AEW'S PERFORMANCE UNDER CONTRACT NUMBER 700-92-0016-003

Audit Report No. 99-001
January 8, 1999

OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

DATE: January 8, 1999

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

FROM: Sharon M. Smith
Director, Field Audit Operations

SUBJECT: *AEW's Performance Under Contract Number 0700-92-0016-003*
(Audit Report No. 99-001)

This report presents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of Aldrich, Eastman, and Waltch's (AEW) performance under contract number 0700-92-0016-003. Generally, we found that AEW was adequately performing the tasks required under the contract. However, we believe improvements could be made to AEW's oversight of equity partnerships and the FDIC is paying too much for the work AEW is performing.

BACKGROUND

From December 1992 through August 1995, the Resolution Trust Corporation (RTC) created 72 equity partnership entities.[1] The equity partnership structure is a joint venture with the FDIC[2] as limited partner and private-sector investors as general partner. The RTC created these entities to manage, develop, and dispose of assets. The RTC retained a residual interest in the equity partnership that entitled the RTC to receive additional proceeds periodically throughout the life of the portfolio as the equity partnership liquidates the assets. The rationale for this type of liquidation was that the net present value of the future asset sales, when added to the up-front cash received, would be greater than the total proceeds that the RTC would have received from a direct asset sale.

The equity partnership agreement between the RTC and the general partner was structured to provide the general partner with the responsibility for determining the most appropriate method for disposing of the assets. The general partner had full responsibility to conduct the day-to-day affairs of the equity partnership, such as managing and servicing the assets. The RTC entered into these agreements as a limited partner partially to alleviate potential liability issues related to the assets. Further, financial incentives for both the limited partner and the general partner were

[1] The term "equity partnership" as used in this report, refers to the entities RTC established in conjunction with private industry to dispose of assets.
[2] Because of the RTC Completion Act of 1993, the RTC ceased to exist on December 31, 1995. Although the equity partnerships were created by the RTC, the FDIC assumed responsibility for them as of January 1, 1996.

aligned to try to ensure that the assets in the portfolio would be liquidated in the most cost-effective and profitable manner. The equity partnership agreements defined the income distribution percentages and, to some extent, the expenses that could be charged to the equity partnership and those that would be borne by the general partner. In addition, the equity partnerships were required to submit reports describing their activities to the RTC on a monthly, quarterly, and annual basis. Each equity partnership was also required to submit audited financial statements and compliance audit reports annually to the RTC.

The RTC established oversight of the equity partnership program with the overall objective of ensuring that all actions taken by the general partners in managing the equity partnerships are aligned with RTC's desire to safeguard and maximize the net present value of its interest in the equity transactions. Because RTC's role as a limited partner restricted it from active involvement in the daily decisions of the equity partnerships, the RTC sought to have effective equity partnership oversight through the incorporation of multiple methods of accountability such as independent financial audits, OIG audits, and oversight contractor reviews. As an integral component of this oversight, the RTC engaged the services of AEW, a private-sector firm, to monitor, review, and report on equity partnership activity.

On September 28, 1992, the RTC entered a Servicing Task Order Agreement with AEW to monitor and oversee certain equity partnerships. The first task order was effective July 22, 1993 with the initial term of 1 year and optional 1-year extensions. The RTC awarded seven additional task orders, each covering an additional group of equity partnerships. The task orders that the RTC awarded to AEW included 40 of the 72 equity partnerships. RTC did not award AEW task orders to monitor the 30 equity partnerships created to dispose of judgements, deficiencies, and charge-offs, nor did AEW monitor 2 other equity partnerships for which it had financial interest.

