a trust for his children, in which he acted as the trustee. Upon his death in February 1997, control of Chillicothe Properties trust passed to his children. In addition, his interest in Bank Midwest and other entities within Dickinson Financial Corporation passed to his children and widow. Bank Midwest acts as the trust servicer and maintains the trust's bank accounts. Figure 1 illustrates these relationships.

Figure 1: Relationship of Related Parties



Source: OIG Analysis

Chillicothe Properties purchased 49 percent of the trust for $8.2 million. The Class B Certificate (which transferred from the RTC to the FDIC as of December 31, 1995) had a 51 percent interest in the trust. The trust, pursuant to an agreement with State Street Bank (the bond trustee), issued $22 million of commercial loan-backed bonds to the RTC, which were secured by a collateral assignment of the trust assets to the bond trustee.

OBJECTIVE, SCOPE, AND METHODOLOGY

We performed an audit of the trust servicer's compliance with the agreements relating to the RTC Mortgage Trust 1995-SN2 for the period of September 1, 1995 through April 30, 1998. The objective of the audit was to determine whether Bank Midwest, as the trust servicer, properly reported income and expenses and made appropriate bond payments and distributions.

We interviewed FDIC personnel from DRR's Asset Management Group to become familiar with the nature of the transaction. To understand the process and controls for collecting, reporting, and paying expenses, as well as paying off the bond, we interviewed personnel at AEW and Bank Midwest. Our audit focused on areas we considered to be material to the trust activity or vulnerable to noncompliance. During our audit, we judgmentally selected samples of expense payments, asset dispositions, and equity distributions to verify whether Bank Midwest properly accounted for these transactions in accordance with the agreements. We also determined whether Bank Midwest properly accounted for receipts and paid off the bond before making equity distributions. At the conclusion of our fieldwork, we provided Bank Midwest the preliminary findings. We have incorporated, as appropriate, their responses in this report.

We did not review the internal control system for the trust servicer, Bank Midwest, because we concluded that the audit objective could be met more efficiently by conducting substantive tests rather than placing reliance on their internal control system. We conducted the audit from July 6, 1998 through December 8, 1998 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

Generally, Bank Midwest complied with the provisions of the deposit trust and servicing agreements and properly accounted for bond payments and equity distributions. However, Chillicothe Properties and Bank Midwest did not always act in the best interest of the trust. We identified seven instances that resulted in recommended recoveries totaling $546,274. Most significantly, Chillicothe Properties, who is ultimately responsible for the operations of the trust, entered into an improper transaction to reduce the outstanding bond principal and accelerate equity distributions. Chillicothe Properties sold a participation interest in pool assets to a private investor. This transaction appeared to violate the terms of the deposit trust agreement and resulted in additional expenses to the trust of $309,775. In addition, Chillicothe Properties did not instruct Bank Midwest to establish interest-bearing accounts, as permitted by the trust agreements. Chillicothe Properties had a fiduciary responsibility to the trust and the FDIC to maximize the economic return of the trust and should have directed Bank Midwest to establish interest-bearing accounts or invest the funds in short-term, liquid investments. Because the trust's bank accounts were not interest bearing, we estimated that the trust lost $88,902 in interest income.

During our review of $17.7 million of the $33.5 million in proceeds received during the audit period, we concluded that Bank Midwest handled loan settlements and asset sales properly, but did not always deposit the receipts timely. In two instances, Bank Midwest held receipts in a Loan Clearing Account for an unreasonable amount of time, before depositing the amounts in the Collections Account. The Loan Clearing Account is a non-trust account. In addition, Bank Midwest did not transfer four escrow account balances that totaled $42,430 to the Collections Account once the assets sold.

Furthermore, Chillicothe Properties or Bank Midwest charged improper expenses to the trust in three instances. During the audit period, total expenditures paid by Bank Midwest with trust funds totaled approximately $5.6 million. We determined that $2.8 million related to high-risk areas from which we selected a sample. Based on our review of $743,439, we identified $147,597 of unallowable expenses. Most significantly, Bank Midwest paid legal fees totaling $111,946 with trust funds to prepare for a lawsuit against the FDIC. Bank Midwest filed the lawsuit after the FDIC claims unit denied a claim of warranty breach. The lawsuit alleged common fraud, misrepresentation, and breach of warranty by the FDIC. The United States District Court of Missouri dismissed all three counts against the FDIC. In addition, Bank Midwest improperly paid a consultant $35,000 with trust funds. Amounts paid to an independent contractor are the responsibility of the servicer, not the trust. Furthermore, Bank Midwest incorrectly calculated servicing fees resulting in an overpayment totaling $651.

Finally, because the agreements were unclear, Bank Midwest included overstated asset balances in the calculation of servicing fees.

