SMARTER PERSPECTIVE: RECEIVABLES

Master and Substitute Servicers Provide Creditor/ Bondholder Protection When Things go Awry

By Guillermo Malo Bahena

In this article, we take a look at an evolving best practice in establishing the parameters of a loan's structure, and how foresight can help mitigate potential downside risk for creditors by ensuring that consistent and ethical business practices are followed in administrating the loan process.

Imagine this scenario. You purchased a car about a year ago, have been receiving monthly installment bills and paying them in a timely manner. Suddenly you realize that you didn't receive your bill last month and sure enough, it doesn't come this month either. What do you do? If you're like many consumers in Mexico and around the world, you do nothing. And therein lies the problem. Actually, therein lies a symptom of a problem which likely began long before that bill was never sent.

Underpinning a multitude of loans issued worldwide by creditors across any number of industries—including automobile manufacturers, their dealer networks and associated finance companies—are bonds funded by bondholders. In much the same way that a consumer who borrowed money to purchase his or her vehicle expects to receive a bill every month, bondholders expect that those who have been put in charge of managing the billing process as well as the accounting and other processes surrounding the collection of those payments, will perform their duties in a consistent and responsible manner. Unfortunately this is not always the case.

For any number of reasons ranging from insolvency to fraud, poor business practices or general incompetence, the administrators of those loans, typically referred to as "Primary Servicers," have the potential to fail in their fiduciary duties. Furthermore, when this does occur, borrowers are not the only party impacted. Bondholders, too, can be put in a difficult and compromising position, particularly because their indicators of a potentially problematic issue regarding the administration of those loans may actually lag those of a borrower.

How can this be the case? Investors' knowledge pertaining to many of the details of their investments is frequently more limited than one might think, particularly in situations where there is no regular reporting in place to protect them. More often than not, an average bondholder simply knows that they bought a series of bonds and that, as a result, they receive regular interest and principal payments. If those interest payment, for example, begin to be issued from reserves rather than funds associated with current loan payments, the bondholder is unlikely to be aware of that important distinction. Even if those interest payments aren't posted to the holder's account for a month or two, they may go unnoticed depending upon the sophistication of the holder's own reconciliation practices. Once the missing interest payment is noted, a month or two might still go by before any action is taken. By then the situation may well have become critical.

Herein lies the case for assignment of additional "Servicer" roles into the loan structure to help ensure that consistent and ethical business practices are followed in administrating the loan process.

Master and Substitute Servicers

A "Master Servicer" is a third party entity which is rated by a rating agency to oversee transactions and is engaged to ensure that all practices are conducted in accordance with the structure and contractual obligations of the loan. It acts in much the same way as a company's own compliance department in enforcing certain policies, procedures and regulatory requirements.

With increasing frequency, we are observing an expressed interest among lenders and rating agencies for insertion of Master Servicers within bond structures to protect the interests of bondholders. Additionally, more of these structures are now including a named "Substitute Servicer" to serve as a backup in the event of a default or other issue, such as those referenced earlier, that prevent either the Primary or Master Servicer from continuing in their roles. In some cases, the loan structure stipulates that a Substitute Servicer run in parallel with the named Master Servicer, providing an ongoing, duplicate layer of oversight and compliance. Without one of these backup measures in place, when servicing does go awry, a consensus of bondholders is typically required to make a decision regarding designation of a replacement. Calling a meeting, securing a quorum, and obtaining a decision are likely to take from a few weeks' to a few months'. Meanwhile, the continuation of causal servicing issues throughout this period of inaction can further amplify the difficulty of implementing corrective measures based on the further deterioration of both the collateral and debtor willingness to pay. While there is, of course, a cost associated with adding each of these layers of risk prevention into the process, we believe doing so reflects current day best practices and expect to see a continued movement toward greater adoption of Master, Substitute and Parallel Substitute Servicer roles in Mexico over the course of the next five years.

The auto finance scenario described above is actually based upon a real world, high profile engagement with which our company, Hilco Terracota was involved directly in the capacity of Substitute Administrator.

During 2018, fiduciary stock certificate holders of three securities issues that were guaranteed with a loan portfolio balance of over $100 million pesos for the acquisition of motor vehicles, selected Hilco Terracota as Substitute Primary Servicer to replace its Primary Servicer, an automotive finance company that was facing significant operational and financial problems. This step was taken as a preventive measure against an escalating situation of non-compliance both in the payment of the issuance and other administrative obligations.

