Office of Inspector General

Executive Summary

Corus Construction Venture, LLC Structured Asset Sale

Report No. AUD-12-009
April 2012

Why We Did The Audit

Within the FDIC, the Division of Resolutions and Receiverships (DRR) has primary responsibility for resolving failed insured-depository institutions, including the liquidation of assets in receivership. One strategy that DRR has employed to liquidate receivership assets is structured asset sales. In general, structured asset sales involve selling or contributing receivership assets, such as loans and real estate owned (REO), to a limited liability company (LLC) formed by the FDIC in its capacity as Receiver for one or more failed institutions. The Receiver then sells an interest in the LLC to a private third-party, with the Receiver retaining either an equity interest in the LLC or a participation interest in the net cash collections to be received from the servicing and liquidation of the LLC's assets. As of December 27, 2011, the FDIC, acting as Receiver for failed banks, had consummated 31 structured sales involving 42,252 assets with a total unpaid principal balance of about $25.4 billion.

The Office of Inspector General (OIG) contracted with CliftonLarsonAllen LLP (Clifton) to conduct a performance audit of the Corus Construction Venture, LLC (CCV) structured asset sale. The transaction involved multiple written agreements, which we collectively refer to as the structured asset sale agreements. The objectives of the audit were to assess: (1) compliance with the structured asset sale agreements related to the CCV structured asset sale and (2) the FDIC's monitoring of the agreements.

Background

On September 11, 2009, the Office of the Comptroller of the Currency closed Corus Bank, N.A., Chicago, Illinois (referred to herein as the Failed Bank), and the FDIC was appointed Receiver. On October 12, 2009, the FDIC as Receiver for the Failed Bank created CCV and subsequently entered into a structured sale wherein 101 assets of the Failed Bank receivership were sold, in part, and contributed, in part, to CCV. The assets had an unpaid principal balance of approximately $4.4 billion and included loans for condominium and office construction projects in a number of markets, such as Atlanta, Chicago, Los Angeles, Miami, New York, and Washington, D.C. Under the terms of the structured asset sale agreements, CCV assumed certain duties, obligations, and liabilities pertaining to the assets and issued Purchase Money Notes (PMN) totaling $1.377 billion to the Receiver as partial consideration for the sale.

On October 16, 2009, following a competitive bid process, the Receiver sold an initial 40-percent managing equity interest in CCV to CCV Managing Member, LLC, later known as ST Residential. ST Residential paid the Receiver approximately $551 million and assumed certain liabilities and contractual obligations for its equity interest in CCV, and the Receiver retained the remaining 60-percent equity interest. ST Residential serves as CCV's Managing Member and, as such, has overall responsibility for managing the business and affairs of CCV. In addition, ST Residential performs asset servicing functions. In exchange for servicing, administering, managing, and disposing of CCV's assets, ST Residential receives a monthly management fee and reimbursement of certain allowable servicing expenses from the proceeds of the assets.

To facilitate the structured asset sale, the Receiver provided CCV an Advance Facility of up to $1.15 billion to fund the construction of incomplete buildings and provide other asset-related working capital. Before the members of CCV can receive equity distributions, the full amount due on the PMN must be deposited into a defeasance account, all borrowings under the Advance Facility must be paid in full, and the ability to lend further under the Advance Facility must be terminated. Further, if ST Residential receives distributions from CCV equal to pre-defined thresholds, ST Residential's equity interest in CCV will decrease to 30 percent and the Receiver's equity interest will increase to 70 percent.

Audit Results

Clifton concluded that CCV and ST Residential were in compliance with certain provisions of the structured asset sale agreements. For example, ST Residential submitted timely financial reports to the FDIC as Receiver for the Failed Bank. In addition, with respect to assets that Clifton sampled, ST Residential had taken steps to increase their marketability by making improvements and placing considerable emphasis on engaging knowledgeable asset and property managers to service and liquidate the assets. Regarding the FDIC's monitoring of the agreements, Clifton found that DRR had implemented certain controls and additional control improvements were planned or underway at the close of audit fieldwork. As described below, however, Clifton identified several matters involving ST Residential's compliance and the FDIC's monitoring that warrant management's attention.

Management Fees on Nonaccrual and Capitalized Interest. Under the terms of the structured asset sale agreements, ST Residential receives a monthly management fee based on the aggregate unpaid principal balance of the loans (including REO and other acquired collateral) held by CCV. During the period of the audit, ST Residential received significant management fees pertaining to nonaccrual and capitalized interest included in the unpaid principal balances of certain assets. Based on Clifton's experience, it is not a customary or usual practice in the financial services industry to pay a management fee on nonaccrual and capitalized interest because there is no economic substance to the interest, and it requires no substantive management work. Because of a lack of clarity in the agreements, we are not questioning those fees, but are recommending that DRR review this matter further and provide additional clarification regarding the treatment of nonaccrual or capitalized interest in future structured asset sale agreements. Given the FDIC's plans to consummate additional structured asset sales in the future, further review and clarification of this issue is warranted.

