

## Asset-Backed Criteria Report

## Rating U.S. Auto Lease-Backed Securitizations : An Update

### Analysts

Ravi R. Gupta  
+1 312 368-2058  
ravi.gupta@fitchratings.com

Nicole Edwards  
+1 212 908-9114  
nicole.edwards@fitchratings.com

David Petu, CFA  
+1 212 908-0280  
david.petu@fitchratings.com

Irma Amador  
+1 212 908-0745  
irma.amador@fitchratings.com

Jennifer San Cartier  
+1 212 908-0205  
jennifer.sancartier@fitchratings.com

John Bella, Jr.  
+1 212 908-0243  
john.bella@fitchratings.com

### ■ Summary

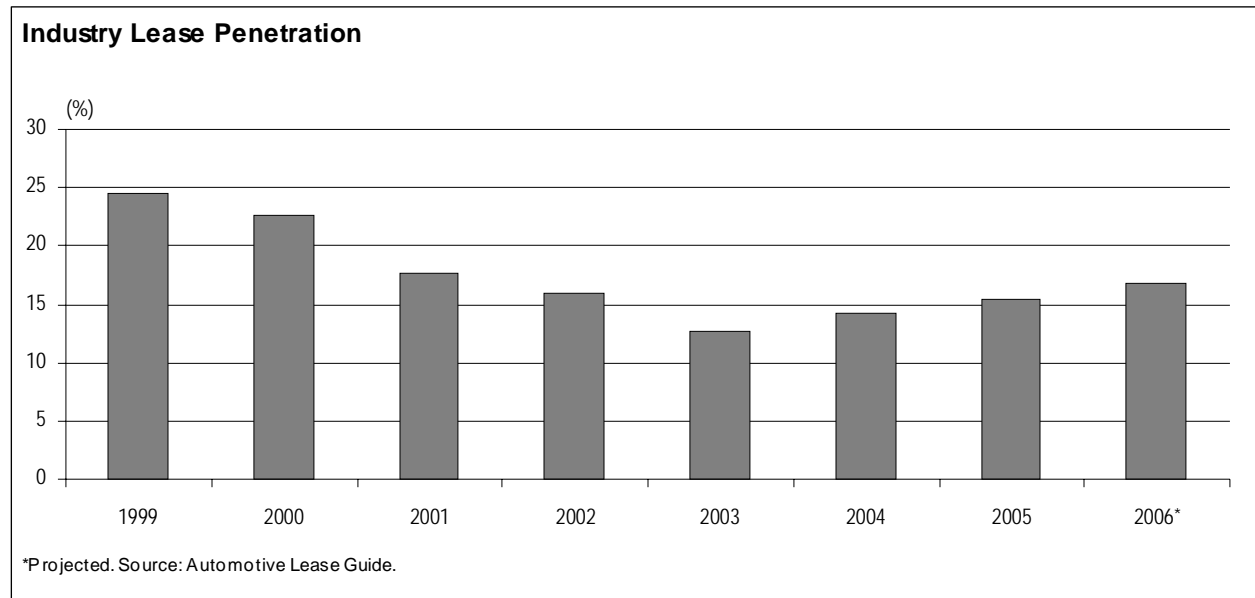
Financing consumer purchases of vehicles through the use of leasing continues to be an important segment of the overall retail automobile finance market. Originally, leasing was a method to finance new high-end luxury vehicles; however, recently it has become a common financing method for all types of automobiles, including used vehicles. Leasing owes its popularity to the rapid increase in new vehicle prices, specific tax law changes and relatively high consumer interest rates in the late 1980s and 1990s. These factors generally made auto leasing a more economical alternative than auto loans and allowed consumers to drive vehicles that ordinarily would be too expensive to purchase. Demand for leasing remained strong through the 1990s and into today, in large part driven by the captive finance subsidiaries of vehicle manufacturers offering aggressive incentive-based leasing programs aimed at increasing vehicle sales.

The growth in auto lease securitization has historically trailed securitization of other asset classes. This is in large part due to a handful of credit and structural issues unique to lease securitizations relative to other auto-related asset-backed securities (ABS). These include residual value risk, vehicle titling requirements, Pension Benefit Guaranty Corporation (PBGC) lien risk and vicarious tort liability, all of which will be discussed further herein.

As the market has evolved to address these issues specifically, the volume of lease securitizations has grown dramatically, with total issuance reaching more than \$5.3 billion in 2005 and \$5.8 billion in 2006. With strong vehicle sales levels, healthy consumer demand for leasing and renewed interest by captive finance companies such as General Motors Acceptance Corporation LLC (GMAC LLC) to diversify their funding sources, Fitch Ratings expects auto lease securitization issuance to continue to grow.

Although performance of auto lease securitizations has stabilized, particularly with regard to residual value losses experienced in the late 1990s and early 2000s, Fitch remains concerned about the wholesale vehicle market and its effect on residual value volatility. Fitch expects to monitor residual value trends closely as new vehicle incentives and adverse changes in the corporate health of key manufacturers are expected to continue pressuring wholesale (used) vehicle values. Moreover, uncertainties regarding future oil and gas prices may lead to further pressures on residual values of high gas consumption vehicles, such as sport-utility vehicles (SUVs) and light-duty trucks.

This report updates Fitch's automobile lease criteria published on June 14, 2000, "Under the Hood: Automobile Lease ABS Uncovered," and covers all aspects of Fitch's auto lease securitization rating criteria,



including collateral evaluation, credit analysis, structural considerations and legal issues.

For a discussion of Fitch’s auto loan securitization rating guidelines, please see the criteria report, “Rating Auto Loan-Backed Securitizations: A Tune-Up,” dated Nov. 17, 2005, and available on Fitch’s Web site at [www.fitchratings.com](http://www.fitchratings.com).

■ **Market Update**

Auto leasing became popular with consumers, manufacturers and finance companies in the mid- to late 1990s, as evidenced by the fact that approximately one-fourth of all new retail vehicle sales during the period were financed by leases. Two major factors contributed to the growth in leasing: rapid increases in new vehicle prices and the late 1980s tax law changes that eliminated the tax deductibility of interest on vehicle loans. As a result, people sought ways to make automobile purchases more affordable, and, in response, manufacturers and finance companies developed consumer lease programs. As shown in the chart above, however, the percentage of new vehicle sales financed by leases dropped steadily from 2000–2003, reaching a low of less than 13% in 2003.

The decline in lease penetration and overall leasing volume is attributable to a number of factors including a low interest rate environment, increasing demand for auto loans versus leases and significant residual value losses suffered by many lessors in their leasing portfolios. These residual value losses were largely due to increased competition in the late

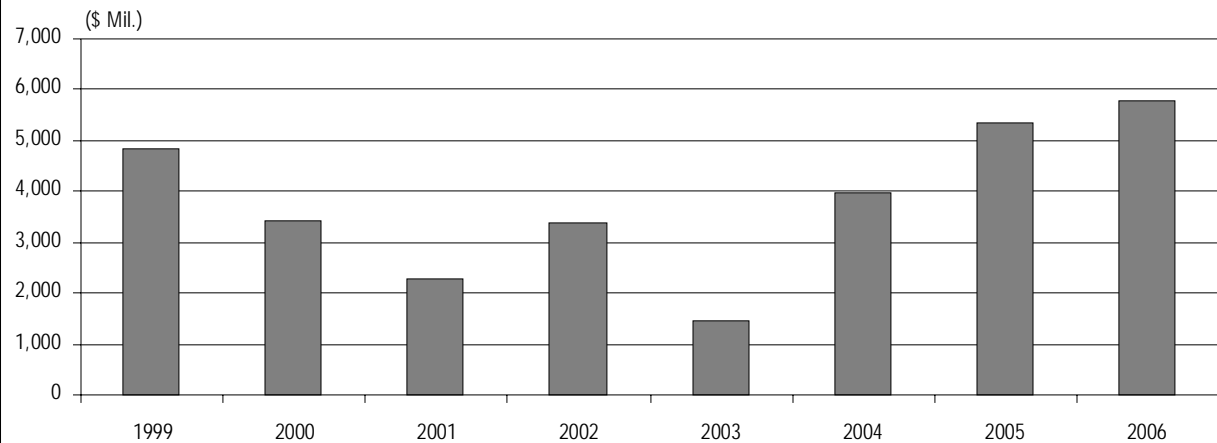
1990s, driving lessors to incentive pricing and aggressive residual value setting policies to originate new leases. The losses were exacerbated by the resultant oversupply in the used vehicle market associated with the disposal of off-lease vehicles that were originated in the same period, ensuring that the fair market value of most vehicles at lease maturity was likely less than the lessor’s booked contractual residual value.

Many lessors responded with downward adjustments to anticipated residual values of new vintages, making leasing less economical for consumers. Additionally, lease originations were negatively affected by vicarious tort liability (discussed further herein), which resulted in many lessors withdrawing from certain states with significant leasing business, such as New York.