CHILLICOTHE PROPERTIES DID NOT ALWAYS ACT IN THE BEST INTEREST OF THE TRUST

The deposit trust agreement required the Class A Certificate Holder to adhere to the fiduciary duty of a general partner under the Delaware Revised Uniform Limited Partnership Act in its administration of the trust. As interpreted by the Delaware Court of Chancery, this fiduciary duty is to exercise the utmost good faith, fairness, and loyalty. Of the $546,274 in recommended disallowances in our report, we found that $398,677 were based on three instances of Chillicothe Properties not acting in the best interest of the trust. These three instances are explained below.

Sale of Participation Costs Trust $309,775 in Interest to Participant

Chillicothe Properties' sale of a participation interest in a pool of assets to a private investor appears to have violated the terms of the deposit trust agreement in several respects. While this sale did allow the trust to pay down the bonds earlier than expected, the end result was not in the best interest of the trust. The prohibited sale resulted in additional expenses of $188,979 to the trust and lost bond interest income to FDIC totaling $120,796.

The express objective of the trust was to dispose of the trust assets in a manner that maximized the return to both the FDIC and Chillicothe Properties. The sale of the participation seems to have violated this objective by increasing trust expenses by $309,775 for interest paid to the private investor. Under the terms of the participation agreement, the trust would pay the investor a participation interest rate of 11 percent on the outstanding principal amount of his investment each month. His original principal amount was $5 million. In addition, the trust would make payments on the outstanding principal amount from funds received each month from the mortgagees in the pool of loans. The trust paid the investor $309,775 in interest over the life of the participation.

There were some offsetting savings to the transaction since the funds generated by the sale of the participation interest were used to pay down the outstanding bond principal and interest. As a result of the sale of the participation, the bonds were paid off in December 1996, and the first equity distribution to the Certificate Holders was made the same month. Had Chillicothe Properties not directed the servicer to complete this transaction, it appeared that other cash flows of the trust would have allowed the trust to redeem the bonds fully on March 15, 1997. The additional interest payment on the bonds for the period from December 1996 through March 1997 would have been $120,796. Therefore, the net additional expense to the trust for the participation was $188,979. This amount was distributed between the Certificate Holders: 51 percent to the FDIC ($96,379) and 49 percent to Chillicothe Properties ($92,600).

Besides its share of the additional expense, the FDIC as the bondholder lost the $120,796 in interest that would have accumulated on the bonds if they had not been paid off in December 1996 from funds received as a result of the prohibited transaction. Therefore, the final cost of the participation to the FDIC was $217,175 for the lost interest plus the additional expense. The cost to Chillicothe Properties was $92,600 for the additional expense. These two combined for $309,775, the amount of interest paid to the investor for his investment.

The sale of the participation interest also appears to have violated the deposit trust agreement in two other ways, which suggest that Chillicothe Properties tried to bypass certain prohibitions of the agreement. The agreement prohibited Chillicothe Properties from borrowing money to pay the principal or interest on the bonds. The private investor borrowed the funds used to finance the purchase of the participation interest from Bank Midwest, which, in addition to being the trust servicer, was a member of an affiliated group of companies that included Chillicothe Properties itself. The loan proceeds check, for exactly $5 million, was disbursed directly from Bank Midwest to the trust at the direction of the investor. The loan from Bank Midwest to the private investor appeared to be an attempt by Chillicothe Properties to circumvent the agreement's prohibition against borrowing to pay off the bond. In addition, the terms of the participation agreement between the trust and the private investor could also be construed as a loan. The private investor advanced funds to the trust, which the trust was obligated to return to the investor in full, plus the interest accrued while the original amount was outstanding.

In its response to this finding, Bank Midwest indicated that more primary than the servicer's obligation to dispose of the assets in a manner which maximized the economic return to the Certificate Holders was the deposit trust agreement's requirement that assets be disposed of as promptly as possible. However, Bank Midwest kept possession of the assets after the participation expired and offered no support that this transaction disposed of the assets more quickly than a sale of the assets. Instead, Bank Midwest stated that once equity funds were returned to the Certificate Holders, those funds could be reinvested at a 15 to 20 percent earning rate. Therefore, it was Bank Midwest's analysis that the earlier equity distributions maximized the economic return to the Certificate Holders by allowing them to reinvest the money. Making equity distributions early so the Certificate Holders could reinvest the money was not the purpose of the trust. In addition, the FDIC was restricted to reinvesting its money at 5 percent. Therefore, the Bank Midwest's analysis of the transaction did not treat both Certificate Holders equitably.