The individual task orders that the RTC, and subsequently the FDIC, awarded under this contract specifically described the work required. Specifically, AEW's responsibilities under the task orders include (1) cash management, (2) reporting, and (3) asset management. For the cash management function, AEW ensures that the equity partnerships timely and accurately distribute cash, and that the partnerships effectively manage cash accounts. For the reporting function, AEW tracks and monitors the reports received from the equity partnerships and compiles the information into summary reports submitted monthly to the FDIC's Division of Resolutions and Receiverships (DRR), which oversees the AEW contract. In the area of asset management, AEW monitors the operations and performance of the equity partnerships through site visits and reviews of the general partners' business plans, financial reports, and projections.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our audit were to (1) determine whether AEW performed in accordance with the terms and conditions of the contract and related task orders, (2) assess the effectiveness of AEW's oversight of the equity partnerships, and (3) assess the cost-effectiveness of AEW's services. Our audit scope included AEW's oversight of 40 equity partnerships for the period January 1996 through March 1998.

To accomplish our objectives, we interviewed personnel from AEW, DRR, the Division of Finance (DOF), and the Office of Contracts. Additionally, we reviewed the FDIC's AEW contract files including the contract, each of the task orders, and the related task order modifications to determine what was required of AEW. We also reviewed pertinent procedures from sections of DRR's draft *Equity Transactions Oversight Manual.*

We reviewed AEW's cash management practices regarding the monitoring of equity partnership cash and revenue/expense activity. We tracked the cash from the equity partnerships through AEW's bank accounts. We discussed AEW's handling of cash with DOF officials to determine DOF's experiences with AEW's performance. We also reviewed AEW's internal controls over the handling of equity partnership cash and tested areas we determined to have a higher risk for errors. Specifically, we determined that the greatest risks were that FDIC funds could be misdirected or that the FDIC could lose earnings from funds not being delivered promptly. To address those risks, we (1) interviewed AEW's controller about AEW's cash handling procedures and related controls, (2) reviewed AEW's instructions to the bank for wire transfers, (3) reviewed AEW's internal procedures for handling cash from receipt of funds through disbursement to the FDIC, and (4) reviewed 3 months of bank records to determine how long funds were in AEW's account before being forwarded to the FDIC. In addition, we reviewed the audited financial statements and compliance reports for two of the equity partnerships to determine if the statements and reports addressed potential internal control weaknesses.

We reviewed the reports compiled by AEW and compared them to DRR's contractual reporting requirements. To gain an understanding of the report preparation process, we reviewed with AEW officials how they produced the reports and how they derived the internal rates of return and expense ratios. We discussed with DRR officials the necessity for, and changes in, the reporting requirements over time. We also discussed with DRR officials how they used the information contained in the AEW reports. We evaluated the timeliness of the reporting process, from AEW's initial receipt of information from the equity partnerships to AEW's submission of the summary reports to DRR.

We reviewed AEW's site visitation program, looking at the frequency of AEW visits to the equity partnerships and noting who participated in the visits. We analyzed two AEW site visitation reports to determine what aspects of the equity partnership operations the visits covered. In addition, we interviewed representatives from four equity partnerships to obtain their perspective on what the visitations covered and accomplished. We also looked at the overall equity partnership program in light of the reduced number of assets the equity partnerships hold and the process AEW used to assist DRR in terminating the equity partnerships once the assets were disposed of.

We limited our review of internal controls to the testing of AEW's activities related to equity partnership cash management. Accordingly, we express no overall opinion on AEW's internal controls. We performed our audit at FDIC offices in Washington, D.C.; AEW's corporate offices in Boston, Massachusetts; and at selected equity partnerships located in Dallas, Fort Worth, and Austin, Texas. We performed our audit from March 1998 through August 1998 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

Generally, AEW performed its contractual duties as required. However, we identified an oversight activity that we believe can be performed more effectively. Specifically, neither DRR nor AEW was reviewing source documentation to verify the validity of the equity partnership disbursements and reports. In addition, we believe that the FDIC may be paying too much for AEW's services because the level of effort required to meet DRR's needs did not appear to be commensurate with the fees the FDIC was paying.