Following a period of significant residual value volatility, the wholesale auto market began to stabilize by mid-2004 as off-lease volume declined, interest rates rose and manufacturers were far less aggressive with incentives on new vehicle sales than seen in earlier years. In addition, assumptions regarding future residual values were refined, and lessors became more conservative in their residual value setting policies. This led to improved accuracy of off-lease residual value forecasts and a steady increase in leasing penetration from 2004 onward.

Fitch expects lease penetration to continue rising and possibly return to previous highs of about 25% of new retail vehicle sales. Reasons for this include the

**Auto Lease ABS Issuance**



\*U.S. issuance only. Excludes rental and fleet issuance. ABS – Asset-backed securities.

stabilizing wholesale markets mentioned previously, rising interest rates making auto loans less competitive and continued leasing incentive programs offered by captive lessors and supported by partner manufacturers, which view leasing as a positive tool to building customer loyalty and driving new vehicle sales.

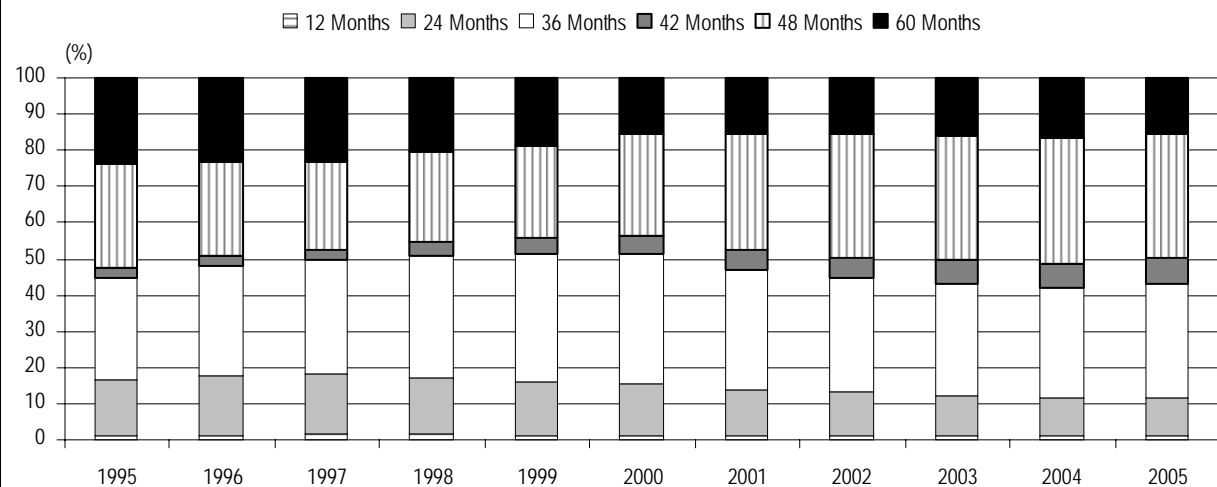
**Auto Lease Issuance**

Despite strong and increasing consumer demand for auto leasing, the historical securitization of these assets has been somewhat limited due to the inherent residual value risk and, to some degree, constraints in the legal structure of lease securitizations. Weak

performance of existing ABS transactions in 1999–2002, coupled with the lower originations of new lease assets, translated into a decline of total auto retail lease ABS issuance levels, from the \$4.8 billion in 1999 to \$1.4 billion in 2003. This declining performance, partially attributable to the slowing U.S. economy, was notably exhibited through increasing residual value losses associated with the disposal of the off-lease vehicles for many securitizations completed during this period.

The trend was reversed in 2005 with new issuances reaching \$5.3 billion and achieving a new peak of \$5.8 billion in 2006. This increase can be attributed

**Retail Leases by Term**



to a number of factors, including a more conservative residual value setting policy, the development of new lease ABS structures, strong vehicle sales levels, healthy consumer demand for leasing, renewed interest by captive finance companies to diversify their funding sources and increasing positive sentiment toward lease ABS in the global fixed-income markets.

In addition to the periodic changes in lease ABS issuance volumes described in the preceding paragraphs, Fitch documented a handful of additional meaningful changes related to the characteristics of the underlying lease collateral supporting these ABS deals.

A noticeable tightening in credit/underwriting parameters for new originations by many lessors was noticed in securitizations from 2003 onward. As a direct consequence of the poor performance experienced by many lessors, a distinctly improved average obligor credit profile evolved in newer lease securitizations, as evidenced by higher weighted-average Fair Isaac Corp. (FICO) scores.

Additionally, the market migrated to longer original contract terms. Similar to what occurred in the retail auto lending industry, finance companies began to increase their originations of lease financing with original contract terms of 48 and 60 months. As indicated in the chart on the bottom of page 3, this trend peaked in 2003–2004 when over 55% of originated contracts exhibited original terms of 37 months or higher. This is in contrast to what was seen in the 1990s and early 2000s when traditional 36-month lease contracts were the primary standard. For lessors, while this term migration reduced overall residual value dollar exposure, it significantly increased the volatility of their expected residual value realizations, given the inherent difficulties in accurately predicting residual values at longer future termination dates. As residual value losses escalated into 2003, the percentage of 36-month and less contracts has gradually increased, reaching approximately 44% of originated lease contracts in 2005.

■ Lease Mechanics

In a typical consumer auto lease transaction, the lessor purchases a vehicle from the manufacturer or dealer and leases it to the consumer. The consumer, or lessee, pays the lessor for the right to use the vehicle during the term of the lease. The lessee's monthly payment is a function of four variables, each determined at the time the contract is written:

Calculation of a Lessee's Monthly Payment (\$)

Manufacturer's Suggested Retail Price (MSRP)	30,000
Negotiated Purchase Price	27,000
Plus Taxes and Fees	800
Less Down Payment	500
Net Capitalized Cost	27,300
Residual Value at 65% of MSRP	19,500
Lease Term (Mos.)	48
Money Factor	0.00292
Monthly Payment	299.16
Approximate APR (%)	7.0
APR – Annual percentage rate.	

- The net capitalized cost of the vehicle.
- The residual value of the vehicle.
- The term of the lease.
- The money factor.

The net capitalized cost of the vehicle is the negotiated purchase price plus fees and taxes, less any down payment. Residual value is determined at the inception of a lease contract and represents an estimate of a leased vehicle's resale value at the end of a lease, typically figured as a percentage of the manufacturer's suggested retail price. Methods of residual valuation and its significance in auto lease securitizations are discussed later. Lease terms can vary from 12–60 months, typically in increments of six or 12 months. The money factor is analogous to an annual percentage rate (APR) on a retail auto loan in that it essentially represents a financing charge. The money factor on a lease contract can be converted to an approximate APR by multiplying by 2,400. This approximate APR is not directly comparable with auto loan APRs since it is applied to an average rather than an amortizing balance; however, it does allow consumers to differentiate among other lease offers.

The table above provides a numerical example of the calculation of a lessee's monthly payment, which is equal to the sum of the following:

- the difference between the net capitalized cost and the residual value, divided by the lease term, and
- the sum of the net capitalized cost and the residual value, multiplied by the money factor.

The first part of this equation represents the principal component of the monthly payment, while the second part represents the “interest” portion.

The lessee is responsible for the vehicle’s maintenance and insurance for the duration of the lease. However, as most lease terms coincide with the manufacturer’s warranty, maintenance is a minor concern for the lessee. At the maturity of the lease, lessees effectively have a call option to purchase the vehicle for the stated residual value. If the actual retail value of the vehicle is greater than the contractual residual value, the lessee will likely purchase the vehicle. Otherwise, the lessee will return the vehicle to the dealership from which it was leased, and the dealer will have the option to purchase it. The dealer will compare the vehicle’s stated residual value to wholesale used auto prices in making a purchase decision. If the dealer also chooses not to buy the vehicle, the lessor takes possession and assumes responsibility for vehicle disposition and residual value realization.

#### Who Are the Lessors?

The major players in the auto lessor market include the captive finance subsidiaries of major vehicle manufacturers, banks and independent leasing companies. The captives have traditionally dominated auto leasing with more than two-thirds of the market. Banks and independents gained market share in the late 1990s, but as a result of significant residual value losses, many have subsequently scaled back or exited the industry altogether.

Any company involved in auto leasing may end up involved in the used vehicle business due to off-lease vehicle returns, which must be disposed of in a timely and efficient manner to realize the greatest residual value on the vehicle. The captive finance subsidiaries have significant advantages over their competitors in this area due to the relationship with their manufacturing parent. In times of high vehicle returns, such as the current environment, the captives can look for support from the manufacturers and their dealers for vehicle disposition. The manufacturers and dealers can ship the vehicles to areas of high demand, resulting in maximum residual value realization. Most banks and independents do not have this luxury and must find other solutions, such as wholesale auctions or developing their own relationships with dealers.

