

Office of Inspector General




March 8, 2001
Audit Report No. 01-008

**Audit of Claims Made to the Credit
Enhancement Reserve Funds for
Securitization Transactions 1992-03
and 1992-04**



DATE: March 8, 2001

TO: Mitchell Glassman, Director
Division of Resolutions and Receiverships

FROM: 
David H. Loewenstein
Assistant Inspector General

SUBJECT: *Audit of Claims Made to the Credit Enhancement Reserve Funds for Securitization Transactions 1992-03 and 1992-04*
(Audit Report No. 01-008)

The Office of Inspector General (OIG) has completed an audit of claims made to the credit enhancement reserve funds for single-family residential (SFR) loan securitization transactions 1992-03 and 1992-04. The Resolution Trust Corporation (RTC)¹ began issuing mortgage-backed securities in June 1991. The RTC and the Federal Deposit Insurance Corporation (FDIC) issued 74 mortgage-backed security transactions (securitizations) with original unpaid principal balances (i.e., book value) of approximately \$43.8 billion. Of these 74 securitizations, 44 were collateralized by SFR mortgage loans with a book value of \$25.3 billion. As of November 14, 2000, there were 15 SFR securitizations remaining with a collateral balance that totaled \$1.2 billion.

BACKGROUND

The RTC used securitization as a method to sell loans from failed institutions. To obtain a high credit rating, the RTC created reserve funds for each securitization. The purpose of the reserve funds is to provide investors with a limited amount of protection against credit risks in the event that borrowers default or fail to make timely remittances on loans included in the securitization. Upon liquidation of a defaulted loan, the servicer prepares an officer's certificate that reports the realized loss or gain from liquidation. Upon receipt of the officer's certificate, the trustee releases the amount of the realized loss or deposits the amount of the realized gain from or to the reserve funds. Any remaining balance in the reserve funds returns to the FDIC after the securitization transaction terminates. Therefore, claims to the reserve funds directly affect the value of the FDIC's residual interest in the reserve funds.

¹ The RTC's legislatively mandated sunset date was December 31, 1995. Responsibility for all RTC-related work as of that date was transferred to the Federal Deposit Insurance Corporation in accordance with the RTC Completion Act.

During 1999 and 2000, the OIG performed audits of all nine securitization transactions serviced by Ryland Mortgage Company (Ryland). Ryland charged the reserve funds \$172 million in net realized losses. The OIG issued nine reports during 2000 with total combined questioned costs of \$7.1 million. On May 16, 1998, PNC Mortgage (PNC) acquired the servicing rights for eight of the nine securitizations previously serviced by Ryland that had not terminated. Because of the numerous errors disclosed in the Ryland audit reports and discussions with management from the FDIC Division of Resolutions and Receiverships (DRR) Mortgage Backed Securities Administration (MBS), the OIG decided to perform an audit of Ryland securitizations that transferred to PNC.

For our audit of PNC, we selected two of the eight acquired securitizations, 1992-03 and 1992-04. These two securitizations accounted for 55 percent of the net realized losses charged to the reserve funds by PNC. As discussed earlier, in September 2000, the OIG issued two audit reports on these two securitizations (for 1992-03, Audit Report No. 00-044 and for 1992-04, Audit Report No. 00-041) that were serviced by Ryland.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine whether the claims on the officer's certificates submitted to the reserve funds for the sample items tested were allowable and adequately supported by documentation. To accomplish this objective, we reviewed a judgmental sample of the officer's certificates for securitization transactions 1992-03 and 1992-04 for the period June 1998 through June 2000. During this period, PNC claimed net realized losses totaling \$6.0 million (\$3.5 million for 1992-03 and \$2.5 million for 1992-04). We initially selected six loans for testing with realized losses totaling \$633,922 (\$304,428 for 1992-03 and \$329,494 for 1992-04). Based on results of the survey, we expanded our sample to include nine additional loans with net realized losses totaling \$518,279 (\$153,181 for 1992-03 and \$365,098 for 1992-04). Therefore, the entire sample size totaled 15 loans with net realized losses totaling \$1.15 million, or 19 percent of the \$6.0 million in realized losses charged to the reserve funds for both securitizations.

During our audit of the sampled loan files, we identified instances when PNC claimed principal and interest advances also claimed earlier by Ryland. We performed additional procedures to identify any other duplicate principal and interest advances for non-sampled loans for all transactions transferred to PNC from Ryland. We presented the results of this review to DRR MBS in our report entitled *Securitization Transactions Serviced by PNC Mortgage, Audit of Duplicate Principal and Interest Advances* (Audit Report No. 01-009).

