United States General Accounting Office

GAO

Report to the Honorable Bruce F. Vento, House of Representatives

July 1994

RESOLUTION TRUST CORPORATION

Recommendations Addressed to Oversee and Account for Cash Flow Mortgages

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-256185

July 26, 1994

The Honorable Bruce F. Vento
House of Representatives

Dear Mr. Vento:

On April 20, 1992, you requested that we monitor the Resolution Trust Corporation's (RTC) cash flow mortgages. After discussions with your office, we agreed to assess RTC's progress in implementing the three recommendations made in our previous report entitled Resolution Trust Corporation Assessing Portfolio Sales Using Participating Cash Flow Mortgages (GAO/GGD-92-33BR, Feb. 25, 1992). In further agreement with your office, we reviewed RTC's oversight of the Patriot and Centrust cash flow mortgages to assess whether oversight efforts implemented by RTC have adequately monitored and administered the terms and conditions of these agreements.

Background

Cash flow mortgages are loans in which the interest payments to the lender are determined by the cash flow generated from the financed asset. Generally, the borrower is not obligated to make payments until a positive cash flow is generated from the asset. In other words, interest payments are made only from the financed asset's operating cash flow, not from the borrower's other resources. This arrangement differs from more traditional financing structures in which the borrower is obligated to make interest payments even if the financed asset is losing money.

Cash flow mortgages may also have a participating feature. Under this financial structure, the lender and the borrower share in the asset's cash flow and sales proceeds on a predetermined basis. If the asset is sold or refinanced, the lender and the borrower share the proceeds on a predetermined basis.

Past Recommendations

In our 1992 report we said that, in concept, portfolio sales using participating cash flow mortgages could be an important disposition strategy for RTC's least marketable real estate assets. The use of this strategy reflected RTC's willingness to be innovative and market responsive. However, portfolio sales using participating cash flow mortgages require diligent postclosing monitoring and administration in order to protect RTC's long-term interests. We recommended that RTC:

1. develop detailed oversight procedures for loan monitoring and administration of participating cash flow mortgages,

2. determine how it would account for the loan assets resulting from the cash flow mortgage transactions and whether any allowance for potential future loss is required, and

3. perform a postclosing assessment of these pilot transactions.

Centrust and Patriot Cash Flow Mortgages

In 1991, as a way to attract investors, RTC began using cash flow mortgages. On November 7, 1991, RTC entered into a participating cash flow mortgage financing arrangement with Winthrop Financial Associates in connection with the sale of the Centrust Tower in Miami, FL. Under the Centrust cash flow mortgage, RTC received a note for $36.8 million. As of February 28, 1994, the balance owed RTC was $36.8 million plus $6.9 million dollars in accrued interest.[1]

On January 1, 1992, RTC entered into a participating cash flow mortgage financing arrangement with Citation Mortgage Limited for the sale of 26 congregate care and assisted living properties[2] located in 12 states. For this sale, RTC received a note for $85 million. Citation Mortgage Limited prepaid the mortgage in full on February 22, 1993, and satisfied its obligation to RTC. As a result, RTC's responsibilities and interests in these assets were terminated.

On August 2, 1991, RTC entered into a participating cash flow mortgage financing arrangement with the Patriot group for the sale of properties in its inventory of which Patriot bought 25 properties—1 hotel and 24 office buildings. On August 21, 1992, 4 of these properties were purchased by Patriot, and on December 7, 1992, 21 more properties were purchased. Under the Patriot cash flow mortgage, RTC received notes for $109.1 million for the properties purchased. As of February 28, 1994, the balances owed RTC equalled $104.8 million.

For the Centrust and Patriot participating cash flow mortgages, RTC's return depends to a great extent on how well the properties are managed

[1]As of February 28, 1994, Winthrop had made two interest payments in this transaction. On July 29, 1993, Winthrop paid $89,046 and on November 1, 1993, they paid $293,779 for a total of $382,825.

[2]Congregate care and assisted living properties are multiunit housing facilities for the elderly, characterized by an array of common services, such as housekeeping, daily communal meals, transportation, organized activities, and security, but generally not health care.

and whether the mortgage terms and conditions are strictly followed. To help protect its interests, RTC hired servicers to monitor and administer the borrower's management of the assets. The servicers are also responsible for making sure that payments are made to the appropriate accounts and that RTC receives its agreed-upon share of the cash flows. Servicers for RTC's participating cash flow mortgages are to take steps to ensure that all terms of the agreements are met and properties are managed pursuant to the loan documents. The servicers are to act on RTC's behalf in approving actions and making decisions that protect RTC's interests. Appendix I provides specific information on each asset included in the mortgages.

Results in Brief

RTC has implemented two of the three recommendations made in our previous report on cash flow mortgages. RTC has implemented the third recommendation to the extent practicable.

In November 1992, RTC implemented oversight procedures for cash flow mortgages as recommended by presenting the instructions for use of the new procedures at a conference of RTC oversight managers and contracting and legal division representatives. RTC also has implemented the second recommendation from our 1992 report by determining how it will account for the cash flow transactions and whether any allowance for potential future loss is required.