Due to the aforementioned strategic benefits, the captives can be more aggressive in setting residual

values on leased vehicles to make monthly payments more competitive, a practice referred to as “subvention.” However, the captives are not immune from an overly aggressive residual setting policy, as their poor residual value realization experiences in the mid to late-1990s indicate. Because banks and independents do not have the resources that the captives do in residual valuation, particularly with respect to future products, production levels and pricing, they often find subvention more difficult in view of the increased risk of loss from an aggressive residual setting policy. Unlike the captives, a large dealer network or the prospect of increased vehicle sales for the manufacturer does not alleviate this risk for banks and independents. Therefore, they generally take a more conservative approach to residual setting and tend to compete on the basis of customer service rather than price.

#### Advantages to Leasing

Leasing as a financing product has many inherent benefits to consumers, manufacturers and finance companies.

#### *Consumers*

In most instances, leasing results in a lower monthly payment for consumers because, under a lease contract, consumers pay only for that portion of the vehicle actually being used (i.e., the depreciation of the vehicle over the life of the lease contract). As a result of the lower monthly payments, consumers are able to get more vehicle for their money and can drive a new vehicle every 2–4 years, depending on the term of the lease contract. Most leases require little or no down payment and, in most states, sales tax is charged on the monthly payment rather than on the initial vehicle price (as is the case with auto purchases). An additional benefit to leasing is fewer maintenance and other used vehicle problems, since by selecting a lease term that coincides with the length of the manufacturer’s warranty, most major repairs and maintenance will be covered.

At lease termination, the lessee has the option to purchase the vehicle or return it to the leasing company and, therefore, is not required to remarket or sell the used vehicle. Moreover, the lessee can obtain a new vehicle by “rolling over” the lease or using any value existing in the current contract to enter into another lease contract for a new vehicle.

#### *Manufacturers*

Leasing allows manufacturers to maintain sales and customer loyalty and market a wider variety of

vehicles to a more diverse client base. Manufacturers are able to take advantage of the affordability of leasing by targeting a wider array of customers with different income levels for a given vehicle price range. A consumer who ordinarily could not buy a vehicle outside of a specific price range is a potential customer for a higher priced vehicle through the availability of leasing. Furthermore, some customers that previously could afford only to purchase a used vehicle may now qualify for leasing a new vehicle. Thus, through leasing, manufacturers are able to sell more high-end, higher margin vehicles. Fitch is aware of the dangers associated with lower monthly payments attracting lower credit-quality lessees and actively reviews each lessor's underwriting criteria as described in the Originations section of the Operational Analysis on page 22. Additionally, the nature of leasing requires that manufacturers and dealers keep continuous contact with lessees to maintain the leased vehicles in as good condition as possible, thereby maximizing residual value realization. The attention given to these customers is likely to result in increased brand loyalty.

### *Finance Companies*

Auto leasing benefits finance companies by providing higher finance charges than traditional auto lending, primarily because rent charges on a lease are calculated from the adjusted capitalized cost over the life of the contract, whereas interest on an auto loan is based on the amortizing balance of that loan. The higher margins offered by leasing, in conjunction with rising new vehicle sales over the past several years, have sparked competition in auto lease financing. However, there is a significant risk with regard to leasing for the finance company: residual value risk. This risk is discussed in further detail herein.

### ■ Rating Approach

Fitch's rating methodology for auto leases is similar to that for auto loans, with the notable exception of residual value risk, and incorporates analysis of the following key areas:

- Isolation of assets and bankruptcy remoteness of the ABS-issuing entity and other legal concerns;
- Credit quality and expected performance of the collateral, including residual valuation;
- Originator/seller's financial condition ;
- Experience and track record of management;
- Viability of the business model and underwriting;

- Servicing strength, capacity and transferability; and
- Cash flow structure and proposed credit enhancement.

The areas outlined above are grouped into five analytical areas—legal, collateral, credit, structural and operational—and are discussed in the remainder of this report.

### ■ Legal Analysis

As with other ABS transactions, auto lease securitizations are structured to isolate the auto leases and related vehicles from the bankruptcy or insolvency risks of the other entities, such as the originator/seller, involved in the transactions. This is achieved by the originator/seller transferring the auto leases by means of a true sale or series of true sales to one or more bankruptcy-remote entities, one of which will ultimately issue the ABS to the investor.

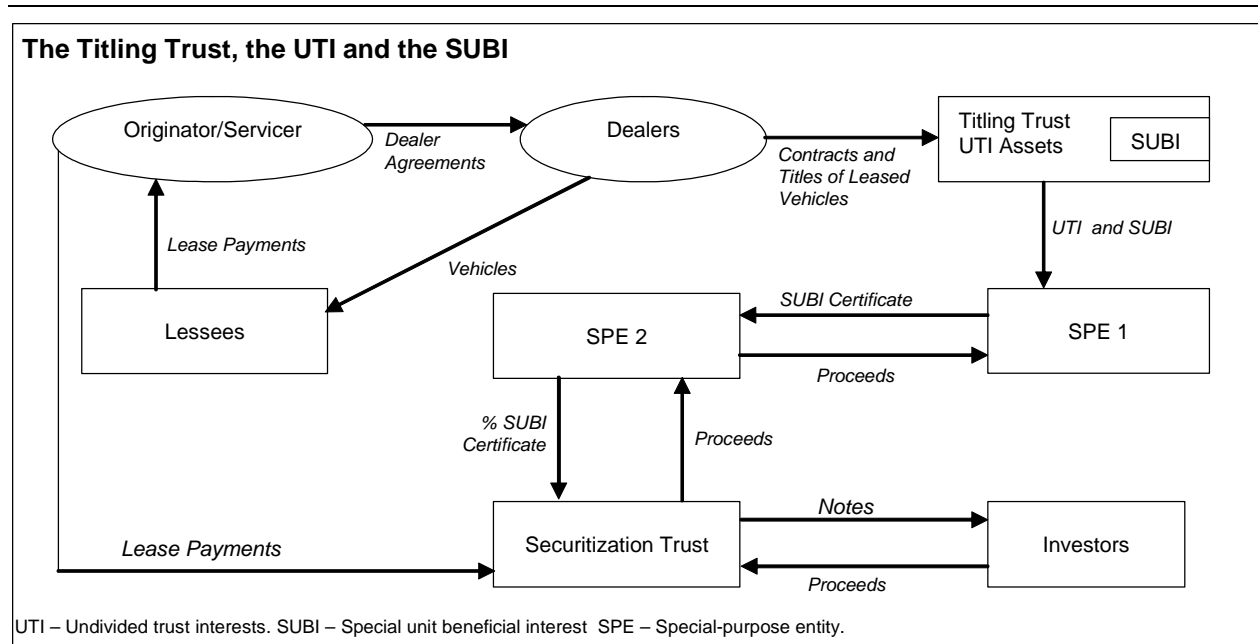
A major difficulty in securitizing auto leases is isolating the leases and vehicles from the assets of the lessor. Unlike auto loans, in which case the auto is owned by the buyer, the lessor is the owner of the vehicle. Motor vehicle and titling laws vary widely by state, creating the imposing and costly burden of retitling each vehicle if it is to be included in a securitization.

### Titling Trust

To facilitate isolation of the vehicles and overcome the vehicle titling problem, initial auto lease securitization structures created titling trusts. The titling trust is a bankruptcy-remote, special-purpose entity (SPE) that is formed to buy both the lease contracts and vehicles directly from the dealer. These are the only assets of the titling trust.

The securitization sponsor/originator is contractually engaged by the titling trust to act as the servicer on its behalf. The titling trust transfers to the sponsor a beneficial interest in its assets. This is referred to as undivided trust interests (UTI). The holder of the UTI obtains the economic value for tax purposes (i.e., depreciation) but not the ownership for accounting purposes.

When the sponsor is ready to securitize a pool of leases and vehicles, the titling trust will issue certificates representing a special unit beneficial interest (SUBI) in only those assets to be securitized. It is of note that the vehicle ownership and the lease contracts still remain



with the titling trust, and it is only the SUBI certificates and the associated rights that are transferred. The SUBI is sold in a true sale to an SPE and is then transferred to the securitization trust.

Multiple SUBIs may be created from a single origination trust; however, the securitization trust and bondholders only have rights in their SUBI-designated portfolio and not in any other assets of the titling trust.

Although the use of a titling trust reduces a majority of the long-term impediments associated with securitizing auto leases, the initial costs of creating one are somewhat onerous. It is necessary that the titling trust be licensed to do business in the states where the vehicles are titled. However, some states do not recognize trusts as legal owners of vehicles. In these instances, it may be necessary for the securitization’s indenture trustee or some other third-party collateral agent to be the titleholder of record.

A titling trust structure may also give rise to other concerns, including issues with priority security interest of the securitization trust against possible liens, such as a PBGC lien arising from the Employee Retirement Income Security Act of 1974 (ERISA) and vicarious tort liability.