Bank Midwest also denied that the sale of the participation was a disguised borrowing by the trust. Bank Midwest's denial is based on the trust's lack of obligation to the investor's lender, Bank Midwest. However, several of the following aspects of the participation transaction suggest a close relationship between the trust and the investor's lender:

- The loan proceeds check was made out to the trust.
- The same Bank Midwest employee signed the participation assignment on behalf of the lender and the trust.
- Participation payments to the private investor were reduced by the amount of the debt owed to the lender.

None of these were addressed in the Bank Midwest response. In addition, the nature of the participation agreement between the trust and the investor suggested a borrowing of funds. The investor provided funds to the trust and expected a return of his original principal as well as periodic payments of interest on his outstanding balance. The servicer characterized this arrangement as a participation, but it is more accurately characterized as a borrowing.

Recommendation

The Assistant Director, Agreement Management Group, DRR, should:

(1) Disallow questioned costs of $309,775 and require Bank Midwest to reimburse the trust for $309,775. The amount related to the increased expenses of the trust, $188,979, will be prorated between the certificate holders, with the FDIC receiving its 51 percent share of this amount, or $96,379, through future equity distributions. The amount related to the lost bond interest, $120,796, will be reimbursed totally to the FDIC as the bondholder.

Bank Midwest Did Not Establish Interest-Bearing Bank Accounts

Bank Midwest did not establish interest-bearing bank accounts for trust funds. Using Bank Midwest's formula for business checking accounts as a conservative estimate, we determined that the trust had lost $88,902 in interest income during our audit period. During our reviews of similar trusts, we have observed that servicers earned income on trust funds. Bank Midwest stated that the agreements permitted the servicer to earn income on the funds but did not require it.

Sections within two of the trust agreements permitted the Chillicothe Properties and Bank Midwest to establish interest-bearing accounts or invest the trust funds. According to section 8.01(h) of the deposit trust agreement, it is the duty of the Class A Certificate Holder to cause the servicer to invest any amounts held in the collections account and the deferred maintenance Account. In addition, the servicing agreement required the servicer to establish and maintain accounts for the benefit of the trust, which were permitted to bear interest. Section 10.03 of the deposit trust agreement stated that the amounts on deposit in any account of the trust shall be invested in eligible investments as directed in writing by the Class A Certificate Holder. Chillicothe Properties did not direct the servicer to invest the funds held in the trust's bank accounts as required by section 8.01(h) of the deposit trust agreement, nor did Bank Midwest exercise prudent business practice by holding cash in non-income producing accounts. Based on our review of four similar trust servicers, we noted that each established interest-bearing bank accounts or invested the funds in eligible investments.

Bank Midwest stated that the specific terms of the servicing agreement that make investment of funds optional seem to be at odds with the general expectation in the deposit trust agreement that funds would be invested in interest-bearing accounts. Bank Midwest's response did not reference its fiduciary responsibility to the trust and the Certificate Holders.

Recommendations

The Assistant Director, Agreement Management Group, DRR, should:

(2) Seek $88,902 in reimbursement from the servicer, Bank Midwest, in lost interest income. The FDIC will receive its 51 percent share of this amount, or $45,340, through future equity distributions.

(3) Require Bank Midwest to earn interest income on trust funds as permitted by the provisions of the agreements.

Bank Midwest Improperly Handled Receipts and Escrow Accounts

Bank Midwest improperly handled escrow account balances and did not deposit receipts in the collections account in a timely manner. Section 2.06 (a) of the servicing agreement requires that the servicer deposit receipts in the collections account. According to management, Bank Midwest as servicer deposits receipts in a loan clearing account held at Bank Midwest. Then, Bank Midwest's loan operation section determines how to allocate the amounts received (e.g., principal, interest, escrow, and payoff) and notifies the accounting department to transfer that amount to the collections account. The loan clearing account is a non-trust account. Our audit identified one instance, where a purchaser of a trust asset wired two installment payments of $25,000 each on January 26, 1996 and March 6, 1996 to the loan clearing account. Bank Midwest held these payments in that account until April 9, 1996, when it received the final payment. Therefore, Bank Midwest held some of those sales proceeds in a non-trust account for almost 3 months. In another instance, we identified that Bank Midwest did not deposit an interest payment in the collections account until 15 months after receiving the payment. Bank

Midwest held the interest ($18,524) in the loan clearing account. Bank Midwest should have better controls over trust funds and deposit all receipts in a trust account when received.

Furthermore, Bank Midwest failed to transfer $42,308 held in four escrow accounts to the collections account once the assets sold. Section 2.05(a) of the servicing agreement permitted Bank Midwest to establish escrow accounts to pay related taxes and similar items. However, once the asset sold, Bank Midwest should have transferred the funds that remained in the escrow account to the collections account.