The third recommendation from our 1992 report, that RTC make postclosing assessments of the cash flow transactions, has been addressed to the extent practicable. A postclosing assessment of the Congregate Care cash flow mortgage was completed shortly after the buyer satisfied its obligation to RTC. RTC has not completed postclosing assessments of Centrust and Patriot because RTC officials determined that these transactions cannot be accurately assessed until they are completed.

We reviewed RTC's efforts to oversee the Patriot and Centrust cash flow mortgages. Both of these cash flow mortgages began operating before RTC implemented its oversight procedures. For the Patriot mortgage, RTC took steps from the beginning to help ensure that the terms and conditions of the agreement were followed by hiring a servicer and clearly defining its responsibilities. Later, RTC transferred the Patriot mortgage servicing responsibilities to a national servicer. However, for the first 20 months of the Centrust mortgage, RTC's oversight efforts did not ensure that the taxpayer's interests were protected as completely as they could have been.

As of July 1993, both the Centrust and Patriot cash flow mortgages were being serviced by the same firm. Overall, we found that this servicer was taking the required steps to determine if the borrowers complied with the terms and conditions of the Patriot cash flow mortgage. In addition, this servicer had developed a similar monitoring plan for the Centrust cash flow mortgage. We believe that this plan, if properly implemented, should enable the servicer to provide adequate oversight of the Centrust mortgage.

However, we found that neither the servicer's routine oversight practices nor the outside accountant's annual audit would determine whether unrelated fees and expenses had been charged to the properties' operating accounts. After we questioned these charges, the servicer developed procedures for the auditor that include a review of these charges. Such procedures are needed to verify that unrelated charges are not being passed on as expenses to the properties.

Objectives, Scope, and Methodology

Our objectives were to determine whether RTC had implemented the recommendations from our previous report concerning participating cash flow mortgages and to assess whether oversight efforts implemented by RTC would be adequate to monitor and administer the terms and conditions of the Centrust and Patriot agreements. We excluded the Congregate Care transaction from our review because RTC's responsibilities and interests in those assets were terminated in February 1993, when Citation Mortgage Limited fully paid the mortgage.

We reviewed RTC policies and procedures to determine whether it had (1) developed detailed oversight procedures for loan monitoring and administration, (2) centralized oversight responsibility, and (3) implemented an oversight process. We had recommended that these actions be taken in our previous report (GAO/GGD-92-33BR, Feb. 25, 1992). We interviewed headquarters officials in RTC's Division of Asset Management and Sales in Washington, D.C., officials in RTC's National Sales Center in Washington, D.C., and regional RTC officials in Dallas and Atlanta to discuss their roles in developing and implementing the oversight procedures. We also interviewed the national servicer currently in charge of the cash flow mortgages and the interim servicer for the Centrust mortgage.

We reviewed RTC's methods of accounting for loans that arise from the transactions and determined whether any allowance for potential future loss is required. We interviewed responsible RTC officials to determine if RTC had performed a postclosing assessment of the transactions.

We obtained and analyzed documents, such as servicing agreements, loan documents, and internal memos, and discussed the monitoring and administration efforts with responsible RTC officials. We obtained and reviewed property reports prepared by the servicers to see how they were performing the property inspection and oversight duties necessary for these mortgages.

We reviewed the quarterly reports prepared by the debtors for RTC to check the reported performance and cash flow of the Patriot properties. As part of our review we examined quarterly budget variance reports for each property. Furthermore, we assessed RTC's efforts to oversee the servicers by (1) reviewing the servicers' reports and subsequent follow-up actions taken by RTC and (2) verifying whether RTC had completed reviews of the servicers. We also interviewed RTC officials responsible for overseeing the servicers.

We did our work from February 1993 through February 1994 in accordance with generally accepted government auditing standards.

In May 1994, RTC provided written comments on a draft of this report. These comments are addressed on pages 15 and 16. We reprinted RTC's comments in appendix II.

RTC Established a Program for Monitoring and Administering Cash Flow Mortgages

On November 6, 1992, in response to our recommendation, RTC established task order procedures for hiring servicers to administer and monitor multi-asset, seller-financed transactions, including cash flow mortgages. On November 10, 1992, RTC presented the Multi-Asset Sales Transaction (MAST) National Servicer Task Order Procedures to the RTC field office oversight managers and contracting and legal department representatives responsible for the implementation of the program. Under these procedures, to determine if a borrower complies with the terms and conditions of its seller-financed transactions, RTC hires firms that have been prequalified, known as RTC's national servicers, to monitor and administer the borrowers' actions and decisions.

MAST is designed like other RTC Task Ordering Agreements (TOA) and may be used when the same services are needed on a recurring basis.[3] Its purpose is to expedite future contracting actions by performing the initial steps in the contractor selection process before a particular service is needed. Under TOA procedures, RTC begins the process by issuing a general description of the services it anticipates needing and solicits proposals from interested contractors. RTC evaluates the proposals and selects qualified contractors to form a pool. When services are needed, RTC provides a pool of preapproved contractors with information about the assignment and solicits proposals from them. RTC evaluates the proposals, selects a contractor, and awards a task order contract. The TOA and the signed task order contract together constitute the contract.