**Perfection of Security Interests**

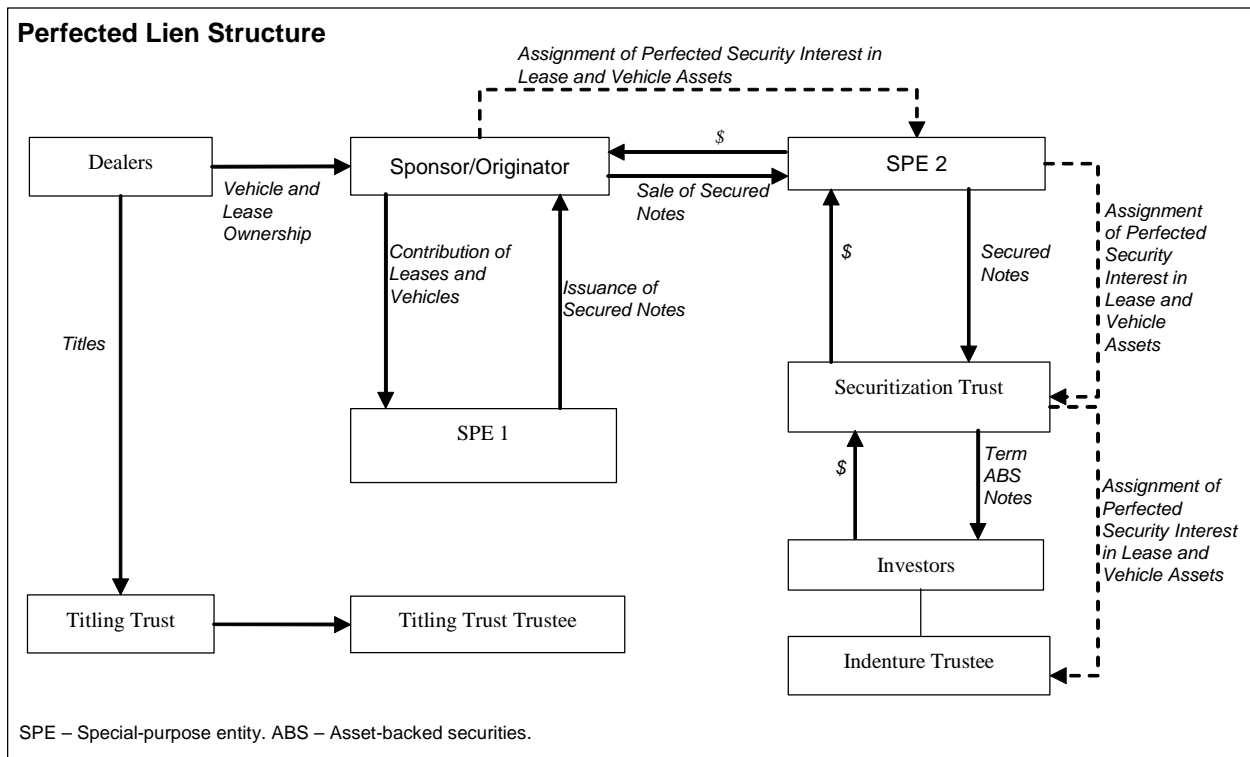
The sale of a SUBI, rather than the leases, vehicles or titles in a lease securitization, allows the titling trust to remain on the certificate of title of each vehicle.

However, the use of the SUBI raises a question regarding the perfection of the security interest in the vehicles and leases. Although the securitization trust can secure perfection of the SUBI and the cash flows relating to the vehicles, the titling trust remains the titleholder of record. Depending upon the ultimate owner of the titling trust, if it is part of an “affiliate group,” the assets of the titling trust could be subject to tax liens and liens of the PBGC for unfunded or underfunded obligations of the sponsor.

Fitch believes the most problematic of these liens arises from the potential for the PBGC to subject the titling trust to liens to satisfy any unpaid ERISA obligations of any member of an affiliated group of the sponsor. Fitch expects to receive opinions of the transaction’s legal counsel to provide comfort that the vehicles and leases, as well as the proceeds thereof, will not be subject to liens that will have priority over the lien of the bondholders.

Recently, issuers have begun to develop legal structures that employ slight variations from the SUBI structure. As shown in the chart above, all securitized leased vehicles were titled in the name of a titling trust, which also holds a beneficial interest in the leases. The originator was granted a security interest in the leased vehicles and was noted as first lienholder on all of the certificates of title to the leased vehicles.

At closing, the originator transferred the beneficial interest in each lease, including the beneficial interest



in each related leased vehicle, to an SPE (SPE 1) via a true sale. SPE 1 financed the purchase by issuing a series of nonrecourse secured notes back to the originator. Each secured note benefited from a perfected first-priority security interest in all lease and vehicle assets in the pool. The originator subsequently sold the secured notes to SPE 2 via a true sale, which in turn deposited them into the securitization trust to support the issuance of term ABS notes. A UCC-1 financing statement was filed in connection with each of the transfers discussed above. In addition, the ABS issuer granted a security interest in the secured notes to the indenture trustee, the transfer of which was also perfected by a UCC-1 filing.

The use of the secured notes served the primary purpose of providing the securitization trust with the right to receive the cash flows generated by the pool of lease assets on a perfected, first-priority basis.

In another transaction, the sponsor utilized the SUBI structure and, in connection with a collateral trust agreement, granted a security interest in favor of a collateral agent (a third party not considered part of the affiliated group) in the leases and leased vehicles on behalf of the issuer and the noteholders. The certificates of title were also changed to reflect the collateral agent as the first lienholder.

### Legal Opinions

In addition to the opinion regarding PBGC liens mentioned earlier, legal opinions should address the nature of the various transfers in the transaction and provide assurance that the assets of the SPE would not be clawed back into the estate of its transferor in the event of a bankruptcy of a transferor. Additionally Fitch expects to receive an opinion that the relevant SPE will not be consolidated with its parent in the event of the bankruptcy of its parent. Fitch also expects to receive an opinion that the ABS issuer or the trustee on behalf of the securityholders (depending upon the structure) has a first-priority perfected security interest in the SUBI or similar collateral. Finally, Fitch is concerned that the cash flows to the issuer are not impaired by tax obligations; therefore, Fitch expects to receive an opinion of transaction counsel advising that the issuer is tax neutral.

### Vicarious Tort Liability

Vicarious tort liability has historically presented a challenge for lease securitizations, because titling trusts have historically been subject to liability for tort claims. Anyone suffering an injury as a result of the operation of the leased vehicle could file a liability suit against the titling trust as the vehicle owner, even though the lessee operated the vehicle.

Earlier lease securitizations have dealt with this risk through the purchase of contingent and excess liability insurance to indemnify the trust for any liability arising from the operation of the vehicles in excess of the insurance maintained by the lessee.

In August 2005, however, the Transportation Equity Act of 2005 was enacted, prohibiting the imposition of vicarious liability against vehicle leasing and rental companies. The act amends 49 U.S.C. Section 30106 and preempts state laws previously applied to leasing and rental companies. Litigation not filed by the date of enactment cannot claim compensation from leasing or rental companies based on vicarious tort liability. This provision applies to securitization and titling trusts and largely mitigates the risk of vicarious tort claims in lease securitizations. However, the judge in a recent case in New York held that the federal law was unconstitutional because vicarious liability is not contemplated under commerce law and Congress should not get involved with tort law, which is reserved to the states. The case is being appealed and will be monitored going forward.

## ■ Collateral Analysis

### Lease Characteristics

Auto leases are primarily originated through dealerships that can be manufacturer or nonmanufacturer affiliated. To derive credit loss severity and frequency projections, Fitch assesses the characteristics of the lease contracts and the vehicles that are securing the auto lease transaction. Variables analyzed include obligor credit quality, lease term and rate, new/used vehicle mix, vehicle make and model concentrations, and geographic diversification.

### *Obligor Credit Quality*

Credit loss frequency in lease securitizations is directly correlated to the overall financial health of borrowers or lessees in each securitization lease pool. While there is no agreed upon market standard for classifying leases by financial health or credit quality, originators tend to rely on complex proprietary scoring models that rank order obligors and contract default probability either on a numeric scale or in more traditional letter groupings. Many of these models use FICO scores as input but augment them with other more predictive variables. Fitch will examine static pool data segmented by FICO, internal credit tiers or score classifications to gauge borrower strength, default performance and the predictability of scoring models. The default expectation for a

securitization pool will reflect Fitch's expectation for each tier and its weight within the pool.

The auto lease finance sector can be segmented into prime and subprime segments. Issuers' portfolios in prime and subprime sectors exhibit distinct profiles that differ in terms of obligor type, the vehicle financed and loan structure. Prime portfolios normally include obligors with average FICO scores above 650, secured by primarily new vehicles under 36–48 month or higher lease terms. This is in contrast to subprime portfolios, which tend to include low FICO borrowers financing used vehicles under relatively short lease terms (36 months or less). Prime issuers tend to experience cumulative credit losses under 2%, while subprime issuers may experience losses almost 4 times as high. To date, a majority of auto lease ABS issuances have been secured by pools of prime quality leases.

### *Lease Term*

Fitch has observed that frequency and severity of default increase for leases with longer original terms. Such leases also exhibit more volatile recovery and residual value realization rates. However, the current high turn-in rate environment can be linked to shorter term leases that had overly aggressive residual value assumptions. Recent history has shown these short-term leases also tend to have greater residual value risk in absolute dollar terms, and longer term leases tend to have greater residual value volatility. Adequate dispersion of original lease terms diminishes the risks associated with such leases.