To accomplish our audit objective, we interviewed personnel from DRR MBS, PNC, and MGIC Investor Services Corporation (MGIC) of Milwaukee, Wisconsin. To fulfill part of its oversight function, DRR MBS hired MGIC to perform "reasonableness" reviews of realized losses submitted by loan servicers of the SFR securitizations. In addition, we performed the following procedures for each sampled loan:

- reviewed all available settlement statements and other disposition documents to confirm the amount of the net proceeds;
- reviewed loan histories and amortization schedules, where available, to verify the proper amount of principal and interest advances and the remaining scheduled principal balances;

- reviewed the adequacy of the documentation supporting the corporate advances charged to the reserve fund;
- searched for unrecorded income and overstated advances;
- recalculated the amortization of the sampled loans to verify that the principal and interest advances that PNC charged to the reserve fund conformed to the terms of the note and that the proper interest rate was used in the calculation;
- traced the interest rate used to the appropriate index to verify that the interest rate used by PNC was correct;
- confirmed that servicing fees were excluded from interest advances;
- verified the default and liquidation dates using evidence in the loan files and verified that PNC ceased principal and interest advances in the month of liquidation; and
- recalculated the unused insurance premium refunds that did not appear to have been credited to the reserve fund.

We performed our work at PNC's office in Vernon Hills, IL, and the FDIC's offices in Washington, D.C. PNC coordinated with Ryland to provide us with documentation from Ryland's servicing period. We conducted the audit in accordance with the standards applicable to financial-related audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. We began our review on July 24, 2000 and completed the fieldwork on December 8, 2000.

We did not evaluate PNC's systems of internal controls because we concluded that the audit objective would be met more efficiently by conducting substantive tests rather than by placing reliance on PNC's systems of internal control.

RESULTS OF AUDIT

We found that \$441,764 of the \$1.15 million sampled, or 38 percent of the claims PNC submitted for the 15 loans, were either unallowable under the terms of the Pooling and Servicing Agreement (PSA) or unsupported. However, as discussed earlier, PNC had taken over servicing from Ryland. We determined that \$187,248 of the \$441,764 in questioned costs related to previous errors by Ryland. We also found that one loan, for which we questioned \$165,644, should not have been included in securitization 1992-04 because it had been satisfied by the borrower. We questioned the costs associated with this loan because the costs should not have been charged to the reserve fund; however, PNC may be entitled to submit a claim to the representations and warranties fund. Finally, \$45,879 questioned related to PNC claiming principal and interest advances that were also claimed by Ryland. Although we believe PNC is responsible for filing the duplicate claims, we do not believe that this would have happened had PNC not taken over servicing from Ryland.

Therefore, we believe that \$398,771, or 90 percent, of the questioned costs we identified are due to poor servicing by Ryland or related to a loan that should not have been included in the securitization. The remaining \$42,993, or 10 percent, of questioned costs related to PNC's servicing of the loans. These questioned costs represent 4 percent of the total sampled items. Accordingly, we conclude that charges to the reserve fund by PNC were generally allowable and supported except as noted.

Table 1 presents an overall summary of the results of our testing of the 15 sample loans.

Table 1: Summary of Total Questioned Costs

Description	Dollars
Unallowable Costs	\$401,309
Unsupported Costs	40,455
Total	\$441,764
Total Realized Losses Tested	\$1,152,201

Source: OIG analysis.

UNALLOWABLE COSTS

Our review disclosed unallowable costs totaling \$401,309, which represents 35 percent of the \$1.15 million in realized losses sampled for the period of June 1998 through June 2000. More significantly, unallowable costs represent 91 percent of all questioned costs identified during our review. These questioned costs consist of charges either not allowed under the terms of the PSA or incurred by the servicer due to the servicer's own error. We have categorized unallowable costs into eight categories for the purposes of this report:

- Fire Loss
- Potential Representations and Warranty Claims
- Principal and Interest Advances
- Duplicate Principal and Interest Advances
- Liquidation Expenses
- Corporate Advances
- Miscellaneous Unallowable Costs
- Escrow Expenses

Table 2 summarizes the results of unallowable costs by category.