From May 22, 1992, to September 15, 1992, RTC competitively solicited and preapproved a group of seven firms to service the cash flow mortgages based on technical qualifications. These firms are known as RTC's national servicers. Subsequently, for each task order request, RTC is to solicit technical proposals and cost estimates from its national servicers and then select one of them primarily on the basis of its ability to service the loan requirements as completely as possible at the lowest price.

National servicers are responsible for specific seller-financed loans or cash flow mortgages via task orders. As part of the MAST procedures, RTC established a standard task order that is modified to fulfill the specific needs of each seller-financed loan or cash flow mortgage. The task order states that the servicer will "Provide full loan servicing pursuant to the loan documents, the agreement and this task order." Loan servicers' duties generally include collecting and remitting loan payments from borrowers, maintaining escrow accounts for real estate taxes and hazard insurance, and, if necessary, foreclosure of and repossession of the collateral on defaulted loans if directed to do so by RTC.

The task order includes a summary of the servicer's responsibilities that identifies the requirements of the cash flow mortgage and the actions that the servicer must take to ensure that the requirements are fulfilled. For example, the task order requires the servicer to review the loan documents and provide RTC with schedules of obligations required to be satisfied by the borrower and lender under the applicable loan documents. The task order identifies other actions the servicer must take to fulfill its role in making sure the borrower complies with the loan documents.

[3] RTC defines a TOA as a written instrument of understanding containing (1) terms applying to future task order contracts; (2) a general description of the services that may be needed; and (3) the methods for pricing, issuing, and delivering task order contracts under a TOA.

An RTC field office representative had been designated to oversee the national servicer assigned to each of the cash flow mortgages we reviewed. These representatives were responsible for oversight of the servicer, including making evaluations of the servicer's performance under its contract by completing on-site reviews, reviewing reports from the servicer, and contacting the servicer on a regular basis regarding the borrower's compliance with the loan documents.

RTC Has Determined How It Will Account for the Cash Flow Mortgages

In our 1992 report, we also recommended that RTC determine how it will account for the loan assets received as a result of the cash flow mortgage transactions and whether any allowance for potential future loss is required. RTC has determined how to account for the loan assets resulting from the cash flow mortgage transaction. In a 1993 report, we said that RTC's methodology for producing recovery estimates was reasonable.[4] RTC has reasonably estimated an allowance for future loss as a result of these transactions. RTC is also accounting for potential future losses.

Generally, RTC accounts for its cash flow mortgage loans in the same way it accounts for its other seller-financed loans. RTC removed the sold real estate asset from its receivership books. RTC then recorded the new loan that resulted from the cash flow mortgage transaction. RTC estimates future losses during the quarterly process of estimating cash recoveries for receivership assets. During our audit of financial statements, we determined that RTC's methodology for producing recovery estimates was reasonable.[5]

Postclosing Assessments Should Be Done When the Centrust and Patriot Cash Flow Mortgages Are Completed

Our 1992 report also recommended that RTC make postclosing assessments of the cash flow mortgages. This recommendation has been addressed to the extent practicable. A postclosing assessment of the Congregate Care cash flow mortgage was completed after the buyer prepaid the mortgage and satisfied its obligation to RTC. RTC found that the RTC financing provided in the transaction substantially improved RTC's collections. According to RTC, its actual collections were about $28 million higher using cash flow mortgage financing than accepting the cash equivalent bid value.

RTC program officials also said that assessments of the Patriot and Centrust cash flow mortgages had not been done because such

[4]Financial Audit: Resolution Trust Corporation's 1992 and 1991 Financial Statements (GAO/AIMD-93-6, June 30, 1993).

[5]GAO/AIMD-93-6, June 30, 1993.

assessments would not be meaningful until these transactions have been completed. Furthermore, RTC does not believe postclosing assessments are currently necessary because the Patriot and Centrust cash flow mortgages are likely to be the last such mortgages. According to RTC officials, this financing structure required aggressive monitoring and administration to ensure that RTC's interests were protected. In addition, RTC found that because the real estate markets had improved it was no longer necessary to use this type of transaction to attract buyers for its real estate assets. However, should market conditions deteriorate, RTC may consider using cash flow mortgages in future disposition strategies.

We agree with RTC and believe that postclosing assessments would not be valid at this point. Postclosing assessments based on partial information could provide misleading assessments of the transactions. However, assessments based on complete information could be beneficial to RTC or its successor should it plan to use cash flow mortgages as part of its disposition strategy. We and RTC believe that assessments should be done when the transactions are completed.

RTC and Its Servicers Have Adhered to RTC Oversight Procedures for the Patriot Cash Flow Mortgage

From June to December 1992, an interim servicer was responsible for the administration and monitoring of the Patriot cash flow mortgage. During that time, only 4 of the 25 properties in this transaction were purchased by Patriot. RTC provided a statement of work to the interim servicer that identified the requirements of the loan documents and summarized the servicer's responsibilities.