The higher default frequency for longer term leases results primarily from credit underwriting, which relies on payment-to-income ratios. Lessees with low income will qualify only for leases with low monthly payments, which are typically achieved by lengthening the contract term. Another risk associated with a longer term lease is that the contract balance amortizes more slowly, increasing loss severity in the event of lessee default. Conservative residual valuation is also extremely important for both long- and short-term leases since the state of the used vehicle market five years, and even two years, from lease inception is very difficult to predict. Numerous factors can combine to affect the used vehicle market adversely and result in significant residual value losses.

More important than original term distribution is remaining term distribution. If a large portion of the lease contracts mature within a tight window, which

can cause low vehicle recovery rates, the potential for residual value losses to affect bond cash flows negatively is heightened. A good distribution circumvents these low vehicle recovery rates. Accordingly, Fitch prefers to see an adequate distribution of both original and remaining lease terms for a transaction.

### *Lease Rate*

In our analysis, Fitch not only considers the weighted-average lease rate but also the distribution of these rates. Lease rates are mainly a function of the lessor's tiered pricing strategy, with higher lease rates assessed to lessees that have a higher risk profile. Lease rates are also a function of the market environment at the time of origination. Therefore, two otherwise identical pools originated by the same issuer may have different weighted-average lease rates.

It is also important to consider the distribution of the lease rates. For example, leases with very low rates may result from incentive programs, as discussed later. Fitch also examines the percentage of leases with high rates to assess whether they exhibit lower credit quality characteristics, as these may charge off at a much higher rate than the overall pool, depleting excess spread.

One of the primary drivers of lease rates has been incentivized leasing promotions such as lease subvention programs. Lease rate incentives or subvention provides for implicit lease payment rates that are below market levels as a result of financial support provided by either the vehicle manufacturer or a finance company. These programs are used to spur demand for new vehicles and are mostly offered by the captive finance companies to strong borrowers who demonstrate excellent credit characteristics. Nevertheless, Fitch carefully reviews the overall concentration of subvented leases in any securitization pool, as the availability of excess spread may decrease over time as higher rate leases prepay or default out of the pool.

### *New Versus Used*

With the growing number of off-lease vehicles, Fitch expects to see some late-model used vehicle leases to begin showing up in future securitizations. Current transactions have primarily consisted of new vehicle contracts. Issuers that include used vehicle leases in a securitization should be able to provide static pool performance data for the used portion of the pool. Conceivably, depreciation should be less severe on a

used leased vehicle, and thus, a more accurate residual valuation should be easier to accomplish. However, given the poorer performance of used vehicles in auto loan securitizations and the inherent volatility in the wholesale vehicle markets, Fitch will generally take a very conservative approach to analyzing used lease collateral unless detailed static pool data on credit and residual value losses prove otherwise.

### *Vehicle Make and Model*

The primary risk of manufacturer and model concentrations lies in the potential for the occurrence of a negative event, such as a manufacturer bankruptcy, to affect depreciation and marketability of those vehicles, thus reducing recovery and residual value realization rates.

Although Fitch prefers diversified manufacturers and models within the collateral pool, some sizable concentrations may not be considered problematic. Manufacturer concentrations and any resulting effect on credit-enhancement levels within auto lease ABS of captive and independent finance companies will be reviewed on a case-by-case basis.

Fitch believes concentration by vehicle type (SUV, luxury sedan, sports vehicle, minivan and light van or truck, among others) also introduces risk to a securitization, increasing the residual value risk associated with one model type. A significant concentration in a particular vehicle type increases the potential for event and market risk to affect the securitization negatively. Event risk results from the potential for some specific external event, such as higher gas prices, tougher emissions standards or increased safety requirements, to reduce the popularity of a vehicle type. Similarly, market risk arises due to falling consumer demand for a particular vehicle type that is unrelated to any external event, as illustrated by the migration from minivans to SUVs. Adequate distribution of vehicle types included in a lease securitization mitigates these risks.

### *Geographic Diversification*

A geographically diversified pool of lease contracts is desired to minimize the effect of adverse economic conditions in a particular region, such as those evidenced in the southeastern United States during Hurricane Katrina. Most lessors have customized their credit scorecards to compensate for this risk. Nonetheless, state concentrations can affect the cash flows from a securitized pool of auto leases,

particularly in states with onerous repossession requirements. Complying with the relevant laws in these states can result in full-balance chargeoffs, where principal is due for the full loan balance but recoveries have not yet been received. Consequently, full-balance chargeoffs usually lead to liquidity strains and credit-enhancement draws if losses escalate. Fitch has recently seen transactions with individual state concentrations approaching 40%. Any state or regional concentration would be a factor when reviewing acceptable credit-enhancement levels for any auto lease securitization.

## ■ Credit Analysis

The two key risks in auto lease ABS are credit risk and residual value risk. Fitch's analysis of auto lease securitizations isolates these two risks, examines all factors that influence collateral performance as it relates to these risks and develops base-case assumptions that can be stressed under various scenarios and applied to model cash flow runs.

### Credit Risk

Credit-related losses in auto lease securitizations are realized upon lessee defaults, when the lessee fails to make the monthly payments and the vehicle is repossessed. The vehicle is typically sold either through an affiliated dealer network or through an independent auction. A loss will be incurred if the sale proceeds plus any insurance recoveries and judgments collected from the lessee are insufficient to cover the remaining lease payments. A lessee default can also occur if the lessee stops making payments prior to the end of the lease because the vehicle has been destroyed or stolen. In both cases, the trust will absorb the full loss.

Credit-related losses for auto lease transactions tend to be more front loaded because of the shorter original terms to maturity compared with auto loans. However, the distribution could change with the introduction of more long-term contracts (i.e., 60 months), resulting in lease pools realizing losses later in the transaction's life. Similar to auto loan transactions, losses are very limited in the first few months due in part to issuers' policies on the timing of chargeoffs, securitization collateral eligibility criteria and limited asset seasoning.

### Static Pool Analysis

The estimation of credit defaults and the associated losses is substantially similar for auto loan and auto lease securitizations. As in auto loan securitizations,

the foundation of Fitch's credit analysis of lessee behavior in lease securitizations is static pool loss data. Static pool data is useful in determining both the magnitude and timing of losses and provides one of the best indications of how the underlying collateral will perform in stress scenarios. Static pool analysis relies on the isolation of static subset of originated leases (vintages) and the detailed tracking of the performance of the vintage over time. Data captured include lease defaults, gross and net losses, the associated timing of these defaults and losses, delinquencies and prepayments.

This information is sourced either directly from the issuer or from prior securitizations. While data from existing securitizations are useful, information provided directly by the issuer is often more detailed and, therefore, superior. Fitch seeks the highest level of detail possible in static pool data, capturing portfolio performance by numerous factors, such as new and used vehicles, lease term and credit score. This analysis is critical in helping Fitch understand the unique loss drivers associated with each issuer's portfolio and aids Fitch in providing the most accurate loss projections and credit-enhancement levels for each securitization.

Relying solely on historical static pool information to gauge future losses would be sufficient if the past were a perfect predictor of the future. Obviously, this is not always the case. Static pools capture performance over a specific period and, thus, will have unique macroeconomic and microeconomic factors influencing their performance. Consequently, it is important to evaluate the economic conditions present for the period captured with each static pool and adjust loss expectations accordingly. Changes in underwriting guidelines also affect pool performance. Therefore, it is important to know all changes made to a lessor's underwriting guidelines over time and adjust current loss expectations as appropriate.

### *Residual Value Risk*

As previously mentioned, the residual value is the expected sale price of the vehicle at the end of the lease term. Upon lease maturity, the leased vehicle can either be i) purchased by the lessee for the contracted residual value; ii) returned to the dealer that subsequently buys it; or iii) returned to the lessor that sells it either through an auction or in the used vehicle market.

Fitch's residual value loss analysis is most concerned with end-of-lease vehicle turn-ins in which the lessee

does not exercise its purchase option. In a typical closed-end consumer auto lease, the lessor assumes the risk of residual value realization since the consumer can simply return the vehicle at lease end and walk away. The lessor is then left to sell the vehicle in an attempt to collect the stated residual value. The risk that the full residual value is not realized upon vehicle disposition is referred to as residual value risk.

In an auto lease securitization, the risk that a vehicle's fair market value will be less than its stated residual value at lease end is passed through to investors since a lease contract's balance includes the residual value of the leased vehicle. As residual values typically represent a large portion of a securitization's balance—on average 65%–80%—realization of residual values emerges as the primary risk in an auto lease securitization.

Fitch's analysis of residual value risk in any given lease securitization is largely driven by the residual value setting policy of the issuer, historical lease early termination and turn-in rates, and the state of used vehicle market.

#### *Residual Value Setting Policy*

Since residual values are determined at lease inception, the lessor has to predict as accurately as possible the amount the vehicle could be sold for at the end of the lease. The method a lessor uses in setting the residual value is important since the actual residual values realized may differ from what is estimated.