AEW performed each of its primary responsibilities of cash management, reporting, and asset management as required by its task orders. In addition, AEW officials were responsive to DRR's changing needs, particularly in the reporting area. For example, during our review, DRR developed an additional 10-page report that it believed provided equity partnership data in a more useful format than had previous reports. AEW promptly added the report to those that it was already producing.

DRR, however, has an opportunity to enhance the effectiveness of equity partnership oversight by requiring AEW to verify to supporting documentation the income and expense information that the equity partnerships report. As part of its monitoring and oversight role with the equity partnerships, we believe that either DRR or AEW should test information that the equity partnerships report to verify the information's accuracy.

Finally, we believe that opportunities exist for FDIC to save on AEW contract costs. During the period covered by our audit, AEW had eight people assigned to the task orders on either a full-time or a part-time basis. The eight people amounted to only six full-time-equivalent positions associated with this contract at a budgeted cost of approximately $1.5 million for 1998. The $1.5 million equates to a $250,000 annual salary for each of the six full-time-equivalent positions. We believe that this amount is excessive, especially when considering that a large portion of AEW's work is clerical in nature.

AEW MET CONTRACT PROVISIONS

AEW adequately performed its duties as described in its task orders under contract number 0700-92-0016-003. The contract's terms and conditions required specific tasks in the areas of cash management, reporting, and asset management. AEW performed each of these tasks and was responsive to FDIC's varying needs.

In the area of cash management, AEW established accounts for each equity partnership and made all distributions from those accounts. AEW ensured that documentation supporting the source of the distributions was forwarded to the FDIC.

AEW tracked the receipt of equity partnership reports. AEW also entered the information contained in these reports into a spreadsheet from which AEW then generated management reports for the FDIC. Whenever the FDIC changed its reporting requirements, AEW incorporated FDIC's changes into its reporting package.

AEW was also charged with monitoring the equity partnerships' asset management activities. In this capacity, AEW performed site visits to equity partnership locations to discuss business plans. AEW was also in regular contact with the equity partnerships by telephone and occasionally provided the equity partnerships technical assistance relative to specific assets. For example, AEW helped contract for an engineering report on a difficult property in Washington, D.C. Based on this report, AEW was able to determine an effective method for developing and marketing the property.

EQUITY PARTNERSHIP OVERSIGHT CAN BE MORE EFFECTIVE

We believe that oversight of the equity partnerships can be improved. Specifically, AEW was not reviewing the source documentation supporting general partner transactions. DRR did not require AEW to review this supporting documentation because DRR believed that routinely requesting source documents from the general partners could be perceived as interfering with the day-to-day operations of the equity partnerships and, consequently, piercing the indemnification afforded FDIC as the limited partner. However, we do not believe the act of requesting source documentation from the general partners interferes in their day-to-day operations. Documentation is a normal by-product of property transactions and should be readily available at the equity partnerships. Further, if neither DRR nor AEW tests source documentation, there is no assurance that the equity partnership activities are accurately reported and distributions properly made. FDIC has the right to protect its investment by requiring efficient and economic use of the equity partnerships' funds.

The lack of a review of source documentation limits AEW's, and thus DRR's, ability to identify problems in the equity partnerships. When AEW suspects a problem, they notify DRR who, in turn, may request that the OIG audit the equity partnership. However, AEW's referrals to DRR have been based on procedural omissions such as an equity partnership's failure to submit required annual financial reports rather than specific indications of wrongdoing. We believe that problems related to false or incomplete source documentation can best be identified by testing the source documentation. To date, DRR has requested OIG audits of 7 of the 42 equity partnerships. AEW and DRR personnel did perform semi-annual site visitations to each of the equity partnerships, but those visits centered on discussions of performance based on business plans relative to the disposition of major assets. Neither AEW nor DRR performed any testing of the equity partnerships' source documentation during those site visits.