On December 17, 1992, 10 days after the December 7, 1992, closing date for the remaining 21 properties in the Patriot transaction, RTC, using the November 1992 MAST task order agreement procedures, transferred the servicing responsibilities to one of its national servicers. RTC also provided this servicer with a complete statement of work that outlined its responsibilities for the Patriot cash flow mortgage. As of June 30, 1993, this servicer had visited 19 of the 25 Patriot properties to verify that repairs and improvements were made and to make an overall assessment of the property.

The servicer had also reviewed related invoices, advised the borrower regarding leasing decisions, and completed required reports for review by the RTC regional representative. Furthermore, the servicer developed additional reports to help RTC oversee the borrowers' compliance with the agreement. For example, the servicer developed a report that included a summary of the payments on the note by the borrower; a schedule of compliance with key steps in the transactions, such as the preparation of operating budgets; an occupancy summary for all properties; and a schedule of payments of real estate taxes by the borrower.

Additionally, RTC has taken steps to oversee the servicer. RTC representatives told us that they communicate with the servicer at least once a week to get an update on the management of the properties. The servicer confirmed regular talks with RTC officials regarding the Patriot mortgage. In November 1993, RTC completed its on-site review of this servicer. A summary of the results of this review was issued on December 7, 1993, and according to this document the servicer was doing a very good job performing under the requirements of the Patriot servicing contract.

Oversight of the Centrust Cash Flow Mortgage Was Deficient

RTC's oversight efforts over the Centrust cash flow mortgage did not ensure that the taxpayer's interests were protected as completely as they could have been. Specifically, RTC did not (1) document whether it serviced the mortgage, (2) hire an interim servicer that could fulfill all necessary duties beyond routine servicing and cash collections, (3) provide this servicer with all the information needed to service the mortgage, and (4) adequately define the servicer's responsibilities to encompass its duties beyond the standard servicer agreement scope of work.[6] RTC recognized the limitations of the standard servicing agreement and amended the standard servicing agreement three times. However, the amendments to the standard servicing agreement did not ensure that all the requirements of the Centrust cash flow mortgage could be performed by the interim servicer. As RTC concedes, the servicing requirements of the Centrust cash flow mortgage "far exceeded the scope of work" in the interim servicer's existing contract. As a result, we do not believe that the amendments were sufficient to ensure that the taxpayer's interests were fully protected.

Although RTC was to immediately provide in-house servicing, for the first 5 months after the Centrust mortgage was signed, November 7, 1991, to April 8, 1992, RTC officials could not provide any evidence that they had performed servicing duties. RTC transferred this mortgage to an interim servicer at the end of the first 5 months.

[6]The standard servicing agreement used in the Centrust transaction specified that the servicer would provide loan administration services, collection of payments for the reduction of principal and application of interest, certain foreclosures and repossession services, collection personnel, escrow administration, and remittance of collected payments to RTC.

RTC transferred the Centrust cash flow mortgage to an interim servicer that was also servicing other, less complex RTC seller-financed loans on April 8, 1992. However, according to the servicer, RTC did not provide the complete loan documents needed to service the loan until 4 months later in mid-August. Although RTC provided this servicer with a standard servicing agreement, it was not adequate to ensure that the complex requirements of the Centrust transaction were fully serviced. Subsequently, in November 1992, RTC gave the servicer a statement of work that included a detailed summary of the servicer's responsibilities describing its responsibilities for fully servicing the Centrust cash flow mortgage. This was about 1 year after the transaction was completed, 7 months after transferring the loan to the servicer, and the same month the MAST procedures were implemented.

Before receiving this detailed summary of responsibilities, the servicer did not know what RTC expected it to monitor and administer. As a result, from April 1992 to November 1992, the servicer, in compliance with its existing contract, serviced the Centrust cash flow mortgage like other RTC seller-financed loans. RTC incurred an unnecessary risk by not providing a clear and detailed definition of responsibilities for servicing the Centrust cash flow mortgage before engaging a servicer.

In November 1992, shortly after RTC provided the servicer with a summary detailing the servicing requirements for the Centrust cash flow mortgage, the servicer informed RTC that there were some requirements that, in the servicer's view, could not be accomplished from a practical perspective, and others that exceeded the servicer's duties in a "typical" servicing role. The servicer informed RTC that under the current contract conditions the servicer would be unable to perform several of the duties from a practical perspective.

Specifically, in a letter to RTC the servicer wrote that, among other requirements, it would be impractical for it to try to (1) monitor for the occurrence of capital events, (2) avoid actions or omissions that could result in the business relationship being considered a partnership, (3) monitor restoration work undertaken by the debtor, (4) investigate CPA firms hired by the debtor, (5) monitor compliance by the debtor with environmental laws, and (6) verify that the debtor has engaged a qualified architect or qualified engineer for improvements on the property.