Servicing Expenses. Clifton identified $6,258,151 in costs incurred during the period October 16, 2009 through September 30, 2010 that were not permissible under the terms of the structured asset sale agreements and that DRR should disallow. The majority of these costs pertain to servicing-related activities provided by real estate development firms engaged by ST Residential. The remaining questioned costs involve travel, meals, and entertainment. These costs have the effect of reducing future cash distributions to be paid to the Receiver from the servicing and liquidation of assets by an estimated $3,754,891, or 60 percent—the Receiver's equity interest in CCV—of $6,258,151. Accordingly, Clifton questioned the $3,754,891 amount.

Controls and Activities Associated with Servicing and Liquidating Assets. Although ST Residential established various controls to help ensure that assets were serviced and liquidated consistent with the terms of the structured asset sale agreements, the company had not developed written policies and procedures for servicing and liquidating assets that were commensurate with the size, risk, and complexity of the assets being managed. The lack of sufficient policies and procedures presented operational risk and was a contributing factor in ST Residential employing loan servicing practices that were not compliant in certain key respects with the servicing standard defined in the agreements. For example, selected loan files that Clifton reviewed lacked key documentation, such as appraisals, site inspection reports, and current borrower financial information.

Protection of Sensitive Information. While ST Residential had implemented certain controls over sensitive personally identifiable information for borrowers and guarantors, its controls as a whole were not consistent with customary and usual standards of practice for prudent mortgage lenders, loan servicers, and asset managers servicing, managing, and administering loans and properties similar to CCV.

Management Fee Calculations. Clifton identified $8,929 in management fees that DRR should disallow (questioned costs of $5,357, or 60 percent of $8,929) due to an erroneous unpaid principal balance amount on a loan. Clifton also noted that improved procedures for ensuring timely application of cash collections to the unpaid principal balance of CCV's assets could reduce management fees.

DRR's Monitoring of the CCV Structured Asset Sale. DRR established certain controls for managing the risks associated with the CCV structured asset sale, such as assigning a dedicated Senior Asset Management Specialist to monitor the agreements and engaging a contractor to provide certain quality assurance services. However, DRR's monitoring needed improvement in several areas. Among other things, DRR was not reviewing servicing expenses reported by ST Residential, conducting independent site inspections of properties, or analyzing relevant documentation in support of advance requests under the Advance Facility. In addition, although DRR had engaged a Verification Contractor to provide certain quality assurance services pertaining to the CCV transaction, the services provided by the contractor were generally not efficient or effective.

DRR advised Clifton that a number of control improvements were either established or planned subsequent to the close of audit field work. Such improvements included issuing policies and procedures for monitoring structured asset sales, engaging a Compliance Monitoring Contractor to perform periodic compliance reviews of CCV and ST Residential, and assigning additional resources to monitor the CCV structured asset sale. DRR also replaced the Verification Contractor and began performing independent site inspections. Further, DRR had entered into a Letter Agreement with ST Residential to, among other things, conduct a comprehensive review of servicing expenses to determine whether they were properly accounted for. Clifton did not assess the effectiveness of controls established subsequent to the close of audit field work. If implemented effectively, the new controls should enhance the quality of DRR's monitoring and oversight of the CCV structured asset sale.

In total, Clifton identified $3,760,248 in questioned costs, which the OIG plans to report in its next *Semiannual Report to the Congress.*

Corporation Comments

The Director, DRR, provided a written response, dated April 2, 2012, to a draft of this report. Before finalizing its response, DRR provided a draft copy of the OIG's Executive Summary to ST Residential for its review and informal comment on March 27, 2012. DRR officials advised us that ST Residential offered no comment on the OIG's Executive Summary. In its response, DRR agreed with all 10 of the report's recommendations and described various corrective actions that were either completed or planned. Such actions include reviewing the manner in which management fees are calculated under structured asset sale agreements; seeking the disallowance of questioned costs; and revising policies, procedures, and guidance that govern the business activities associated with the CCV transaction. DRR's planned and completed actions are responsive to all 10 recommendations.

Because this report contains sensitive information, we do not intend to make the report available to the public in its entirety. We will, however, post this Executive Summary on our public Web site.