Table 2: Summary of Unallowable Costs

Category	Number of Loans with Errors	Amount of Unallowable Costs
Fire Loss	1	\$141,230
Potential Representations and Warranty Claims	1	124,245
Principal and Interest Advances	13	64,721
Duplicate Principal and Interest Advances	8	45,879
Liquidation Expenses	7	10,294
Corporate Advances	8	9,344
Miscellaneous Unallowable Costs	8	4,182
Escrow Expenses	3	1,414
Total		\$401,309

Source: OIG analysis.

Fire Loss

We questioned PNC’s claim of \$141,230 related to one loan due to servicer error on the part of Ryland. Specifically, Ryland released two-thirds of the fire insurance proceeds to the borrower before the borrower rebuilt the dwelling. The loan file indicated that the borrower subsequently “disappeared.” PNC eventually liquidated the remaining collateral, the lot, and submitted a \$141,230 claim for the loss to the reserve. DRR’s oversight contractor, MGIC, noted that the fire loss should not have resulted in a loss to the reserve, but rather that the property should have been rebuilt. We concur with MGIC and believe that if Ryland had properly disbursed the insurance proceeds, the loss to the reserve fund would not have occurred. PNC has submitted a claim to Ryland for the entire amount of the loss; however, PNC has not yet reimbursed the reserve for the loss it claimed. Therefore, until the reserve fund is made whole, we question the entire loss of \$141,230 as avoidable.

Potential Representations and Warranty Claims

We identified one loan for which PNC submitted a realized loss claim after determining that the original loan had been forgiven by the failed institution. Therefore, the loan was ineligible for inclusion in the securitization. The amount questioned, \$124,245, represents the portion of the realized loss associated with the unpaid principal balance transferred into the securitization. Corporate advances made by PNC and principal and interest advances made by both Ryland and PNC are questioned below under the principal and interest advance section of this report. While PNC is responsible for reimbursing the reserve fund for the questioned costs associated with this loan, it may be eligible to file a representations and warranty claim for this portion of the questioned costs.

Principal and Interest Advances

We questioned \$64,721 of principal and interest advances for 13 of the sampled loans. One loan alone constituted \$27,329 of the total questioned costs. In this instance, PNC claimed \$27,329 of interest advances for a loan that was satisfied by the borrower. Two other loans constituted \$19,526 of the total questioned costs. For these two loans, PNC claimed principal and interest payments from the reserve account for balloon payment loans. In each of these cases, we found that the borrowers defaulted on the balloon payment date, but the servicer continued to advance principal and interest payments to the trust, thus incurring additional interest expense. The PSA requires that the servicer advance the monthly payment due on defaulted loans. The balloon payment is considered a monthly payment under the PSA. We therefore believe that the servicer should have advanced the balloon payment and avoided the additional interest expense. Another loan constituted \$13,810 of the questioned costs. For this loan, PNC claimed principal and interest advances for several months following the liquidation of the property. The remaining \$4,056 related to minor rate differences and excess servicing fees claimed by PNC for principal and interest advances. The PSA required that the servicer make timely and correct interest adjustments. Additionally, the PSA specifically prohibited the servicer from collecting servicing fees on defaulted loans.

Duplicate Principal and Interest Advances

We identified \$45,879 of questioned costs related to eight of the sampled loans. While it serviced the questioned loans, Ryland deemed these eight loans “non recoverable” and submitted claims against the reserve accounts for principal and interest advances prior to liquidating the loans. We found that when PNC subsequently liquidated the loans, it claimed principal and interest amounts for the same period as Ryland resulting in the duplicate payments.

FDIC personnel explicitly warned PNC of the possibility of duplicate advances being claimed in its May 20, 1998 letter to PNC counsel. However, we found that for the sampled loans PNC initially claimed \$91,275 in duplicate interest. PNC subsequently reimbursed the FDIC \$40,242 of this amount and the OIG questioned \$5,154 of it in OIG Audit Report No. 00-044. Therefore, we question the remaining \$45,879 of duplicate principal and interest payments for these loans.

We have also reviewed the remaining loans in these transactions as well as the other securitization transactions serviced by PNC for duplicate payments. We issued a separate report entitled *Securitization Transactions Serviced by PNC Mortgage: Audit of Duplicate Principal and Interest Advances* (Audit Report No. 01-009).