The servicer said to us that the compensation level for the servicing contract was well below what would have been necessary for the servicer to actually service the contract as the summary of servicer's responsibilities described. When we asked the servicer how the issues raised were resolved, the servicer told us that these issues were not resolved until the national servicer took control of servicing for the loan. These issues were addressed under the solicitation for a new servicer.

An RTC official acknowledged to us in a June 21, 1993, letter that the servicing requirements of the Centrust cash flow mortgage "far exceeded the scope of work" in the interim servicer's existing contract. According to an RTC official, this servicer was selected on an interim basis until the MAST oversight procedures were finalized and a national servicer could be engaged. RTC's MAST procedures were completed in November 1992.

It was not until July 22, 1993, almost 9 months after the MAST procedures were developed, that RTC hired a national servicer for the Centrust cash flow mortgage. From November 1991 until July 1993—about 20 months—the Centrust cash flow mortgage was not being adequately serviced.

A national servicer was not hired to service the Centrust cash flow mortgage until July 1993 because RTC believed that, given the lack of cash remittances due to RTC under the terms of the loan documents, the risk in underservicing this mortgage before the national servicer was engaged was minimal. According to RTC, under the terms of the mortgage, payments were not required to be made to RTC until the Centrust asset generated 3 consecutive months of profitability. According to RTC, since sustained profitability was unlikely given the low demand for office space in the Miami area at that time, and no payments were expected, the risk associated with this servicing arrangement was minimal. We neither determined the level of risk nor reviewed the payment history or other related documents for the Centrust mortgage because at the time of our review the RTC Inspector General was performing an audit of the transaction.

Furthermore, the national servicer could not immediately begin servicing the mortgage. The servicer had to become familiar with the borrower's requirements. This meant that the servicer, after being hired, had to make the initial contacts with the borrower and get the necessary documentation to service the mortgage. On August 12, 1993, the servicer met with the borrower to discuss the mortgage requirements and initiate their relationship. On September 16, 1993, the servicer sent a letter to the borrower reviewing the open items discussed in the August 12, 1993, meeting. This letter marks the servicer's first documented follow-up of the borrower's actions to make sure that the requirements of the mortgage were followed.

The new servicer for Centrust is also servicing the Patriot cash flow mortgage. Our review found that the servicer had developed a monitoring plan for Centrust that is similar to the one used for Patriot. However, at the time of our review the servicer had not had time to fully implement this plan. If the servicer fully implements this plan, we believe the oversight of the Centrust mortgage should be adequate.

Routine Monitoring and Administration Practices May Not Detect Unrelated Charges

The MAST oversight procedures establish mechanisms to monitor compliance with respect to the operation of the properties and the administration of cash flow mortgages. However, the servicer's routine monitoring and administration practices may not detect charges to the properties' operating accounts for fees and expenses not directly related to the administration of the financed properties. RTC officials agreed that such unrelated charges could go undetected. According to RTC officials, under the terms of the MAST agreement, they expect the servicer to review charges in order to minimize this problem.

Both the Patriot and Centrust cash flow mortgage documents provide that the borrower will be reimbursed for operating expenses directly related to the financed properties by charging these costs to the properties' operating accounts. The loan agreements state that the operating expenses shall be for only normal, reasonable, and customary fees, costs, and expenses in connection with the operation, management, leasing, security, and/or repair of the mortgaged property.

We determined that the borrower charged the Patriot properties' operating accounts for fees and expenses that may not have been directly related to the administration of the properties. On the basis of our review of the variance reports in the quarterly report, we found that fees and costs for indirect expenses, such as professional association memberships, advertising, stationery, consultants, and acquisition-related matters, were charged to the properties' operating accounts. Because these costs and fees are used to support the buyer's overall operations, they should not be charged to the operating accounts. Under the terms of the agreement the buyer can charge RTC no more than a 5 percent management fee. Therefore, when any of these fees are instead charged to the operating accounts the buyer is not complying with the terms of the agreement.

Additionally, we identified costs related to legal expenses associated with purchasing some of the properties that were charged to the operating accounts. For example, according to the master agreement of sale of the Patriot properties, RTC and Patriot were responsible for paying their own legal fees with respect to each closing. We brought these issues to RTC representatives who told us that the servicer would be addressing our concerns for both Patriot and Centrust.

The servicer said that it monitored all charges to the properties' operating accounts for reasonableness. The servicer said that some charges, particularly the membership fees, were acceptable as fringe benefits. However, the servicer depended on the auditor to check these charges to see if they were directly related to the operation of the property. The servicer said that it was aware that it was possible for costs that were not directly related to be passed on to RTC, but it believed that an audit would detect such inappropriate operating expenses during the annual audits required by the cash flow mortgage agreement.

However, the terms of the audit engagement do not require the auditors to verify whether charges are within the terms of the loan agreement. Generally, the auditors are only required to determine whether receipts or invoices match the amounts charged to the operating accounts. As a result, charges that may not be within the terms of the agreement may not be identified during these audits.