The actual residual value of an off-lease vehicle is determined by several factors, including the following:

- Condition of the vehicle;
- State of the used vehicle market, including supply of off-lease vehicles;
- Demand for the particular vehicle make and model;
- New vehicle prices; and
- General economic conditions, both regionally and nationally.

As each of these factors changes over the term of the lease, the stated residual value could be drastically different from the true realizable residual value at lease end.

To estimate residual values, many leasing companies develop proprietary models to approximate the future fair market value of each vehicle secured under a lease. These models incorporate factors such as lease tenor; vehicle characteristics, including make and model; current auction prices; and expected mileage. Lessors often adjust these expected residual values to make the contracts appear more appealing to lessees; a practice known as residual value subvention. Under residual value subvention, a vehicle's stated residual value is set above the expected value at lease maturity to reduce the monthly payment. This tactic is often employed by captive finance companies, which initiate subvention programs in conjunction with their manufacturer parent to boost new vehicle sales.

Higher subvention negatively affects used vehicle prices and can result in faster depreciation of the vehicle value than originally expected. As the rate of depreciation increases, the actual market value of the motor vehicle declines and there is reduced incentive to buy back the vehicle at the end of the lease term. In Fitch's view, excessive residual subvention introduces greater volatility in residual realization rates and is worrisome because a substantial portion of a securitization's cash flow becomes dependent solely on full collection of residual values. Prospective lease securitization pools are carefully analyzed to determine if subvented leases introduce any additional risks to the transaction.

Lessors that do not have their own proprietary residual value setting models often use residual values determined by third-party information providers such as Automotive Lease Guide (ALG), an independent publisher of vehicle residual value information. ALG was the first third-party company to provide this service and is currently the most recognized provider of vehicle residual values. A few years ago, National Automobile Dealers Association (NADA) also provided residual values. However, NADA is now primarily an industry source for new, used and wholesale vehicle values.

Fitch has noted that many recent lease securitizations, particularly those carried out by the captive finance subsidiaries of auto manufacturers, have utilized ALG's services in order to assess residual value risk in their lease portfolios. ALG uses a process blending more than 40 years of quantitative history with a qualitative review of multiple factors to determine a vehicle's average condition and open-market and wholesale auction value by make, model and year. Used vehicle data is compiled from a combination of

auction house and manufacturer auction reports and vehicle price guides.

The used vehicle price information assists in developing price depreciation curves for vehicles of specific make, model and year. These depreciation curves are adjusted based upon ALG's periodic evaluation of industry and macroeconomic data and trends in used vehicle prices. Qualitative adjustments are made to the final estimate to reflect additional information obtained through ALG's ongoing communication with the auto manufacturing industry.

New model types are evaluated utilizing a comparable estimation process. ALG first examines how the manufacturer performs and then assesses how that performance relates to the segment in which the new vehicle will be. Next, the vehicle's attributes (exterior, interior, ride and handling, engine, etc.) are assessed with respect to the peer group of vehicles. Finally, pricing and volume considerations are examined to determine an initial residual projection. ALG works closely with manufacturers to understand future product lifecycles and production schedules and the effect these will have on vehicle depreciation.

Additional information on Fitch's utilization of issuer-provided ALG residual value risk studies is detailed further herein.

#### Early Termination

Leases can be terminated on schedule (i.e., at the end of the specified lease term) or early (prepaid anytime before the lease ends). In addition to historical loss experience, the early termination history associated with a particular issuer is evaluated to determine the magnitude and timing of lease terminations. Terminations provide an indication of the risk posed by residual values. When the lease is terminated early, the lessee must return the vehicle to the dealership. The lessee is usually required to complete an odometer disclosure statement and must pay an amount equal to the total unpaid monthly payments (less unearned lease charges) plus any unpaid fees, taxes and charges for excess mileage and excess wear and tear. The greater the number of leases that terminate early, the less vulnerable a securitization is to residual value risk. This is due mainly to the stipulation that closed-end leases require the lessee to make whole the lessor upon early termination. Therefore, when a lease is prepaid and terminated early, the risk of not realizing the booked residual value is largely eliminated.

Additionally, some lessors (primarily the captive finance companies) have periodically marketed voluntary early termination programs to their base of lessees. These early termination programs allow lessees to terminate their leases prior to contractual maturity at minimal incremental cost if they buy or lease another vehicle from the same manufacturer/lessor. The programs are largely designed and initiated by manufacturers to promote customer loyalty and generate new vehicle sales.

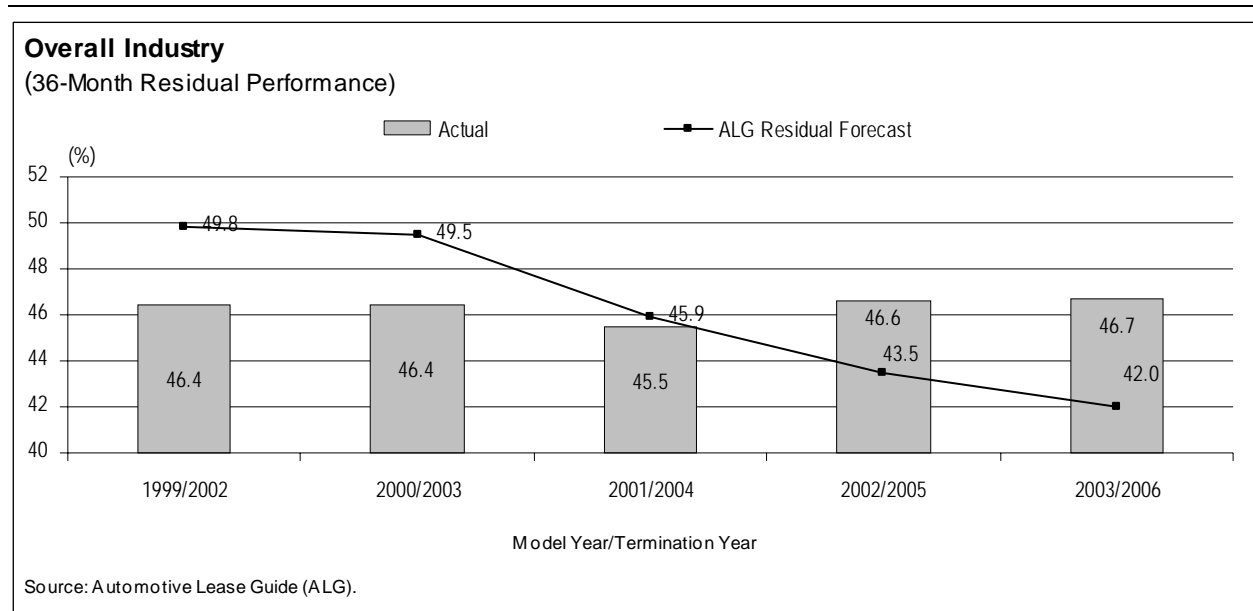
Under such programs, a manufacturer notifies the lessor, and both parties agree to offer the program to either specific bands of scheduled lease maturities or specific motor vehicle models. The remaining contract payments are waived for lessees who choose to return their vehicles and simultaneously purchase or lease another qualified vehicle. Excess mileage and the related costs are determined on the original full lease terms and are not adjusted for the shorter term. The vehicles are sold using normal disposition processes, and the remaining monthly payments owed by the lessees are reimbursed by the manufacturer, resulting in prepayment of the lease.

To the extent a lease securitization allows for a lessor to initiate future early termination programs for pools of previously securitized leases, Fitch will carefully review the payment mechanics to ensure the securitization trust is made whole from manufacturer reimbursements. Additionally, Fitch will assess any incremental risk early termination programs may create such as artificially increasing prepayments, reducing excess spread and introducing greater residual realization volatility.

#### Turn-In Rates

The proportion of lessees who do not purchase their vehicle at the end of the lease contract or return the vehicle during the term of the contract is measured by the turn-in rate. This is calculated as the number of vehicles returned to the lessor at lease maturity as a percentage of the number of lease contracts that were scheduled to mature during the same period.

Fitch has noted a steady increase in average portfolio turn-in rates for most major lessors over the past 10 years. Turn-in rates for publicly issued lease securitization in 1994 averaged slightly more than 10%. This number has progressively increased, reaching more than 50% in 1999 and currently averaging over an estimated 70% for most issuers.



Turn-in rates are affected by a number of factors, including the condition of the new and used vehicle markets, financial conditions of borrowers and the structure of lease terms. Additionally, turn-in rates are usually higher for short-term leases than for long-term leases, because the residual value as a percentage of the capitalized cost is higher. Therefore, lessees would rather not pay a significant amount at lease end when they can lease a new vehicle for the same monthly lease payment.

#### Used Vehicle Market

Vehicles that are not purchased by the lessee or the dealership at lease maturity must be sold by the lessor, often at an auction or in the used vehicle market. The used vehicle market is influenced by many factors including supply, risk relating to specific vehicles and new vehicle prices. If there is an oversupply of a certain make or model in the market or if there is decreasing demand for an exact vehicle in the new vehicle market, the sale proceeds the lessor may receive might be lower than expected. Additionally, falling prices for new vehicles generally lead to price pressure on used vehicles. This is due to the general decrease in market values for vehicles, taking the new vehicle as the initial benchmark. Further, lower new vehicle prices cause a shift in demand from used to new vehicles.