Bank Midwest agreed with the finding and provided documentation to support the correction of these errors. In addition, Bank Midwest stated that it had instituted better communication between loan officers and loan operations to try to reduce or eliminate the incidence of these errors in the future.

Recommendation

The Assistant Director, Agreement Management Group, DRR, should:

(4) Require Bank Midwest to strengthen its controls over the escrow account and the handling of receipts. DRR should ensure that Bank Midwest deposits receipts timely and transfers remaining funds in the escrow account to the collections account after an asset is sold.

BANK MIDWEST CHARGED IMPROPER EXPENSES TO THE TRUST

The servicing agreement described expenses that may be properly charged to the trust accounts. In three separate instances, Bank Midwest charged $147,597 in improper expenses to the trust. These instances are explained below.

Legal Expenses Improperly Charged to the Trust

Bank Midwest improperly used trust funds to pay legal expenses totaling $111,946. Chillicothe Properties incurred these expenses as it prepared for a breach of warranty case against the FDIC. The servicing agreement's definition of a Property Protection Expense includes costs and expenses of prosecuting remedies for breaches of representations and warranties made to the trust. However, this would not permit Chillicothe Properties to continue to expend funds where there is no significant likelihood of success or benefit to the trust. Therefore, the legal expenses incurred should be the responsibility of Chillicothe Properties and not the trust.

Initially, the trust servicer filed a claim with the FDIC Claims Group on March 28, 1996 that alleged breach of warranty by the FDIC. The FDIC Claims Group denied the claim on July 12, 1996. Then the trust and Chillicothe Properties filed a lawsuit against the FDIC. The plaintiffs in the lawsuit were the RTC Mortgage Trust 1995-SN2 and Chillicothe Properties, Inc. The lawsuit filed on September 11, 1996 alleged common fraud, misrepresentation, and breach of warranty by the FDIC. The lawsuit claimed that the FDIC sold the trust a non-performing loan secured by an asbestos-contaminated office building. Therefore, the servicer could not market the building, as the cost of renovations would be significant. On October 9, 1997, the United States District Court of Missouri dismissed all three counts based on FDIC's sovereign immunity defense[2]. Furthermore, on October 16, 1997 the trust sold the loan associated with the building without making any renovations to the building.

Chillicothe Properties incurred legal expenses from July 1996 to October 1997 totaling $149,261. Chillicothe Properties allocated 75 percent ($111,946) of the legal costs to the trust and 25 percent ($37,315) to itself. Bank Midwest management stated that this was a conservative allocation of the legal expenses. Bank Midwest could not provide support for the allocation.

Bank Midwest stated that the OIG apparently applied 20-20 hindsight by stating "there is no significant likelihood of success or benefit to the trust." Bank Midwest added that it decided to pursue the litigation at a time when they were unable to foreclose on the collateral of this loan due to the extraordinary potential environmental liability that ownership would entail. However, Bank Midwest failed to address in its response the FDIC Claims Group's initial denial of the claim of warranty breach. The FDIC Claims Group denied the claim based on the advice of a

[2] Sovereign immunity is a legal doctrine that generally bars lawsuits against the government. This doctrine acts as a defense to suits, unless the government, either by statute or otherwise, specifically waives its immunity from suit.

third-party environmental firm. Bank Midwest also stated that they retained the services of experienced trial attorneys and proceeded on their advice. In its analysis whether to proceed with the litigation, the experienced trial attorneys should have included the probability of the FDIC using the sovereign immunity defense.

Recommendation

The Assistant Director, Agreement Management Group, DRR, should:

(5) Disallow questioned costs of $111,946 for improper legal fees charged to the trust and require Bank Midwest to reimburse the trust $111,946. The FDIC will receive its 51 percent share of this amount, or $57,092, through future equity distributions.

Compensation for Contract Employee Improperly Charged to Trust

Bank Midwest improperly compensated a consultant with $35,000 in trust funds for work performed on the sale of a trust asset. Section 2.02 of the servicing agreement stated that the " ...Servicer may, **at its own expense**, contract with any subservicer, or Independent contractor satisfactory to the Class A Certificate Holder **to perform all or any portion of its duties** (emphasis added)...." Based on our evaluation of the transaction, we determined that the compensation paid to the consultant was the financial responsibility of Bank Midwest rather than the trust.

Before starting an independent loan brokerage and consulting business, the consultant was employed by Bank Midwest as a vice president until May 31, 1996. On June 4, 1996, the Dickinson Financial Corporation and Bank Midwest entered into an Employment Termination and Consulting Agreement with the employee. A recital listed in the termination agreement stated that Bank Midwest wished to compensate the employee for years of faithful service, to fairly compensate the employee for current projects pursued but not yet completed and to retain the employee's services as an independent consultant to aid in ongoing and future projects. In addition, a provision in the termination agreement permitted the consultant to work on the sale of a trust asset, for a negotiated commission.