Since neither the servicer's routine oversight practices nor the outside accountant's annual audits include reviews to determine if all charges are related to the properties' operations, we believe it is important that the servicer verify these charges and ensure that they are directly related to the operation of the property and in accordance with the mortgage agreements. While the unrelated charges identified in the variance reports for the properties in one quarterly report that we examined equalled only .02 percent of the $109.1 million value of the mortgage and 1.36 percent of the $1.8 million quarterly operating expenses, these charges could be passed on several times each year and, therefore, reduce the return to RTC.

After we questioned these charges, RTC said the servicer developed procedures for the auditor that include a review of these charges to ensure that unrelated charges are not passed on as expenses to the properties, affecting the return to RTC. RTC officials said that the servicer will require the auditors to follow these procedures during the 1994 audit of Patriot and Centrust.

Conclusions

RTC has implemented two of the three recommendations we made in our 1992 report. In response to our first recommendation, RTC established oversight procedures that should enable it to verify whether borrowers complied with the terms and conditions of cash flow mortgage agreements. Under these procedures, RTC is to contract with qualified national servicers to monitor and administer the loans, provide these servicers with complete statements of work, and oversee the servicers via regular reports, discussions, and on-site reviews. In response to the second recommendation, RTC has determined how it will account for the cash flow mortgage loans and potential future losses.

The third recommendation from our 1992 report, that RTC make a postclosing assessment of the cash flow mortgage transactions, has been addressed to the extent practicable. A postclosing assessment of the Congregate Care cash flow mortgage was completed. However, RTC has not assessed the Patriot and Centrust cash flow mortgages. RTC program officials said that assessments of the Patriot and Centrust cash flow mortgages had not been done because such assessments would not be meaningful until these transactions have been completed. We agree with RTC and believe that postclosing assessments would not be valid at this point. Postclosing assessments based on partial information could provide misleading assessments of the transactions. However, assessments based on complete information could be beneficial to RTC or its successor should it plan to use cash flow mortgages as part of its disposition strategy.

RTC's oversight efforts for the Patriot and Centrust cash flow mortgages differed greatly. For the Patriot mortgage, RTC ensured that the terms and conditions of the agreement were met by contracting with an interim servicer and defining its duties. The servicing of this contract was later transferred to a national servicer after the sale was completed. In contrast, for the first 20 months of the Centrust mortgage, RTC did not ensure that the terms and conditions of the agreement were met. RTC failed to provide immediate servicing to the mortgage. When RTC engaged a servicer, the service requirements of the cash flow mortgage servicer "far exceeded the scope of work" in the servicer's existing contract. In addition, RTC failed to provide adequate definition of the servicer's role. Finally, it was not until about 20 months after the Centrust cash flow mortgage sale was completed that RTC contracted with a national servicer that was fully capable of monitoring and administering this mortgage. As a result, RTC could not be certain that the borrower was complying with the terms and conditions of the agreement for about a 20-month period.

We found that the national servicer hired using the MAST procedures was taking the necessary steps to determine if the borrowers complied with the terms and conditions of the Patriot cash flow mortgage. We also found that this servicer plans to use similar steps to monitor the Centrust cash flow mortgage, and we believe these steps, if properly implemented, should be adequate to service this mortgage.

However, neither the servicer's routine monitoring and administrative practices nor the auditors' annual audits included reviews to detect unrelated charges made to the properties' operating accounts. RTC said the servicer has now established oversight procedures for the auditors to follow during the 1994 audit cycle of the Patriot and Centrust cash flow mortgages to address this problem. Although such unrelated charges individually may not represent large amounts of money, we are concerned that these charges, over the lives of these mortgages, could add up and reduce the overall return to RTC. It is important that the servicer implement procedures to verify the fees charged to the properties' operating accounts.

Recommendation

We recommend that RTC's Deputy and Acting Chief Executive Officer direct RTC servicing oversight personnel to require RTC's cash flow mortgage servicer to implement procedures requiring that the annual audits of cash flow mortgages include verification of the charges to the properties' operating accounts throughout the life of the mortgages.

Agency Comments and Our Evaluation

In commenting on a draft of this report, RTC agreed with our recommendation. In response to our recommendation, RTC said that the servicer has developed procedures to ensure that unrelated charges are not passed on as expenses to RTC. According to RTC, the auditors will follow these procedures during the 1994 audit cycle.

RTC also agreed with all of our findings except one. RTC said that the interim servicing agreement for the Centrust note included a very detailed scope of work that provided for an acceptable level of servicing, in its opinion, and ensured that any payments due under the terms of the Centrust loan documents would be received and properly applied to the appropriate accounts. We disagree. The contract terms under which the interim servicer was hired did not provide an acceptable level of servicing.

