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Servicer Evaluation: FirstCity Servicing Corp.

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Opinion

Standard & Poor's Ratings Services has an ABOVE AVERAGE commercial finance special servicer ranking on FirstCity Servicing Corp. (FCSC), a wholly owned subsidiary of FirstCity Financial Corp. The outlook is stable.

As a commercial finance special servicer, FCSC's business principally centers on acquiring and resolving smaller-scale nonperforming or underperforming loan portfolios collateralized by specialty real estate and a range of other assets, such as equipment and business inventories.

Our overall ranking reflects our composite view of FCSC's operations based on the following characteristics:

- The servicer's technology environment, which we believe enables the company to meet its data management and reporting needs in an overall effective manner.
- The high average years of asset recovery experience of the professional staff (31 years for senior managers, 24 years for middle managers, and 21 years for asset managers).
- What we view to be generally effective operating procedures for asset resolution decision-making and execution, in our view.
- The quality and scope of the company's ongoing internal audit function and other compliance practices.
- What we consider to be a solid track record of attaining overall successful loan recovery results principally involving portfolios, with an assortment of smaller balance secured and unsecured assets and often located in tertiary markets.

The company has 15 years of reporting and asset management experience on behalf of various private investors and joint venture partnerships, although the company has not participated in a securitized transaction since the late 1990s.

FCSC is currently the only special servicer we rank specifically as a commercial finance special servicer. As such, our ranking also remains constrained by our limited ability to evaluate FCSC's performance specifically relative to other special servicers that exclusively handle similar types of portfolios.

Table 1

Total Special Servicing Portfolio

Loan portfolio	Jun-10	Dec-09	Dec-08	Dec-07	Dec-06
Volume ($000)	676,452	536,482	321,658	284,161	295,748
Loans (No.)	1,328	1,542	1,015	859	1085
Avg. loan size ($000)	509	348	317	330.8	272.6
Performing loans (No. of loans)	553	618	334	337	402
Avg. aging: nonperforming loans only (months)	38	20	51	42	46
REO portfolio					
Volume ($000)	52,325	34,797	52,291	43,954	20,029
Assets (no.)	113	104	140	94	68
Avg. loan size ($000)	463	335	374	468	295
Avg. aging (months)	29	31	36	N.A.	N.A.

Table 1

Total Special Servicing Portfolio (cont.)
N.A.-Not available.

Outlook

The outlook is stable. We believe that FCSC has the operational attributes to continue performing as an effective commercial finance special servicer.

Profile

FirstCity Financial Corp. (FirstCity) was originally founded as J-Hawk Corp. in 1995 as a financial services company. FirstCity operates in the U.S. through four primary subsidiaries: FirstCity U.S. Portfolio Acquisitions, FirstCity Servicing Corp. (FCSC), FirstCity Denver Corp., and American Business Lending Inc. (ABL). Through other affiliates, the company also has a small investment presence in Latin America and Europe.

FirstCity's core business is purchasing smaller scale non- or underperforming loan and real estate assets at a discount to their principal balances or collateral values. The company noted that national, regional, and community banks have traditionally been and continue to be the source for portfolio acquisitions. The company noted that it has been buying FDIC-owned assets since 2008.

Since its inception, FirstCity, through its affiliates and partnerships, has acquired approximately $10 billion in assets secured by a variety of specialty real estate and other collateral types, such as business equipment, inventories, receivables, rolling stock, and special purpose properties, as well as traditional commercial and industrial properties across the U.S. In 2009, FirstCity invested approximately $160 million toward portfolio acquisitions and stated that it expects to invest at least that amount again in 2010.

FCSC manages portfolios either owned by its parent (or affiliates) or through third-party coinvestment partnerships. For many years, FirstCity's principal coinvestment partner was Cargill. The company indicates while it still has an asset management and coinvestment relationship with Cargill, FirstCity's newer asset management assignments now largely involve investments with other investors, such as Varde Partners. The activities of the Denver Corp. affiliate and the ABL affiliate complement this business. The activities of the Denver Corp. affiliate include acquiring and financing distressed businesses, originating junior- and senior-bridge loans, and executing lower middle-market buyouts, and the activities of the ABL affiliate includes originating Small Business Administration (SBA) loans.

FirstCity has its headquarters in Waco, Texas, but the company also has two Dallas office locations for SBA loan originations and portfolio due diligence. FCSC has indicated that it currently has one asset manager stationed in one of the Dallas offices.