The trust was not a party to the employment termination agreement, yet Bank Midwest paid a

1-percent commission to the consultant with trust funds for work performed on the sale of the trust asset. Bank Midwest also paid an allowable 4-percent commission to a real estate broker in connection with the sale. The former employee acted as an independent contractor to assist Bank Midwest with the sale, and the consulting commission should have been the responsibility of Bank Midwest and not the trust.

Bank Midwest stated that it paid the former employee a 1-percent commission on the sale of the asset. Based on our review of correspondence relating to the payment, Bank Midwest paid the former employee a "consultation fee." The correspondence did not state that Bank Midwest paid a 1-percent commission to a loan broker. Furthermore, Bank Midwest's response did not address the employment termination agreement by and among Bank Midwest, Dickinson Financial Corporation, and the former employee. A recital in the termination agreement stated that Bank Midwest wanted to compensate the former employee for work not yet finished and to retain the former employee as an independent consultant.

Recommendation

The Assistant Director, Agreement Management Group, DRR, should:

(6) Disallow questioned costs of $35,000 for improperly compensating a consultant with trust funds, and require Bank Midwest to reimburse the trust for $35,000. The FDIC will receive its 51 percent share of this amount, or $17,850, through future equity distributions.

Bank Midwest Incorrectly Calculated Servicing Fees

Bank Midwest incorrectly calculated servicing fees, resulting in an overpayment totaling $651. Section 1.01 of the servicing agreement stated that Bank Midwest would be paid a servicing fee that accrued at an annual rate equal to 0.5 percent for mortgage loans with a July 1, 1995 principal balance greater than or equal to $1 million and 1 percent for mortgage loans less than $1 million. The agreement also required Bank Midwest to reduce the total principal balance as assets were sold. The mortgage loan schedule attached to the assignment and assumption agreement contained each asset's principal balance used in the calculation of the monthly servicing fee.

Bank Midwest failed to reduce the outstanding principal balance for the sale of one asset, resulting in an overpayment of servicing fees totaling $651. After the completion of our fieldwork, Bank Midwest reduced the amount due for the August 1998 servicing fee by $651.

Recommendation

The Assistant Director, Agreement Management Group, DRR, should:

(7) Ensure that the servicer, Bank Midwest, properly calculated servicing fees after the end of our audit period, April 30, 1998, and that Bank Midwest properly reimbursed the trust $651 during the fieldwork. The FDIC will receive its 51 percent share, or $332, through future equity distributions.

THE FDIC SHOULD PURSUE CLARIFICATION OF THE SERVICING AGREEMENT

The language in the servicing agreement is unclear concerning servicing fee calculations for assets sold with a resulting deficiency, related real estate owned, or loan to facilitate a sale. Bank Midwest included in the calculation of servicing fees the value of assets sold with a related deficiency, real estate owned, or loan to facilitate a sale. Section 1.01 of the servicing agreement stated that Bank Midwest would be paid a servicing fee on each mortgage loan listed on the attachment to the assignment and assumption agreement which remained outstanding during a collection period. During the period of September 1, 1995 through April 30, 1998, Bank Midwest included in the calculation of servicing fees the original value of six sold assets. Bank Midwest officials stated that if they serviced a deficiency, real estate owned, or a loan to facilitate after the sale of an asset, then they should receive a servicing fee based on the original principal balance of the asset.

In most cases, when Bank Midwest disposed of a trust asset, Bank Midwest removed the original principal balance of that asset from the next month's calculation of the servicing fee, as required by the servicing agreement. However, Bank Midwest disposed of the assets listed in table 1, but did not remove the assets from the calculation of servicing fees because of a related deficiency, real estate owned, or a loan to facilitate. Instead, Bank Midwest used the asset's original principal balance in the calculation of the servicing fee and not the value of the new asset. Table 1 highlights the differences between the original asset value and the amount serviced by Bank

Midwest after the sale of the asset.

It is our interpretation of the servicing agreement that Bank Midwest should not receive a fee for servicing a deficiency. In addition, Bank Midwest should include the value of the new real estate owned or loan to facilitate a sale in the calculation of servicing fees instead of the original principal balance. Had Bank Midwest used this interpretation of the servicing agreement, servicing fees would have been reduced by $99,866, as shown in table 1.