As discussed on pages 9 to 12 of the report, cash flow mortgages like the Centrust note require a much higher degree of servicing than provided by a standard servicing agreement. This servicing must ensure that all the terms and conditions in the mortgage agreements are monitored because these terms and conditions affect the cash flow generated by the asset and, therefore, RTC's return. For example, if the servicer did not monitor restoration work performed by the purchaser, RTC would not know if the property was being restored properly. The standard servicing agreement used for the interim servicing of the Centrust note did not provide for such monitoring. The servicer needed to monitor these expenditures to ensure that the necessary work was being done and reasonable prices were being charged for these services. Further, as stated in the report, the servicer acknowledged that it did not and could not monitor all the terms and conditions of the mortgage. Currently, the Centrust cash flow mortgage is under a servicing agreement that should enable RTC to ensure that adequate oversight is maintained.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to other interested congressional members and committees, the Deputy and Acting Chief Executive Officer of RTC, and the Chairman of the Thrift Depositor Protection Oversight Board. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix III. Please contact me on (202) 736-0479 if you or your staff have any questions concerning this report.

Sincerely yours,

Gaston L. Gianni

Gaston L. Gianni, Jr.
Associate Director, Government
Business Operations Issues

Contents

Abbreviations

MAST	Multi-Asset Sales Transaction
RTC	Resolution Trust Corporation
TOA	Task Order Agreements

Patriot and Centrust Cash Flow Mortgage Properties as of 10/21/93

All monetary values in millions

Cash flow mortgage	Type property	Book value	Appraisal	Appraisal/book value	Sale price	Sale price/ appraisal
Patriot American	**Office Buildings**					
	Bexar Office Tower	$25.1	$13.0	52%	$8.6	66%
	5255 Katy Freeway	10.4	3.9	38	3.0	77
	3100 Monticello Office Building	20.1	11.3	56	7.0	62
	Memorial Office Building	9.4	9.3	99	6.7	72
	Town and Country Central	17.9	5.4	30	4.5	83
	1717 St. James Place and 1770 St. James Place	21.5	5.2	24	2.9	56
	7700 San Felipe Office	8.7	5.5	63	3.5	64
	Cornerstone Regency	2.1	1.3	62	1.0	77
	Metroport	8.6	4.7	55	4.9	104
	Preston Center Office	15.7	5.3	34	4.1	77
	Republic Place	10.3	3.6	35	2.4	67
	Santa Fe Plaza Office	7.8	1.3	17	1.1	85
	Landmark Bank Center	7.0	2.9	41	2.3	79
	Commerce Plaza	30.7	6.8	22	4.6	68
	Century Building	9.7	4.4	45	3.3	75
	Atrium at Coulter Ridge	1.5	1.5	100	.5	33
	Brandeis Building	7.5	5.6	75	6.2	111
	Phelan Building	36.8	29.5	80	20.8	71
	Western Savings Building	36.0	6.5	18	7.0	108
	Westage Business Center	10.8	11.5	106	7.7	67
	Silver Square	6.0	4.1	68	4.4	107
	Beardsley Corporate Center	8.2	4.0	49	2.6	65
	Century III Building	5.4	6.6	122	5.3	80

(continued)

All monetary values in millions

Cash flow mortgage	Type property	Book value	Appraisal	Appraisal/book value	Sale price	Sale price/ appraisal
	Hotel					
Patriot American	Bourbon Orleans Hotel	11.0	14.3	130	11.0	77
	Totals	**$328**	**$167**	**51%**	**$125.4**	**75%**
Centrust	**Office Building**					
	Centrust Tower	$166.4	$70	42%	$44	63%

Comments From the Resolution Trust Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

RTC
RESOLUTION TRUST CORPORATION
Resolving The Crisis
Restoring The Confidence

May 18, 1994

Mr. Gaston L. Gianni, Jr.
Associate Director, Government Business Operations Issues
General Government Division
United States General Accounting Office
Washington, DC 20548

RE: GAO Report titled "Resolution Trust Corporation: Recommendations Addressed to Oversee and Account for Cash Flow Mortgages"

Dear Mr. Gianni,

Thank you for the opportunity to review and comment on the GAO report referenced above.

Background:

Between February 1993 and February 1994 your office reviewed RTC's servicing oversight of and accounting for the cash flow mortgages associated with the Patriot American and Centrust sales transactions. Your two stated objectives were: 1) to determine whether RTC had implemented the recommendations from GAO's previous report concerning cash flow mortgages (RTC: Assessing Portfolio Sales Using Participating Mortgages- GAO/GGD-92-33BR, February 25, 1992); and 2) to assess whether oversight efforts implemented by RTC would be adequate to monitor and administer the terms and conditions of the Centrust and Patriot Agreements.

GAO Findings:

RTC accepts and agrees with your findings that:

1) RTC has developed detailed oversight procedures for loan monitoring and administration;

2) RTC has determined the appropriate accounting methodology for the cash flow mortgages and RTC has reasonably estimated an allowance for future loss as a result of these transactions (GAO/AIMD-93-6, June 30, 1993); and

3) RTC has addressed the third recommendation, that RTC make post-closing assessments of the cash flow transactions, to the extent GAO believes is practicable at this time.

801 17th Street, N.W. Washington, D.C. 20434

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Pre-M.A.S.T. Servicing of Centrust:

See comment 1.