As of June 30, 2010, FSCS had 55 employees, slightly up from 53 in June 2008.

Management And Organization

The subranking for management and organization is ABOVE AVERAGE.

The subranking reflects our view of the following:

- The company's stated internal control practices, which it bases on its documented procedures and the extent of its internal audit program.
- A technology platform that we believe enables FCSC to operate with effective data management and reporting capabilities.
- What we consider to be high experience levels and overall low turnover rate of the professional and management personnel.
- An organizational structure that uses teams to match portfolio types and staff expertise, including a dedicated REO department.

Professional experience and training

In our view, FCSC has maintained a stable management team while hiring some well-experienced staff during 2009 in its efforts to counter some turnover and to absorb new portfolio assignments.

- We believe that FCSC's average years of staff experience is high compared with some other commercial mortgage special servicers we rank.
- For 2009, the company reported an overall staff turnover rate of 12.5%, 3.6% of which for management positions and 8.9% of which for nonmanagement staff positions. We believe that these are moderate turnover rates based on the company's size and our assessments of other special servicers.
- During 2009, FCSC hired six people, which, in our view, largely offset the turnover.
- For the first half of 2010, the overall turnover rate was approximately 2% (consisting solely of one involuntary staff member departure).
- The company reported no management departures during the second half of 2009 or first half of 2010.
- The company noted that when portfolio acquisitions have concentrations in certain collateral types, such as agricultural assets or equipment leases, it will seek to hire asset managers with expertise in such collateral types.

FCSC appears to provide only a limited amount of formalized ongoing internal training and development offerings for its staff.

The company does not have a dedicated training coordinator, which is a position that some of our other ranked servicers have in their organizations. However, training activities largely involve on-the-job mentoring for new employees. The company noted that because its asset managers are highly experienced, it does not provide an ongoing schedule of formalized training programs other than weekly and monthly portfolio review meetings, which we believe do offer some training benefit. Additionally, staff may participate in other scheduled training events on a periodic basis.

Table 2

Staff: Average Years Of Experience As Of June 2010

	Overall industry experience	Company tenure
Senior management	31	18
Middle management	24	9
Remaining professional staff	14	5
Asset managers	21	5

Technology

We believe FCSC's technology environment enables the company to meet its data management and reporting needs in an overall effective manner. In our view, FCSC's data management, asset tracking, and management reporting appear to be largely handled in an automated and centralized manner.

- FCSC uses a Web-based proprietary asset management system that the servicer integrates with a purchased loan servicing and accounting system (Fidelity National Information Services' BancPac application).
- The features of the asset management system include: cash flow and budget projection screens to compare original and actual cash recovery performance, including NPV and IRR analyses based on asset resolution strategy assumptions; access to property and portfolio level data; and electronic approval of recommended actions.
- The company continues to use a separate loan servicing system (PCFS) designed to service SBA loans.
- FCSC uses a document-imaging tool within the servicing system and incorporates document imaging into its portfolio acquisition and closing procedures.
- The company stated that it continues to make various enhancements to its asset management system.

We believe that FCSC has effective disaster recovery planning based on its documented disaster recovery plan, which outlines the company's data backup routines and restoration process. However, the company does not appear to have a fully delineated business continuity plan, which we find with some other special servicers we rank.

- FCSC uses a colocation facility for real-time mirrored backup. It also moves data tapes offsite to a vendor location daily.
- The company's data restoration and business recovery sites are more than 25 miles from the location of the primary office.
- Testing of the disaster recovery plan occurs twice a year. FCSC noted that its targeted maximum timeframe to recover investor reporting and remaining servicing functions is three days, which is a longer period than recorded by many other special servicers we rank.

Internal controls

In our view, FCSC maintains generally well-documented policies and procedures for its special servicing operation. We believe the company also effectively monitors adherence to established procedures and controls through a recurring internal audit program.

- An internal audit manager, who works independently and reports to the parent company's board of directors, conducts operational audits annually. The audit scope focuses on various procedural and reporting compliance items, including cash controls and any related IT exceptions.
- The last audit reports from 2008-2009 identified a few generally minor exceptions, which FCSC remedied according to its stated audit responses.
- The company's internal auditor is also responsible for monitoring operational controls covering financial reporting related to Sarbanes Oxley 404 compliance.
- Additionally, FCSC has two closing managers who reconcile transaction approvals with closing documents and system inputs. The company noted that it will not release any documents or related transaction funds until a closing manager completes the review process. We therefore view the closing managers' function as complementary to FCSC's internal audit program.