Table 1: Servicing Fees Calculated on Overstated Asset Balances

Asset Number	Original Value	Value of New Asset or Deficiency	Bank Midwest Calculation After Sale	OIG Calculation (if Deficiency, then $0)	Difference Per Month	Total for Audit Period – Sale Date to April 1998
118	$4,516,563	$2,222,830	$1,882	$0	$1,882	$43,286
144	2,815,000	480,000	1,173	400	773	17,779
177	1,959,835	1,000,000	817	417	400	10,000
1038	1,400,000	87,500	583	0	583	2,332
763	4,232,161	600,000	1,763	500	1,263	1,263
105	13,082,653	3,000,000	5,451	1,250	4,201	25,206
Total	-	-	$11,669	$2,567	$9,102	$99,866

Source: OIG Analysis

Bank Midwest stated that the trust agreements were silent or unclear relating to the issues described in the finding. We interpreted the definition of the servicing fee to exclude deficiencies but agree that the remaining language is unclear. Section 1.01 of the servicing agreement stated that the "… principal balance as of the Cut-Off Date of each Mortgage Loan **outstanding** during such Collection Period (emphasis added)…" should be included in the calculation of the monthly servicing fee. It is the OIG's position that once the asset sold or partially sold the original Mortgage Loan is no longer "outstanding," but may be replaced by a loan to facilitate or real estate owned. The servicing agreement did not address these situations. Because the language in the agreements was unclear concerning the handling of loans to facilitate and real estate owned after the sale of the asset, we recommend that Chillicothe Properties and the FDIC negotiate an amendment to the agreement.

Recommendation

The Assistant Director, Agreement Management Group, DRR, should:

(8) Negotiate with Chillicothe Properties to amend the servicing agreement to clarify the method of calculating servicing fees on deficiencies, related real estate owned, and loans to facilitate. The amendment should be written to include all servicing fees going forward.

MANAGEMENT RESPONSE AND OIG ANALYSIS

On March 31, 1999, the Deputy Director, Asset Management Branch, DRR, provided a written response to the draft report.

The Deputy Director, Asset Management Branch agreed to pursue recovery of $425,478 of the $546,274 in recommendations. In addition, the Deputy Director will pursue settlement of these findings within 60 days of the audit completion.

The Deputy Director stated that DRR would not pursue collection of the $120,796 in bond interest payments owed to the FDIC as the bondholder. Although we accept DRR's management decision, we are convinced that it is in the best interest of FDIC Corporate and FDIC as Class B Certificate Holder, to implement the recommendation.

The Corporation's response to the draft report provided the elements necessary for management decision on the report's recommendations. Therefore, no further response to this report is necessary. Appendix II presents management's proposed action on our recommendations and shows that there is management decision for each recommendation in this report.

As a result of our audit, we will report questioned costs of $337,789, FDIC's share, in our *Semiannual Report to the Congress*.

APPENDIX I

FDIC

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

DATE: March 30, 1999

MEMORANDUM TO: David H. Loewenstein
Assistant Inspector General
Office of Inspector General

D Stelton

FROM: Gail Patelunas, Deputy Director
Asset Management Branch

SUBJECT: OIG Draft Report:
RTC Mortgage Trust 1995 - S/N2

On February 22, 1999, the Office of Inspector General (OIG) issued its draft report on the results of an audit of Bank Midwest, NA, the trust servicer for RTC Mortgage Trust 1995 - S/N2 (Trust), in which the FDIC is the non-controlling Class B Certificateholder. As noted in your memorandum, OIG selected this Trust for review in response to DRR's request for an audit of various trusts. The report concludes that, except as noted below, the Servicer, Bank Midwest, complied with the provisions of the Deposit Trust Agreement (DTA) and Servicing Agreement, and properly accounted for cash receipts and bond payments.

As noted in OIG's draft report, Chillicothe Properties, Inc. (Chillicothe) has full responsibility for the daily operations of the Trust. Chillicothe hired Bank Midwest, an affiliated party, to service loans and to manage, market, and dispose of Trust assets. The FDIC does not have the legal authority to direct the Servicer's (Bank Midwest, NA) or Chillicothe's management of the disposition of the assets held by the Trust through its interest as the non-controlling Class B Certificateholder. However, the DTA, Servicing Agreement, and other related documents give FDIC certain rights to protect its interest in the transaction.

Following are Management's responses to the findings presented in the audit report.

Chillicothe Did Not Act in the Best Interest of the Trust

The OIG questioned whether Chillicothe acted in the "best interest" of the Trust in certain situations. The following findings were cited under this general heading.

1. *The sale of a $5,000,000 participation interest in a pool of performing loans cost the Trust $309,775 in interest paid to the entity purchasing the participation in the loan*

> *pool. The net cost to the Trust was $188,979, because the Trust paid off the bonds more quickly than it would have without proceeds from the sale. The Trust saved $120,796 in interest on the bonds. As Certificateholder B in the Trust, FDIC's 51% share of the cost equals $96,379.*
>
> *From the perspective of FDIC as Bondholder, the sale of the participation interest resulted in lost interest of $120,796 that it would have earned on the bonds had the bonds not been repaid from proceeds realized from the sale of a participation interest in the loan pool.*
>
> *The overall finding totals $309,775 from (a) the additional net cost of $188,979 to the Trust of which FDIC's interest equals $96,379, and (b) $120,796 in interest that FDIC would have otherwise earned on the bonds had the bonds been retired without proceeds from the sale of the participation.*

Management's response is separated into the two components comprising OIG's finding.