Liquidation Expenses

We identified \$10,294 of questioned liquidation expenses for seven of the sampled loans. The questioned liquidation expenses were primarily related to avoidable fees for interest and penalties on taxes, excessive commission charges, and avoidable homeowners' association late fees. The PSA specifically required that the servicer advance taxes and assessments in the event the borrower failed to make these payments to avoid the imposition of liens. Additionally, the servicer had an inherent duty to minimize the loss on the disposition of foreclosed property. Finally, we considered sales commissions of more than 6 percent to be questioned costs unless there was a documented, acceptable reason in the loan file, like a stated dollar amount for a low valued property.

Corporate Advances

We identified \$9,344 of questioned corporate advances for eight sampled loans. The majority of these questioned costs that were paid through the servicers' corporate accounts related to one loan for which we found that the servicer had expended \$6,721 to maintain a property for which the mortgage had been previously satisfied. The remaining \$2,623 related primarily to duplicate payments of invoices and other avoidable fees paid through PNC's corporate account.

Miscellaneous Unallowable Costs

We identified \$4,182 in miscellaneous unallowable costs related to eight loans. This amount primarily consisted of unrefunded hazard insurance premiums. The PSA required the servicer to minimize the losses to the reserve, and PNC should have sought these refunds.

Escrow Expenses

We identified \$1,414 of questioned escrow expenses for three of the sampled loans. The questioned costs relate to two tax penalties paid through escrow and a duplicate payment of an attorney invoice paid through escrow. As stated earlier, the PSA clearly required the servicer to make timely payments of taxes. Additionally, the PSA required that the loss to the reserve fund be minimized.

Recommendation

We recommend that the Manager, MBS, DRR:

- (1) Disallow the unallowable costs of \$401,309 as detailed below:
 - Fire Loss \$141,230
 - Potential Representations and Warranty Claims \$124,245
 - Principal and Interest Advances \$64,721
 - Duplicate Principal and Interest Advances \$45,879
 - Liquidation Expenses \$10,294
 - Corporate Advances \$9,344
 - Miscellaneous Unallowable Costs \$4,182
 - Escrow Expenses \$1,414

UNSUPPORTED COSTS

Our audit disclosed \$40,455 of unsupported costs, which represented 3 percent of the realized losses that we sampled for the period of June 1998 through June 2000. These results suggest that PNC was maintaining adequate support for most of the escrow expenses, corporate advances, and liquidation expenses charged to the reserve fund for the two securitization transactions. Nevertheless, the servicer is required to maintain adequate supporting documentation for all realized losses charged to the reserve fund.

Section 3.04 of the PSA states: "... the Servicer shall keep and maintain separate accounting records for each Mortgage Loan for the purpose of justifying **any withdrawal** from the Certificate Account (**emphasis added**)..." The Certificate Account is a custodial account established and maintained by the servicer on behalf of the securitization. The PSA also requires the servicer to retain this documentation for its most recent 5 fiscal years.

We categorized the unsupported costs into three categories for the purposes of this report:

- Escrow Expenses
- Corporate Advances
- Liquidation Expenses

Table 3 summarizes the unsupported questioned costs by category.

Table 3: Summary of Unsupported Costs

Category	Number of Loans with Errors	Amount of Unsupported Costs
Escrow Expenses	9	\$26,367
Corporate Advances	7	8,330
Liquidation Expenses	3	5,758
Total		\$40,455

Source: OIG analysis.

Escrow Expenses

We identified \$26,367 of unsupported escrow expenses for nine of the sampled loans. These unsupported costs related to attorney fees, foreclosure costs, property inspections, and other expenses paid by the servicer before liquidation. A majority of these expenses were paid by Ryland from the escrow account. We considered any escrow disbursement to be supported if there was (1) a detailed invoice² from the vendor who provided the service or utility and (2) evidence of actual payment. If one or the other was missing from the loan file, then we considered the expense to be an unsupported cost. Acceptable evidence of payment included copies of checks that agreed to amounts claimed or subsequent invoices that identified prior balances as paid.

Corporate Advances

We identified \$8,330 of unsupported corporate advances. For seven of the sampled loans, we could not locate sufficient evidence in the file (i.e., invoice and evidence of payment) to substantiate the corporate advances. Examples of corporate advances were property management bills, attorney fees, and utilities.

Liquidation Expenses

We identified \$5,758 of unsupported liquidation expenses. For three of the sampled loans, we could not locate sufficient evidence in the file (i.e., invoice and evidence of payment) to substantiate the deductions from sales proceeds on the settlement sheet. Examples of liquidation expenses were sewer fees, repairs, home warranty, and other additional settlement charges deducted from proceeds on the settlement sheet.