The GAO report states that during the early months of the Centrust transaction, "RTC's oversight efforts did not ensure its interests were protected as completely as they could have been" until the Centrust note was transferred into the Multi-Asset Sales Transactions ("M.A.S.T.") Program where it is currently being serviced by one of the nation's premier servicers.

See comment 2.

Operating within RTC's Contracting and Procurement Guidelines, RTC was aware that it could not provide the maxmimum level of servicing required for cash flow mortgage loan documents within the scope of work or compensation structures contained in any of RTC's existing servicing agreements in place at that time. RTC was however, actively establishing policies and procedures and soliciting for servicers to protect its interests in these newly originated notes within a newer and broader level of contract services under its M.A.S.T. Servicing Program.

See comment 3.

During this M.A.S.T. servicer contracting process, RTC established interim servicing arrangements for its earlier transactions. The GAO report correctly notes that RTC repeatedly expanded Centrust's interim servicer's scope of work to provide the best servicing available to RTC.

See p. 16.

The interim servicing engaged for the Centrust note from August 1992 to July 1993 included a very detailed scope of work which provided for an acceptable level of servicing and ensured that any payments due under the terms of the Centrust loan documents would be received and properly applied to the appropriate accounts.

Current and Future Servicing:

See comment 4.

Centrust and Patriot are currently being serviced under the M.A.S.T. program, and therefore the RTC agrees with GAO that its interests are now, and will continue to be, protected to the fullest extent possible under the loan documents.

GAO Conclusions:

The subject GAO report indicates that, during its year long review of RTC's oversight of cash flow mortgages, GAO identified one area for potential improvement in the M.A.S.T. Servicing Oversight Program's procedures as they are applied to cash flow mortgages.

See comment 5.

It was determined that the M.A.S.T. servicer's routine oversight practices and the outside accountant's reviews would not determine whether unrelated fees and expenses had been charged to the properties operating accounts. The servicer has since developed procedures and is currently soliciting a third party accountant to verify, among other things, that unrelated charges are not being passed on as expenses to the properties for the Patriot transactions (see attached January 10, 1994 memo). As noted by the GAO, the servicer has established a similar approach in its servicing methodology to the Centrust transaction and RTC expects it to continue to do so in this regard.

2

RTC agrees with GAO's conclusion that the current "... servicer was taking the required steps to determine if the borrower complied with the terms and conditions of the Patriot cash flow mortgages. In addition, the servicer had developed a similar approach to monitor the Centrust cash flow mortgage and that, if properly implemented, should enable the servicer to provide adequate oversight of the Centrust mortgage."

RTC's Implementation of GAO Recommendation

RTC's Vice President for Asset Management and Sales will direct RTC servicing oversight personnel to insure that RTC's servicer continues to implement procedures to effectively monitor and verify the appropriateness of expenses charged against the Cash Flow Mortgages' collateral properties' operating accounts subject to the authority granted to RTC under the loan documents and RTC's contracting procedures.

Thank you for your constructive review of this important loan servicing oversight program at RTC. Please contact me at your earliest convenience if you have any additional comments or if I may be of further assistance.

Sincerely,

Thomas P. Horton
Vice President for
Asset Management and Sales

cc w/out attachments:
- Jack Ryan
- Susan Whited
- Phil Jones
- James Wigand
- Amy Hersh
- Diane Crawford
- David McDonough
- Joan Millane
- Pat Stewart-Gordon
- Mark King
- John Cutcliff
- Chris Drown
- Stan Pawlowski

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The following are GAO's comments on the Resolution Trust Corporation's May 18, 1994, letter.

GAO's Comments

1. We did not determine the relative strengths and weaknesses of all possible servicers of the cash flow mortgages, and we cannot confirm RTC's assertion that the current servicer of the cash flow mortgages is one of the nation's premier servicers.

2. While RTC states that it actively solicited servicers for both cash flow mortgages after MAST was established, RTC was far more successful in obtaining a servicer for the Patriot cash flow mortgage than it was with the Centrust cash flow mortgage. While it took RTC only 10 days after the December 7, 1992, closing date of the Patriot cash flow mortgage to have a MAST servicer under contract, it took RTC almost 9 months from the time MAST was established to engage a servicer for the Centrust cash flow mortgage. As we stated in our report, we do not believe that the Centrust cash flow mortgage was adequately serviced during the time previous to the July 1993 engagement of the MAST servicer for Centrust. This delay increased the amount of time in which the contract was not being adequately serviced.

3. While we recognize that RTC made changes to amend the servicing coverage of the Centrust cash flow mortgage, we did not say that RTC provided the best servicing available to RTC in its oversight of the Centrust cash flow mortgage. As previously stated, it took RTC almost 9 months, from the time MAST was established, to engage a national servicer for the Centrust cash flow mortgage.

4. We did not say that RTC interests are now, and will continue to be, protected to the fullest extent possible under the loan documents. Instead, we said that a national servicer was adequately servicing Patriot and developed a similar plan to service Centrust. We also said that if the servicer fully implements the plan, Centrust should be adequately serviced.

5. The report was modified to reflect RTC's response.

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