(a) FDIC's interest as Certificateholder B in additional Trust expenses of $188,979

Management concurs with the OIG's recommendation that Bank Midwest reimburse the Trust $188,979 for the increased expenses to the Trust resulting from the sale of the participation interest in the pool of loans owned by the Trust. Management will issue a demand letter within 60 days of issuance of the audit report seeking full reimbursement of the money.

(b) FDIC's Interest as Bondholder impacted adversely by the loss of interest income it would have earned on the bonds by $120,796.

Management disagrees with the OIG finding that Chillicothe, the Class A Certificateholder, has an obligation to the Bondholder to maintain the outstanding balance of the Bonds beyond the soonest possible repayment date. This is contrary to Section 2.01 (b) (iv) and (v) of the Deposit Trust Agreement, which states that "The purposes for which the Trust is created and established are …(iv) to service the Mortgage Loans and manage any property acquired in respect thereof or otherwise included in the Trust Property with the objective of disposing of the Mortgage Loans and such properties as promptly as possible and in an orderly manner that maximizes the economic return to the Certificateholders, and (v) to engage in any activities necessary, convenient, or incidental to the foregoing." Additionally, since the primary responsibility of the Class A Certificateholder is to the Trust, and the Class A Certificateholder has no ownership interest in the bonds, then the bonds cannot be considered a Trust asset. Consequently, Chillicothe has no obligation to keep the bonds outstanding any longer than necessary.

The OIG did not cite any accounting or regulatory criteria that would cause the sale of an interest in a pool of loans under the circumstances described in the finding to be considered a financing arrangement rather than a sale. It is also DRR's understanding that examiners from the Division of Supervision reviewed Bank Midwest's loan and did not find any problems with the loan from a regulatory perspective.

The OIG states that Bank Midwest did not treat both Certificateholders equitably because the FDIC was restricted to reinvesting its money at 5 percent. The OIG states that making equity distributions early so the Certificateholders could reinvest the money was not the purpose of the Trust and did not maximize the return to both the FDIC and Chillicothe.

The Agreements do not require that Chillicothe consider the different reinvestment opportunities of the Certificateholders in making any business decision. Specifically, Section 8.01 of the DTA (which also provides the Class A Certificateholder with the sole authority and responsibility for the operation and management of the Trust) requires that the Class A Certificateholder "…service the Mortgage Loans and manage any properties acquired in respect thereof in accordance with servicing standards for the commercial mortgage loans and asset management standards for commercial properties and collateral that are customarily employed by prudent servicers servicing comparable mortgage loans for their own account and prudent asset managers managing comparable properties and collateral for their own account and in a manner intended to achieve the purposes of the Trust set forth in Section 2.01(b)(iv)." This does not require Chillicothe to consult with the FDIC as Bondholder and determine its reinvestment opportunities prior to retiring the bonds or for that matter, the FDIC's reinvestment rate on monies it receives as the Class B Certificateholder.

2. Bank Midwest did not establish interest bearing bank accounts. Had such accounts been established, OIG calculates the Trust would have earned an additional $88,902 in income and FDIC's share would have been $45,340. OIG recommends FDIC seek reimbursement of the lost interest income.

Management concurs with OIG's recommendation and will issue a demand letter within 60 days of issuance of the audit report seeking reimbursement of the lost interest income to the Trust.

3. Bank Midwest should begin earning income on Trust funds as permitted by the provisions of the agreements.

Management concurs with OIG's recommendation and will issue a demand letter within 60 days of issuance of the audit report requesting Bank Midwest establish interest-bearing accounts for Trust funds, so the Trust will begin earning interest on the funds.

4. Bank Midwest should strengthen its controls over the escrow account and the handling of receipts. DRR should ensure Bank Midwest deposits receipts timely and transfers remaining funds in the escrow account to the collections account after an asset is sold.

Management concurs with the recommendation and will issue a demand letter within 60 days of issuance of the audit report requesting Bank Midwest tighten its controls over the escrow account and handling of receipts.

Bank Midwest Charged Improper Expenses to the Trust

OIG found three instances where Bank Midwest charged "improper" expenses to the Trust.

5. Bank Midwest sued FDIC over a breach of warranty case when FDIC refused to repurchase an asset sold to the Trust. OIG recommends DRR disallow questioned costs of $111,946 for improper legal fees charged to the Trust. FDIC's 51% share equals $57,092.