FCSC is not required to undergo a USAP or Regulation AB attestation based on the private nature of its portfolio acquisitions and the fact that it does not participate as a third-party special servicer in the capital markets. FCSC noted that Varde Partners, one of its principal clients, also conducts periodic operational audits of FCSC.

Additional items

- As of June 30, 2010, First City disclosed that it was a defendant in a few asset-level lawsuits. However, the company represented that it does not view these outstanding lawsuits as being material to its ability to conduct and maintain operations.
- FCSC maintains corporate insurance coverage policies (directors and officers, and errors and omissions) with rated carriers.

Special Servicing Administration

The subranking for special servicing is ABOVE AVERAGE.

It reflects our composite view of the following:

- The company's stated practices and written policies and procedures, which we believe reflect an overall controlled and proactive approach for asset recovery management.
- A dedicated REO team to address increased foreclosure activity.
- FCSC's generally effective procedures to oversee vendors for appraisal, environmental, brokerage, and property management. An effective legal oversight process for case monitoring and supporting asset management decision-making.
- Asset recovery statistics provided by FCSC, which we believe indicate overall successful resolution results taking the nature of the assets into consideration, and relative to FCSC's corresponding collateral value, estimates and its acquisition cost basis.
- The company's history of managing and liquidating a diverse mix of nonperforming, smaller-scale assets.
- FCSC's investor reporting experience and ability to deliver detailed portfolio performance reports, although the company currently does not participate in or have much history as a special servicer within securitized portfolios.

The portfolio remains geographically diverse across all regions of the U.S., with a mix of commercial collateral types, including various non real-estate business interests. FCSC handles many commercial and industrial assets involving real estate-secured recourse loans to smaller- and middle-market businesses that may or may not include other business assets as collateral. As of mid-year 2010, FCSC stated that approximately 75% of its managed portfolio had some form of associated real estate collateral.

FCSC stated that asset managers are able to handle a much higher workload than is typical for a commercial mortgage special servicing portfolio. In our opinion, this is likely a result of the smaller size of the assets the company services in comparison to most commercial mortgage special servicers' portfolios, as well as the fact that some of the assets may comprise unimproved land and noncash-flowing collateral. We calculated the assets to asset manager ratio at 80:1, and a lower ratio of 49:1 when we exclude the loans that FCSC classified as performing. These ratios also appear to be lower than the company's year-end 2009 data. We believe that FCSC's asset manager workload ratio may actually be lower if we account for assignments based on borrower relationships rather than individual loans. By comparison, we generally see the typical workload ratio for a large volume commercial mortgage special servicer to be in the 15-20:1 range.

Table 3

Special Servicing Portfolio Addition And Resolution Activity

	Jan-June 2010		2009		2008	
Loan portfolio	**Volume ($)**	**No.**	**Volume ($)**	**No.**	**Volume ($)**	**No.**
Beginning of period	536,481,891	1,542	321,658,453	1,015	284,160,844	859
Loans added	243,723,417	80	505,966,678	1,062	165,256,645	541
Loans restructured	(15,875,109)	(14)	(6,778,818)	(21)	(99,452)	(2)
Full payoffs	(6,085,525)	(43)	(14,418,097)	(121)	(26,681,832)	(107)
Liquidated through DPO or note sale	(85,507,265)	(170)	(94,958,132)	(365)	(18,348,924)	(60)
Converted to REO	(14,738,202)	(22)	(22,456,399)	(31)	(34,165,795)	(57)
Removed through rep. and warranty claim	0	0	0	0	(184,480)	(1)
Other adjustments*	18,452,452	(45)	(152,531,794)	3	(48,278,553)	(158)
End of period	676,451,659	1,328	536,481,891	1,542	321,658,453	1,015
Performing loan volume included above	343,524,188	553	231,008,101(43%)	618 (40%)	125,311,901	334
Loans in foreclosure	8,053,622	7	4,415,507	9	2,984,193	6
Loans in foreclosure and bankruptcy	197,044	1	0	0	3,521,699	2
All loans in litigation	71,419,884	194	N.A.	N.A.	N.A.	N.A.
REO portfolio						
Beginning of period	34,797,340	104	52,291,348	140	43,953,884	94
Additions- acquired as REO	15,362,309	6	0	0	256,000 (?)	2
Added through foreclosure/deed-in-lieu	14,738,202	22	22,456,399	29	34,165,795	79
REO sold	(6,926,669)	(18)	(4,498,372)	(48)	(8,699,811)	(37)
Other REO removed from portfolio			(10,061)	(1)	0	0
Other adjustments¶	(5,960,505)	(1)	(35,441,974)	(16)	(17,384,520)	2
End of period	52,010,677	113	34,797,340	104	52,291,348	140
Total active special servicing portfolio	728,462,336	1,441	571,279,231	1,646	373,949,801	1,155

*Charge-offs and reclassified as uncollectible. ¶Other REO adjustments are largely other REO-related collections. N.A.-Not available.