#### ■ Estimating a Base Case

Fitch's base case represents the expected lifetime losses experienced by the asset pool under normal economic conditions. In a lease transaction, base-case assumptions are determined for credit losses, residual

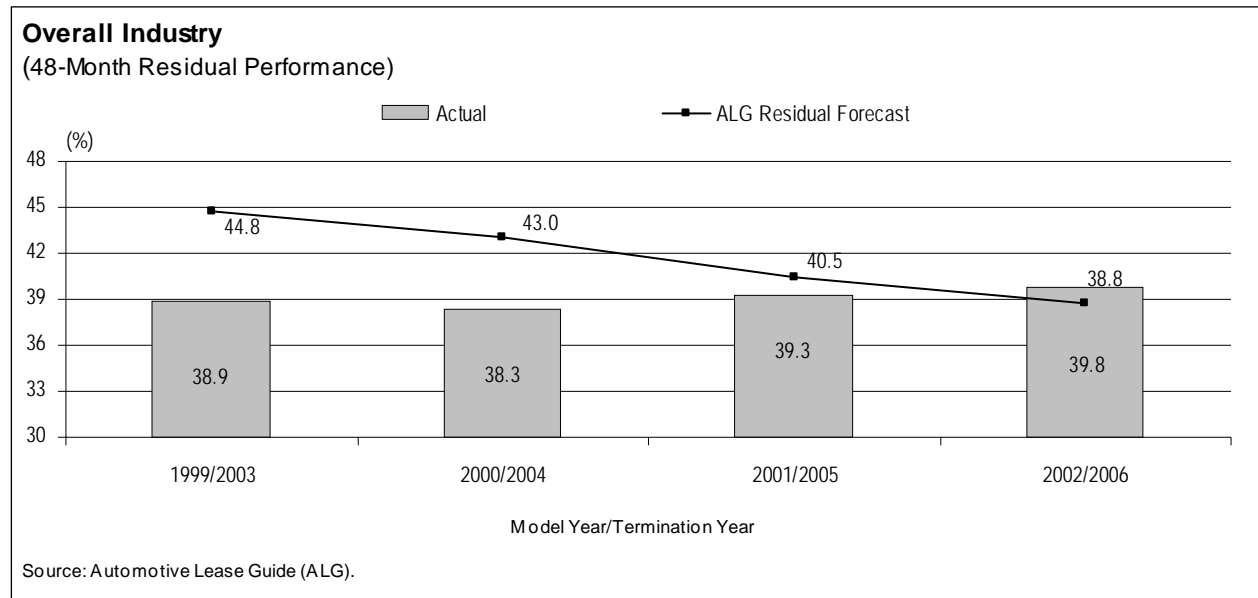
value realizations and turn-in rates. Fitch stresses these base-case assumptions to determine the recommended coverage level the securitization's cash flow must meet at each rating level.

#### Credit Loss Estimate

As mentioned previously, Fitch's methodology for determining base-case credit losses for lease securitizations mirrors the methodology currently used for standard auto loan securitizations. Static pool data is reviewed to derive base-case gross and net loss estimates for the securitized pool. Fitch generally recommends at least five years of historical static data in order to capture the effect of various economic cycles on lease performance and to gauge the full-term residual value cycle. Average loss speeds and cumulative loss curves are developed and used to forecast cumulative losses for each origination period. To the extent this static data can be stratified into more detailed subsections, such as lease term and/or credit scores, this additional data will be used to refine any given lease pool's projected performance further. Fitch generally calculates the securitized pool's base-case cumulative net credit loss estimate by weighting its exposure to these pool-specific characteristics.

#### Stress Multiples for Base-Case Credit Losses

Rating Category	Multiple Ranges (x)
'AAA'	4.0–5.0
'AA'	3.5–4.5
'A'	2.5–3.5
'BBB'	2.0–2.5



Standard credit loss multiples are applied to stress base-case credit losses appropriately at the required rating level. Fitch has used ‘AAA’ stress multiples ranging from 4.0 times (x) to 5.0x the base-case loss estimate and ‘A’ stress multiples ranging between 2.5x and 3.5x the base case. Stresses outside the standard multiples are lessor specific and are a function of servicing ability, historical loss volatility, availability and amount of static loss data, portfolio growth and collateral composition.

#### Residual Value Realization Estimate

To estimate residual value realization for any given asset pool, Fitch considers two key variables: residual value realization rates and vehicle turn-in rates. Residual value realization rates represent the severity or dollar value loss and/or gain that results from the disposition of a vehicle, and turn-in-rates represent the frequency of residual value losses and/or gains.

#### *Residual Value Realization Rate*

To determine a base case, Fitch relies primarily on the historical residual value realization experience of the issuer. Fitch reviews each issuer’s residual valuation methodology, the historical performance of their proprietary models and residual value realization data. The static residual value pool data received by Fitch is often stratified into segments such as vehicle make, model and lease term. To determine a base-case assumption, Fitch considers the historical residual gain/loss experience measured by a securitization pool’s weighted-average residual realization based on these individual segments. When static pool residual loss data is not available, Fitch

uses portfolio performance data, which also can be segmented by the same parameters mentioned above.

Fitch also considers the effect of other qualitative factors, such as a potential financial distress at the manufacturer level, prolonged use of incentives and wholesale price volatility, when estimating a base-case assumption. Additionally, in recent auto lease securitizations, Fitch’s residual realization analysis has been augmented by issuers providing detailed residual valuation studies of potential lease securitization pools performed by ALG.

These reports utilize ALG’s proprietary models, incorporating both quantitative and qualitative variables and factors, to estimate each individual leased vehicle’s projected residual value, assuming the lease goes to maturity and is turned in by the respective lessor. Information is provided in a number of different formats, including by vehicle make and model and lease term, as well as by different possible vehicle turn-in conditions, such as in clean condition or with excessive wear and tear. Projected residual values can be provided both at the time of inception of an individual lease and at the time a seasoned pool of leases is being analyzed for securitization (a mark-to-market study).

While periodic volatility in the accuracy of ALG’s residual value estimates has been documented (in particular for model years 1999–2001 for 36- and 48-month residuals, as shown in the charts above and on page 14), ALG’s studies have proven to be insightful in a number of instances, including isolating a

lessor's true historical residual realization experience during periods of heavy residual subvention and early termination program use, filtering out the effect on historical residual value performance of differing collateral composition and base residual assumptions in an originator's portfolio over time, and highlighting inconsistencies and validating the estimates of each lessor's proprietary models and residual value setting policies. In cases where a particular lease pool may contain a large percentage of leases subject to residual subvention, issuers will often cap their securitized residual values to the lesser of the projected ALG value or the contractual residual value. Fitch will take into account these adjustments when calculating a residual value realization estimate.

#### *Turn-In Rates*

Using historical static pool turn-in rates (or portfolio turn-in rates if there is no static pool data), Fitch determines a base turn-in rate assumption for each securitization pool. As mentioned earlier, turn-in rate assumptions dictate the effect residual value realization has on a securitization. As Fitch's credit analysis for auto lease securitizations separates risk of loss into two components (credit defaults and residual value realization) that portion of a lease pool subject to residual value realization risk will be determined by the vehicle turn-in rate assumption. In this sense, the turn-in rate assumption represents the expected frequency of residual value losses and/or gains in any representative pool of leases.

Both scheduled and early terminations, as well as terminations due to incentives (early termination programs), are considered in this analysis. Just as with credit loss and residual realization static data, Fitch is often provided historical static turn-in rates stratified by various segments, such as vehicle model, lease term and incentive/nonincentive leases. Fitch's base-case turn-in-rate assumption for any given lease pool will be a weighted average of the turn-in rates for each of these segments.

Turn-in rates exhibit seasonal fluctuation, so when using portfolio data, annual turn-in rates are determined by averaging the last 3–5 years of historical portfolio data to derive the current trend. Although older vintages might not be representative of the current environment, they are also reviewed to assess performance under various economic conditions.

#### *Collateral Loss Calculation Example*

The Collateral Loss Estimation Worksheet on page 17 illustrates Fitch's methodology for calculating collateral loss coverage levels, including stressed residual value realization assumptions, for a pool of auto leases. Using a hypothetical example, a securitization involves a pool of 4,000 lease contracts with an average lease balance of \$25,000. For this \$100 million pool, approximately 65%, or \$65 million, of the securitization aggregate principal balance represents the residual value component of the leases. Our base-case credit loss assumptions for this pool, as shown in the aforementioned table, are a 4% gross default rate with a 50% recovery rate, resulting in a 2% net credit loss assumption. Additionally, our residual value assumptions include a base-case residual value loss rate of 5.00% under a 45% base-case turn-in rate scenario.