Management concurs with the recommendation and will issue a demand letter within 60 days of issuance of the audit report seeking reimbursement of the legal fees.

6. *Bank Midwest improperly charged the Trust $35,000 for a consultant formerly employed by Bank Midwest to assist a real estate broker close the sale on a loan owned by the Trust. OIG recommends DRR disallow questioned costs of $35,000 for improperly compensating a consultant with trust funds and require Bank Midwest to reimburse the Trust for $35,000. FDIC's share equals $17,850.*

Management concurs with OIG's recommendation that Bank Midwest reimburse the Trust $35,000 and will issue a demand letter within 60 days of issuance of the audit report seeking reimbursement of the funds.

7. *Bank Midwest incorrectly calculated servicing fees resulting in the Trust overpaying Bank Midwest $651. FDIC's share equals $332. OIG recommends that DRR ensure Bank Midwest reimbursed the Trust the $651 overpayment and properly calculates servicing fees after the end of the audit period.*

Management concurs with the recommendation and will issue a letter within 60 days after issuance of the audit report requesting Bank Midwest document its $651 reimbursement to the Trust. Management will also request its equity partnership oversight contractor to verify that Bank Midwest is properly calculating the servicing fee.

FDIC Should Pursue Clarification of the Servicing Agreement

8. FDIC should negotiate with Chillicothe Properties to amend the Servicing Agreement to clarify the method of calculating servicing fees on deficiencies, related real estate owned, and loans to facilitate on a going forward basis.

Management concurs with OIG's recommendation and will issue a demand letter within 60 days of issuance of the audit report requesting Chillicothe Properties amend the Servicing Agreement to clarify the method of calculating servicing fees on deficiencies, related real estate owned, and loans to facilitate sale of real estate owned.

We appreciate the professionalism of your staff in carrying out the responsibilities of the assignment. If you have any questions, please contact Assistant Director Stinchcum at (202) 898-8939.

cc: Marilyn Kraus, OIG
Sean Cassidy, OIG
Giovanni G. Recchia, DRR
Douglas Stinchcum, DRR
Elliott Pinta, Legal
Henry Abbot, DRR
Dean Eisenberg, DRR
Ronald Sommers, DRR
Jim Mealey, AEW
Edward Dox, AEW

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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 representatives.

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	The Corporation agreed to seek reimbursement to the trust of $188,979 of the $309,775. The Corporation's prorated share totaled $96,379. The Corporation stated that they would not pursue collection of the $120,796 of lost bond interest.	60 days from final report	Bank Midwest's distribution	$96,379 disallowed costs	Yes
2	The Corporation agreed with the recommendation. The Corporation will seek reimbursement to the trust of $88,902 in lost interest income to the trust. The Corporation's prorated share of the lost interest income totaled $45,340.	60 days from final report	Bank Midwest's distribution	$45,340 disallowed costs	Yes
3	The Corporation agreed with the recommendation. The Corporation will issue a demand letter requesting Bank Midwest establish interest-bearing accounts for trust funds.	60 days from final report	Bank Statement for each trust account	Not Applicable	Yes
4	The Corporation agreed with the recommendation. The Corporation will issue a demand letter requesting Bank Midwest tighten its controls over the escrow account and handling of receipts.	60 days from final report	Internal Control procedure memorandum	Not Applicable	Yes

MANAGEMENT RESPONSES TO RECOMMENDATIONS

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Documentation that will confirm final action	Monetary Benefits	Management Decision: Yes or No
5	The Corporation agreed with the recommendation. The Corporation will seek reimbursement to the trust totaling $111,946 of improper legal fees. The Corporation's prorated share of the legal fees totaled $57,092.	60 days from final report	Bank Midwest's distribution	$57,092 disallowed costs	Yes
6	The Corporation agreed with the recommendation. The Corporation will seek reimbursement to the trust of $35,000 for improperly compensating a consultant. The Corporation's prorated share of the compensation totaled $17,850.	60 days from final report	Bank Midwest's distribution	$17,850 disallowed costs	Yes
7	The Corporation agreed with the recommendation. The Corporation will issue a letter requesting that Bank Midwest document its $651 reimbursement to the trust. The Corporation's prorated share of the servicing fee totaled $332.	60 days from final report	Canceled Check	$332 disallowed costs	Yes
8	The Corporation agreed with the recommendation. The Corporation will make a good faith effort to cause the Class A Certificate Holder to amend the servicing agreement to clarify the method of calculating servicing fees on deficiencies, related real estate owned, and loans to facilitate the sale of real estate owned.	60 days from final report	An amendment to the agreement	Not Quantifiable	Yes