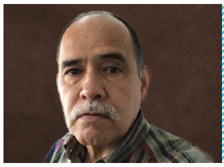
After being initially engaged to provide a comprehensive review and analysis of the portfolio guaranteeing the issues, Hilco Terracota was asked by the bondholders to assume administrative responsibility over the portfolio of approximately 4,000 loans. The results of our analysis had served to inform bondholders about significant documentation deficiencies and the deficient recovery status of the loans. Of particular concern was the lack of reliable information on debit balances. Accordingly, as the new primary servicer, Hilco was given responsibility for 1) conducting a recalculation of balances and reconciling those with borrowers and; 2) identifying which loans had, in fact, been paid and recovering those that had not. Our recovery efforts, which involved the painstaking work of locating and contacting every borrower, as well as negotiating payment terms to either bring each of them up to date or settle their debt, yielded collection levels in excess of 90% of the total balances due. We also took additional steps with insurance companies for payments associated with damaged units/vehicles. Proceeds collected through these efforts were then allocated back to payment of the bond issuance.

This, of course is just a brief summary of the critical role we played in assisting this particular client to regain control over its mismanaged loan portfolio.

With unparalleled expertise and a proven track record, Hilco Terracota is an ideal partner as Master Servicer in a public or private debt structure, as well as for performance of Primary Administration functions, particularly in cases of special collection. More and more, private creditors are asking us to carry out Primary Servicer or Substitute Administration duties with follow-up. This provides creditors with both a source of reliable information independent of the originators or primary administrators they finance, and helps to ensure that they will be prepared to make quick decisions with minimal interference to the ordinary collection process when the circumstances so warrant. During this volatile period, Hilco Terracota can provide certainty and effective collection for the benefit of portfolio creditors and investors. We encourage you to reach out to our team to learn more. We are here to help!

Hilco Terracota is a recognized Loan Servicer founded in 2001 by its current CEO, Guillermo Malo Bahena. The company's other executives were pioneers in Mexico, credited with solving Operadora Auritec (1994) and GMAC-RFC (1998) pending accounts. Among recent high profile efforts, the company was engaged to resolve administrative issues for creditors of the Planfia matter (2018). With more than a decade of operations, Hilco Terracota has complied mandates of more than 50 customers, administrated more than 35,000 overdue and on-due term loans and has performed master administration of more than 200,000 loans. At present, the company is actively engaged in administration of accounts valued in the range of U.S. $450 million.

Hilco Terracota and Hilco Global Mexico are part of Hilco Global, a privately held diversified financial services company and the world's preeminent authority on maximizing the value of assets for both healthy and distressed companies. Hilco Global operates as a holding company comprised of over twenty specialized business units that work to help companies understand the value of their assets and then monetize that value. Hilco Global has a 30-year track record of acting as an advisor, agent, investor and/or principal in any transaction. Hilco Global works to deliver the best possible result by aligning interests with clients and providing them strategic insight, advice, and, in many instances, the capital required to complete the deal. Hilco Global is based in Northbrook, Illinois and has 600 professionals operating on five continents.



GUILLERMO MALO BAHENA IS FOUNDER AND CEO OF HILCO TERRACOTA

Guillermo founded Hilco Terracota in 2001 and since then has directed its course, developing Master Administration activities in stock and private funding and Administration and Resolution of Overdue Loan Portfolios. Prior to his tenure at Hilco Terracota, Guillermo headed GMAC-RFC-Auritec for 6 years, a company that actively participated in the Fobaproa auctions, acquiring more than 41,000 expired mortgage loans. Prior to that, he worked for 14 years in the Securities and Banking Sector, in various management roles within Corporate Finance, Mergers & Acquisitions and Venture Capital. Guillermo studied Chemical Engineering at UNAM and received his Master Degree in Business Administration at Universidad Panamericana (IPADE). Contact Guillermo at guillermo.malo@hilcoterracota.com.mx or Phone 55.8500.8504. Additionally, you may contact Anthony McCarthy at anthony.mccarthy@hilcoterracota.com.mx or 55.8500.8512.