Loan recovery and foreclosure management

In our view, FCSC has an effective loan recovery and foreclosure management process based on its asset analysis and internal approval practices.

- The company's collection and asset resolution process is controlled through electronic approvals administered through the asset management system based on delegated levels of authority.
- Asset managers develop a budget and business plan, known as an asset status report (ASR) within 90 days of acquisition for new assets. We believe 90 days is a common timeframe, although some of our other ranked commercial mortgage special servicers require shorter time frames for asset managers to complete their initial asset business plans.
- ASRs are created and archived through the asset management system.
- FCSC uses a formal credit committee process to approve asset budgets, most dispositions, and the ASRs.
- The servicer uses the asset management system to generate reminder notices to asset managers and electronically circulate daily reports in connection with portfolio and asset-level cash collections, valuations, and document inventories.
- Upon a portfolio acquisition, credit administrators record documents into a document inventory system and note

any deficiencies so that asset managers are aware of any issues related to collateral, lien position, or documentation.

- Asset managers can access the company's intranet site for internal policies and procedures, investor listings by portfolio, state foreclosure laws and bankruptcy code summaries, and approved attorney contact information.
- The asset management system stores updated collateral valuations along with asset managers' recovery progress comments, disposition strategies, and budgets.
- First City expects asset managers to monitor property level income and expenses for budget variances.
- The asset recovery process is based on an NPV and IRR driven analysis using a module with the asset management system. In cases where foreclosure is recommended, FCSC has a two-step approval process that requires authorization to file the foreclosure action and a second ASR approval to take title to the property.
- A foreclosure recommendation case includes tax and title search results, environmental assessment results, and valuation and cash flow projections factoring estimated legal costs. The cash flow and asset recovery projections associated with the foreclosure approval request are the basis for the REO budget.
- The company expects the loan asset manager to consult with the assigned REO asset manager to determine the expected sales recovery and likely marketing period.

FCSC requires that all loans with an NPV and collateral value greater than $500,000 be formally revalued either through third-party valuations or internal analyses at least annually.

Table 4

Special Servicing Loan Resolution Results

Full payoffs	**Jan.-June 2010**	**2009**	**2008**
Full payoffs (No.)	43	121	93
Proceeds/UPB (%)	93 (less than 100% due to accounting treatment on some equipment leases)	133	146
Avg. resolution time (months)*	25.3	30.3	34.3
Median resolution time (months)	8.9	6.8	21.4
DPO and note sales			
Loans disposed (No.)	170	365	163
Net proceeds/collateral value (%)	78 (based only on real-estate secured loans)	N.A.	N.A.
Net proceeds/UPB (%)¶	60	123.5	113.1
Average resolution time (months)	18.7	16.3	16.7
Median resolution time (months)	6.8	7.2	6.1
Restructures			
Loans (No.)	14	21	9
Loan volume - UPB ($)	15,875,109	6,778,818	2,245,845
Average resolution time (months)	9.4	15.5	11.9
Median resolution time (months)	5.9	9	9
Converted to REO			
Loans (No.)	22	31	36
Loan volume - UPB ($)	14,738,202	22,456,399	26,266,152
Average time (months)	19	17.4	20.9
Median time (months)	20	9.5	22.1
Overall average hold time all loans-full pay, DPO, restructures, and converted to REO.	19.6	19.5	22.5

Table 4

Special Servicing Loan Resolution Results (cont.)

*Average resolution time on full payoffs based on time between acquisition and resolution dates, which may include an initial period when loan was performing.¶The DPO proceeds/UPB in 2008 and 2009 include total collections over the life of the loan.

In addition to achieving total cash collections consistently well over its acquisition cost basis, FCSC also stated that its actual collections have consistently exceeded 100% of budgeted amounts.