Because RTC formed the equity partnerships to dispose of assets, after the assets are sold and the equity partnership terminates, the general partner's personnel may disperse, which may make the people and records involved particularly difficult to locate. Moreover, as pointed out in an OIG memorandum to the DRR Director dated February 2, 1998, the OIG is concerned about FDIC's ability to act on OIG recommendations resulting from equity partnership audits where the FDIC surrenders its certificates and the equity partnership terminates.

Good business practices dictate that the FDIC take reasonable precautions to protect its equity partnership interest by ensuring that cash collections are complete and expense deductions are appropriate. We recognize that the equity partnership agreements are not normal contracts for services. However, in all formal relationships certain principles and practices are inherent to protect one's interests. Clearly, the FDIC has the right to protect its investment by requiring efficient and economic use of the equity partnerships' funds.

Previous OIG audits[3] have found that the expenses deducted from distributions to the FDIC were not always supported, reasonable, or allowable. Further, these OIG audits showed that the information in the reports submitted to AEW by the general partner was not always adequately supported or accurate.

We discussed the issue of reviewing source documentation with AEW personnel who told us they had talked to DRR about the possibility of requesting certain documentation from the equity partnerships. DRR managers then explained that they had considered having AEW review closing documents for major asset sales but had not yet asked the general partners to submit this information.

OPPORTUNITY EXISTS FOR COST SAVINGS

Although FDIC's payments to AEW complied with the terms and conditions of the contract, we believe the contract costs for 1998 may be excessive given AEW's current level of work effort. Specifically, the contract's budget is $1.5 million for 1998 for the services of six full-time-equivalent AEW employees. In addition, the cost for AEW's services has remained relatively constant while equity partnership activities such as collections and asset balances have declined significantly. Even allowing for reasonable overhead, we believe AEW's level of effort does not justify the current contract fee schedule.

The OIG believes that, given the evolving nature of this contract and the length of time it has been in effect, DRR management should review the work AEW is currently performing and determine whether the work required is commensurate with the compensation paid. Based on information AEW provided, at the time of our audit, AEW personnel dedicated about six full-time-equivalent positions to the equity partnership contract. The FDIC paid $1.7 million for the contract in 1997 and has budgeted $1.5 million for the contract in 1998. As we previously stated, the $1.5 million equates to a cost of $250,000, or $125 per hour, for each full-time-equivalent position AEW had working on the contract in 1998.

Further, a substantial part of the work AEW personnel performed appears to be is clerical in nature. For example, compiling the contractually required reports is simply a matter of entering data from the equity partnership reports into automated spreadsheets. In addition, AEW staff accountants performed most of the cash management tasks. Finally, equity partnership terminations, a major part of AEW's efforts over the next 2 years, consist primarily of AEW completing a checklist to ensure that the general partners take specific actions. Although not entirely clerical in nature, in our opinion, completing the termination checklist does require an experience level justifying $125 per hour for each AEW employee.

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[3] *S-Series Transaction 1993 S-2* (Audit Report No. 97-045, dated April 15, 1997) and *RTC Mortgage Trust 1995-S/N1* (Audit Report No. 98-049, dated June 10, 1998).

AEW's responsibilities include monitoring the equity partnerships that service the assets. However, the total number of these assets has declined significantly. Specifically, at the inception of the contract, AEW was monitoring equity partnership management and disposition activities for about 6,000 assets with a combined book value of $7.3 billion. By September 1996, the number of assets had decreased to 2,494 with a book value of $3.3 billion, and by June 1998, the number of assets had decreased to 648 assets with a book value of $1.2 billion. DRR projects that 14 equity partnerships will terminate in 1998, 18 in 1999, and 7 in 2000. Therefore, the number and value of assets will continue to shrink.

We acknowledge that under the contract, AEW's fees are based on the number of equity partnerships, not the number of equity partnership assets or the revenue collected form these assets. However, DRR tracks asset sales and revenue collections, and the overall success of the equity partnership program is often measured in these terms. Although the FDIC does not control the pace of asset resolution and the completion of termination activities, the near-term winding down of equity partnerships is inevitable and will change the nature of the services AEW provides.