² For example, property managers would often pay expenses and claim reimbursement from PNC/Ryland by submitting an invoice that itemized these expenses. We considered these property management expenses to be unsupported if the underlying detailed invoices from the actual third-party vendors were not available to adequately support the property management invoices.

Recommendation

We recommend that the Manager, MBS, DRR:

(2) Disallow the unsupported costs of \$40,455 as detailed below:

- Escrow Expenses \$26,367
- Corporate Advances \$8,330
- Liquidation Expenses \$5,758

CORPORATION COMMENTS AND OIG EVALUATION

On February 20, 2001, the Deputy Director, Franchise and Asset Marketing, DRR, provided a written response to the draft report. The response is presented in Appendix I of this report.

DRR management agreed to disallow all of the questioned costs in Recommendations 1 and 2, totaling \$441,764. DRR also stated that it is pursuing collection of the disallowed amount through settlement discussions with PNC. DRR expects the discussions to be completed by June 30, 2001. DRR will maintain all documents pertaining to the settlement discussions with PNC.


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 I 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, the OIG will report questioned costs of \$441,764 (of which \$40,455 is unsupported) in its *Semiannual Report to the Congress*.



DATE: February 20, 2001

TO: David Loewenstein
Assistant Inspector General

FROM: James R. Wigand 
Deputy Director, Franchise and Asset Marketing

SUBJECT: Response to Draft Report Entitled *Review of the Claims Made on the Credit Enhancement Reserve Fund for the Securitization Transaction 1992-03 and 1992-04*

The following describes the management actions in response to recommendations contained in the above referenced report.

1) Disallow the unallowable costs of \$401,309 as detailed below:

Fire Loss - \$141,230
Potential Representations and Warranty Claims - \$124,245
Principal and Interest Advances - \$64,721
Duplicate Principal and Interest Advances - \$45,879
Liquidation Expenses - \$10,294
Corporate Expenses - \$9,344
Miscellaneous Unallowable Costs - \$4,182
Escrow Expenses - \$1,414

A) Specific Action Already Taken:

MBS Administration concurs with the OIG findings to disallow \$401,309 in unallowable costs claimed by PNC and Ryland Mortgage to the Credit Enhancement Fund for each detailed category listed above. We are currently pursuing the collection of the total disallowed amount from PNC Mortgage in accordance with Section 3.04 of the corresponding Pooling and Servicing Agreements.

B) Corrective Actions to be Taken Together with Expected Completion Date:

MBS Administration has contacted PNC regarding the disallowed amount and it appears generally agrees with disallowed amount. We will follow up with a written request for reimbursement. We expect that collection of the deficiency to be resolved by June 30, 2001.

- C) Documentation that will confirm the completion of the corrective action.

DRR will maintain all documents pertaining to the settlement discussion with PNC Mortgage.

- 2) Disallow the unsupported costs of \$40,455 as detailed below:

Escrow Expenses - \$26,367
Corporate Advances - \$8,330
Liquidation Expenses - \$5,758

- A) Specific Corrective Action Already Taken:

MBS Administration concurs with the OIG findings to disallow the \$40,455 in unsupported costs claimed by PNC and Ryland Mortgage to the Credit Enhancement Fund for each detailed category listed above. We are currently pursuing the collection of the total unsupported amount from PNC Mortgage in accordance with Section 3.04 of the corresponding Pooling and Servicing Agreements.

- B) Corrective Action to be Taken Together with Expected Completion Date:

MBS Administration has contacted PNC regarding the disallowed amount and it appears generally agrees with disallowed amount. We will follow up with a written request for reimbursement. We expect that collection of the deficiency to be resolved by June 30, 2001.

- C) Documentation that will confirm the completion of the corrective action.

DRR will maintain all documents pertaining to the settlement discussion with PNC.

cc: Director, Office of Internal Control Management
Director, Division of Resolutions and Receiverships
Associate Director for Internal Review, DRR
Internal Control Liaison, DRR

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	The Corporation agreed to disallow \$401,309 and will pursue collection of this amount through settlement discussions with PNC.	June 30, 2001	Documents pertaining to settlement discussions with PNC.	\$401,309 in disallowed costs	Yes
2	The Corporation agreed to disallow \$40,455 and will pursue collection of this amount through settlement discussions with PNC.	June 30, 2001	Documents pertaining to settlement discussions with PNC.	\$40,455 in disallowed costs	Yes