Table 5

Loan Collections Relative To Budgeted Amounts And Acquisition Basis

	Jan.-June 2010	2009	2008	2007	2006
Cash collections ($)	73,374,513	136,418,164	62,483,826	93,866,314	113,302,336
Assets (No.)	249	538	226	284	348
Actual collections/budgeted collections (%)	107.00	106.00	118.00	110.00	110.00
Cash collections/cost basis (%)	147.00	129.00	166.00	126.00	130.00

REO management and dispositions

FCSC operates with a dedicated four-person REO department. We believe that FCSC has proactive and generally controlled REO management and sales processes based on the company's stated policies and procedures and its property disposition track record. Relative to prior years, we believe the company operates with strengthened procedures governing REO management and monitoring sales progress.

Our positive assessment of the company's REO resolution capabilities reflects the following:

- Procedures that require the loan asset managers to consult with REO asset managers at an early stage in the foreclosure process to discuss due diligence and other issues affecting the expected sales price.
- A REO coordinator who assists both the loan and REO asset manager with various aspects of the transition process, the review of any monthly property management operating reports, and with the sales closing process.
- A standardized memorandum within 48 hours of a completed foreclosure, which asset managers prepare, so that the latest accounting records and investor reports reflect the new REO.
- The company's policy requiring that all REO properties be formally revalued through third-party valuations or internal analyses annually if the NPV and collateral value exceed $100,000.
- The company's completion of 103 property sales (average $371,000 net proceeds) during 2008 through June 2010, which collectively yielded net sales proceeds of 84% of FCSC's estimated collateral values.
- An overall average disposition time of approximately 20 months for REO sold since 2008, which we believe is a successful result based on the nature of the assets.

Table 6

REO Sales Results

	Jan.- June 2010	2009	2008
Property sales (No.)	18	48	37
Net sale proceeds ($)	12,409,650	11,899,286	13,929,420
REO net sale proceeds/collateral value (%)	80.9	85.9	85.5
REO sales: average hold time as REO (months)	22.4	18.4	21
Median hold time (months)	12.3	12.9	11.8

REO accounting

Given the generally smaller scale nature of its REO, FCSC stated that these properties typically do not generate enough income or require an engagement with a property management company apart from the listing broker. For those properties requiring a property management company, FCSC stated that it prefers to establish dual bank accounts to receive rental income and then disburse funds for operating expenses. The asset manager is responsible for monitoring external property managers in conjunction with the REO coordinator. FCSC's accounting staff also reconciles the monthly bank accounts. The company tracks actual cash flow to budgeted amounts through the asset management system.

Subcontracting management

In our view, FCSC effectively oversees third-party vendor engagements through approved lists, the use of standard agreements for most subcontracting needs, required management approvals, and system-managed activity tracking reports.

- FCSC's asset managers directly coordinate the engagement of vendors for services, such as property management, brokerage, environmental audits, and legal counsel.
- A collateral valuations manager is responsible for ordering and reviewing appraisals.
- While the company uses a standard property management agreement, it does not use a standard agreement for broker engagements, which many of our other ranked special servicers usually require.
- Asset managers track vendor engagements via the asset management system.
- FCSC uses a third-party consulting firm together with in-house counsel to review environmental reports.
- Senior credit committee must approve new vendors for valuation services before the vendors are added to the approved list.
- The company states it does not conduct a formal vendor performance review, but it can remove those vendors from the approved list whose work product it deems unsatisfactory with senior credit committee approval.

Legal oversight

The company maintains in-house general counsel to support the asset managers and monitor the performance of outside counsel.

- The company's asset management system includes a litigation tracking feature to assist with managing case activity and billings, and to monitor that only approved counsel is engaged.
- The legal module also tracks asset managers' assessments of law firm performance.
- Because of the small average balance of its assets, FCSC noted that one of the legal staff's key functions is to assist asset managers in determining that any contemplated legal action makes economic sense from a cost/benefit perspective.
- FCSC stated that whenever possible, the in-house legal staff will prepare any required transaction documentation.

Asset managers are responsible for coordinating the engagement of external counsel. However, in our experience, the legal departments within some of our other ranked special servicers centrally administer external law firm engagements as a way to increase efficiency and control over the process.

Financial Position

We deem FCSC's financial position as SUFFICIENT based on a review of the parent's audited financial statements.

Related Criteria And Research

- Servicer Evaluation Ranking Criteria: U.S., published Sept.21, 2004.
- FirstCity Commercial Finance Special Servicer ABOVE AVERAGE Ranking Affirmed; Outlook Stable, published Sept. 15, 2010.