The OIG also recognizes that AEW may have incurred certain start-up costs related to its contract. However, we believe the contract considered these start-up costs by paying AEW 130 percent of its flat servicing fee during the first 6 months of the contract.

FDIC contracting officials stated that it is neither unprecedented nor uncommon to renegotiate the fee structure in contracts that have extended for a number of years. According to the contracting officials, this is true because workloads and needs may have changed over time. DRR managers agreed and said they planned to discuss this issue with AEW.

CONCLUSION AND RECOMMENDATIONS

Although AEW performed as required by the contract, the work performed did not provide FDIC assurance that it was receiving the appropriate distributions from the equity partnerships. In addition, we believe the work AEW currently performs warrants lower fees than the FDIC has been paying. Our main concern is that the fees be commensurate with the services that are ultimately agreed upon and performed. Accordingly, we recommend that the Director, DRR:

(1) Expand equity partnership oversight to include testing equity partnership income and expense transactions, such as fees and overhead transactions, and major sales.

(2) Determine and implement the most effective method, or combination of methods, to minimize the cost of AEW's future equity partnership oversight.

DRR managers have considered several approaches to accomplish our second recommendation. One approach involved consolidating the equity partnerships to reduce overhead and fees because AEW's fees are based on the number of equity partnerships. Another approach DRR suggested is a selective sale of FDIC's limited equity partnership interests. DRR could consider other potential approaches to achieve cost savings, including bringing some of the work, such as cash management and terminations, in house.

CORPORATION COMMENTS AND OIG EVALUATION

On December 11, 1998, the Assistant Director, DRR, provided a written response to the draft report. The response is presented in appendix I of this report.

The Assistant Director, DRR, stated that he agreed with the OIG's recommendations. Specifically, he concurred that there should be testing of income and expenses. In addition to reemphasizing traditional oversight procedures and practices, he instructed AEW to obtain, review, and verify the accuracy of net sales proceeds on sales transactions. In addition, DRR negotiated a new fee structure with AEW. This modification reduces projected payments to AEW in 1999 by 11.3 percent or $150,000 for its services under this contract.

The Corporation's response to the draft report provided the elements necessary for management decisions 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 a management decision for each recommendation in this report.

Based on the audit work, the OIG will report funds put to better use of $150,000 in its *Semiannual Report to the Congress*.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429 Division of Resolution and Receiverships

December 11, 1998

TO: Sharon M. Smith
Director, Field Audit Operations

FROM: Douglas G. Stinchcum
Assistant Director, DRR

SUBJECT: Response to Draft Report Entitled *AEW's Performance Under Contract Number 700-92-0016-003*

On October 21, 1998 the Office of the Inspector General (OIG) issued its draft report on the results of an audit on the performance of AEW Capital Management under Contract 700-92-0016-003. The report concludes, "AEW was adequately performing the tasks required under the contract". It does go on, however, to make recommendations regarding the *Program Office's* equity partnership oversight procedures (#1 below) and costs of the oversight contract (#2 below).

Following are Management's responses to the areas questioned in the audit report.

1. *Expand equity partnership oversight to include testing equity partnership income and expense transactions, such as fees and overhead transactions, and major sales.*

We concur with the recommendation that there should be testing of income and expense transactions. To accomplish this we have relied on requirements built into the transaction documents and established oversight procedures that over time have served us well. As a first line of defense each partnership must submit independent annual audits which review and attest to the overall veracity of their financial statements and systems. Annual compliance reports, which review the extent to which the partners/servicers are complying with the partnership agreements, also must be submitted by the partnerships.

A second layer of protection is afforded through AEW's regular requests for aggregate expense and income information from each partnership. This aggregate information is analyzed across all transactions for reasonableness and for month to month variances. Given the uniqueness of these portfolios, i.e. raw land and non-performing loans from failed thrifts, AEW focuses on peer comparisons. If a ratio is out of line as compared to other partnerships with similar asset compositions, or from period to period, the partnership servicer is contacted to discuss any potential problems. If unexplained irregularities remain, AEW notifies the DRR Oversight Manager while continuing to monitor the situation. Where the situation persists, the DRR Oversight Manager contacts the OIG and an audit of the partnership is requested.

Historically, DRR has worked closely with the OIG to ensure compliance with the equity partnership agreements, particularly in areas related to income and expense allocation. Since 1996 the OIG has undertaken 28 audits involving all but one of the existing partners.[1] From inception of the Equity Program, it was envisioned that DRR and the OIG would work in partnership to minimize risk to RTC/FDIC as limited partner. We continue to rely on the safeguards in place, including our relationship with the OIG, which we believe has produced beneficial and cost effective results. If it should become logistically impractical to continue working with the OIG, we will explore other options at that time such as engagement of independent CPA firms with the requisite expertise to conduct reviews.

Management also agrees with the recommendation that major sales transactions be tested. In its 1997 Oversight Review of AEW the DRR Program Office and DOF made the following recommendation:

> *Modify [AEW's] semi-annual site visitation program to include a request for copies of settlement statements and related expense documentation to facilitate the validation of sales proceeds. …DRR and DOF encouraged AEW to continue recommending partnerships and trusts to the OIG for review. We further reminded AEW of the provision in the Task Orders for the use of third party auditors, subject to agreed upon procedures**, should the OIG's schedule not accommodate a review.***

As a result AEW agreed to: 1) issue a letter to partners and servicers requesting copies of settlement statements for major REO sales; 2) revise its meeting agendas to include this request; and 3) review settlement statements to verify the accuracy of net sales proceeds calculations. Copies of the form letter and sample agenda are attached as Exhibit 1.

For more detailed discussion of income and expense review refer to the Appendix, specifically the section entitled "Review of Source Documents".

2. *Determine and implement the most effective method, or combination of methods, to minimize the cost of AEW's future equity partnership oversight.*

Management concurs with the recommendation. On November 2, 1998 we negotiated a new fee structure with AEW Capital Management effective Jan. 1, 1999 for the eight task orders under which it monitors FDIC's limited partnership interest in the equity transactions. Under the new schedule, the fixed fee paid to AEW will be reduced by 25% during the "wind up" phase of a transaction. Wind up is the time between the liquidation of the last asset in the trust and acceptance of AEW's last deliverable, a termination package, by the FDIC Oversight Manager. Fees to AEW for a particular transaction will terminate on the last day of the month in which the FDIC Oversight Manager acknowledges in writing and conveys to AEW acceptance of the final termination package delivered by AEW. We decided not to pro rate based on actual day of acceptance since AEW still has an obligation to report on the transaction in the following month.

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[1] An audit of PNL is scheduled for 1999. For more information on audits refer to (16) I the Appendix.

On average the 25% step down reflects the decreased workload associated with the wind up phase of a transaction. It does not, however, take into account time spent during that period in non-routine or unique activities that could be required under the statements of work. Based on our best estimates for final asset liquidation and trust terminations in 1999, this modification has the effect of reducing projected payments to AEW next year by approximately 11.3% from $1.34 million under the current fee schedule to $1.19 million.

We are following up with DOA- Contracts to modify the existing Task Orders and implement this revised fee structure effective January 1, 1999. (See Exhibit 2.)

Cc: Hank Abbot, DRR
Dean Eisenberg, DRR
Bruce Gimbel, OIR
Gail Patelunas, DRR
Giovanni Recchia, DRR

APPENDIX II

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.

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	Begin requesting, reviewing, and verifying equity sales transactions.	30 days from final report	Copy of the letter instructing AEW to begin testing transactions.	Not Quantifiable	Yes
2	Modify existing task orders and implement revised fee structure.	30 days from final report	Copies of the modified task orders for 1999.	Estimated $150,000 funds put to better use	Yes