The first step in calculating the pool's projected residual value losses is to separate those leases that are assumed to prepay or default out of the lease pool. This is done to avoid applying a residual value loss on a prepaid or defaulted contract, which would result in double counting of losses. When a contract prepays, there typically is no residual value loss since the lessee is obligated to repay the full outstanding contract balance plus any applicable fees and taxes. Additionally, if a lessee defaults on a lease contract, the residual value loss on such contract is already captured in the net credit loss assumption. Therefore, Fitch adjusts for the effect of prepayments and credit defaults in cash flow models. In our aforementioned base-case example, if 4% of the pool is assumed to default, that will mean that the remaining 96%, or \$96 million, in leases is remaining and subject to a residual value risk analysis. To simplify this hypothetical analysis, we assume 0% base case and stressed case prepayments and/or early terminations.

Again using our base-case residual value assumptions from earlier, if 45% of the remaining lease pool is assumed to turn in at scheduled lease maturity, \$43.2 million of the remaining \$96 million pool must now be disposed of by the lessor and will be subject to residual value risk. If 65% represents the residual value component of the lease pool, the total dollar amount of pool cash flows subject to residual value losses is \$28.08 million (65% of the \$43.2 million in turned-in leases). With a base-case residual value loss rate of 5.00%, residual value losses under our hypothetical base-case scenario will be approximately \$1.4 million, resulting in a residual realization rate of approximately 95% (\$26.68 million in residual proceeds as a

Collateral Loss Estimation Worksheet

	Base Case	'AAA'	'A'
Original Pool Balance (\$ Mil.)	100.00	—	—
Pool Residual (% of Original Pool Balance)	65.00	—	—
Gross Credit Default (% of Original Pool Balance)	4.00	16.00	12.00
<b>Net Credit Loss (% of Original Pool Balance)</b>	<b>2.00</b>	<b>8.00</b>	<b>6.00</b>
Credit Loss Multiple (x)	1.00	4.00	3.00
Vehicle Turn-In Rate	45.00	80.00	60.00
RV Loss Rate (% of Pool Residual)	5.00	8.89	6.67
% of Pool Subject to RV Risk	96.00	84.00	88.00
RV Component of Lease Turn Ins (\$ Mil.)	28.08	43.68	34.32
Residual Value Losses (\$ Mil.)	1.40	3.88	2.29
RV Losses (% of Original Pool Balance)	1.40	3.88	2.29
Residual Realization Rate (%)	95.00	91.11	93.33
Residual Realization Haircut (%)	0.00	17.00	10.00
Stressed Residual Realization Rate (%)	95.00	75.62	84.00
<b>Stressed RV Losses (% of Original Pool Balance)</b>	<b>1.40</b>	<b>10.65</b>	<b>5.49</b>
<b>Total Loss Coverage Available (Net Credit + RV Losses) as % of Original Pool Balance</b>	<b>3.40</b>	<b>18.65</b>	<b>11.49</b>
RV – Residual value.			

percentage of the \$28.08 million in possible proceeds). As detailed in the example, this transaction must now be able to support combined residual and credit-related losses equal to 3.40% of the original \$100 million lease pool under a base-case scenario.

Under 'AAA' assumptions, Fitch typically assumes the percentage of leased vehicles returned to dealers at the end of the lease contract will be significantly higher than the historical turn-in rates. The assumed turn-in rates utilized are generally in the range of 1.5x–3.0x base-case turn-in rate assumptions and may be as high as 100% in cases where the historical and base-case turn-in rate is initially at a high level (e.g., 70% and above). Fitch also assumes the residual value loss upon sale of the leased vehicle will be higher than current levels experienced by the originator/servicer. Additionally, base-case credit default assumptions will be stressed using a multiple commensurate with the requested rating level.

If, under a 'AAA' stress scenario it is assumed that a multiple of 4x base-case credit defaults is required, 84% of leases in the pool are subject to residual value risk. If 80% of the vehicles are turned in at maturity with a 65% residual value component, using the same methodology presented in our base case, approximately \$43.68 million will represent the residual value component of turned-in leases. The corresponding residual value loss rate is scaled to 8.89% to account for the increased turn-in rate assumption (5% base-case loss at a 45% turn-in rate scaled for an 80% turn-in rate), resulting in residual

value losses of approximately \$3.88 million and a residual value realization rate of 91.11% (100% minus 8.89%).

A realization haircut is then applied to determine the stressed residual realization rate. This haircut is utilized by Fitch primarily to capture systemic risks to future wholesale vehicle values. In general, these haircuts range from 15%–20% at the 'AAA' level down to 5%–10% at the 'A' level and are influenced by factors such as the quality of transaction data, market conditions, and the overall diversification and strength of manufacturers and vehicles in the pool. Assuming a hypothetical 17% haircut, the realization rate under our 'AAA' scenario becomes 75.62%, resulting in stressed residual value losses of \$10.65 million (or 10.65% of the \$100 million original pool balance). This is equivalent to a stressed residual value loss of 24.38% on the turned-in portion of the portfolio's residual value (100% minus 75.62%) and is the residual value loss number used in Fitch's cash flow modeling.

Combining the net credit loss assumption with the residual value loss assumption results in a total 'AAA' loss projection of 18.65%. The same procedure is repeated for each requested rating category. To earn a specific rating, the transaction must be able to withstand a combination of credit losses and residual value losses commensurate with the desired rating category.

Cash Flow Sources

There are five outcomes that can befall a lease contract and determine the sources of cash flow for an auto lease securitization:

- The contract can go full term, with the lessee purchasing the vehicle at contract maturity. In this instance, the securitization trust receives full and timely payment on the lease contract (assuming no delinquencies), including full residual value realization.
- The contract can prepay and the trust would receive full early payment on the principal portion of the lease contract, including full residual value realization.
- The underlying vehicle can be stolen or totaled. In this case, insurance proceeds would be available to the trust to cover the cash value of the vehicle. However, the cash value may be less than the remaining lease contract balance, resulting in a credit loss to the trust.
- The lessee can default on the lease. As a result, the servicer must repossess and liquidate the vehicle. This typically results in credit losses due to delays in repossession and disposition of the vehicle.
- The contract can go full term with the lessee returning the vehicle to the dealer. In this case, the dealer has the option to purchase the vehicle. If the dealer exercises this option, the securitization trust receives full and timely payment on the lease contract, including full residual value realization. If the dealer does not purchase the vehicle, it must be disposed of in the used vehicle market, typically through auctions. It is in this instance that the trust is exposed to residual value losses, since the vehicle may potentially be sold for less than the contractual residual value. In the rare event a vehicle is sold for more than its contractual residual value, only the residual value amount is generally transferred to the trust.

### Cash Flow Modeling

Fitch's cash flow modeling is most concerned with lessee defaults and vehicle turn-ins in which the dealer does not exercise its purchase option. Fitch utilizes cash flow runs, which include all aspects of the securitization structure.

For modeling purposes, Fitch recommends that base-case lease cash flows on a zero prepayment, zero default basis are provided. Each monthly cash flow

should be broken out to show monies received and payments made according to the waterfall.

Credit losses are applied based on a loss speed curve that is consistent with the actual speed with which losses have come in on a static pool basis. To add some conservatism, Fitch may front load losses to strain excess spread and tap any hard credit enhancement earlier. In addition, a delay of 3–5 months from contract default to receipt of recovery proceeds is typically assumed.

To analyze the effect of residual value losses on the transaction, Fitch runs various cash flow scenarios, including the following:

- A zero prepayment scenario that results in the most severe stress to residual value losses, since more lease contracts reach full term and are assumed to turn in. These vehicles must then be sold at auction or in the used vehicle market to collect on the residual value portion of the lease contract.
- A haircut to the pricing prepayment assumption scenario that results in the least severe stress to residual value losses, since fewer lease contracts reach full term due to higher prepayments.
- A targeted turn-in rate scenario in which a prepayment level consistent with the desired rating category's targeted vehicle turn-in rate is assumed. This results in a more consistent application of residual value losses in accordance with the desired rating category's stress assumption.

Collateral cash flows and the resulting stressed credit and residual value losses under various combinations of these scenarios are run. At each rating level, the respective class of notes must pay full and timely interest and ultimate principal under each model assumption.

The first two cash flow scenarios listed earlier are straightforward; however, the targeted turn-in approach deserves additional comment. Under this method, which Fitch considers the most relevant stress scenario for each rating category, a multiplier is applied to the base-case prepayment assumption such that, with credit losses and prepayments, the aggregate dollar amount of residual value cash flows received on the collateral as a percentage of the original pool residual value equals the targeted turn-in percentage. For example, under the 'AAA' scenario where an 80% turn-in rate is targeted, prepayments are adjusted until the aggregate dollar

amount of residual principal received equals 80% of the original pool residual value.

As mentioned previously, it is important to note that in Fitch's modeling, stressed rates of vehicle returns at all investment-grade rating levels will likely be significantly higher than the historical and current experience of an originator's lease portfolio. A typical 'AAA' turn-in assumption of 80% allows for 20% of the leased vehicles to prepay, default or be purchased by the lessee at maturity. This allows Fitch to adequately capture and cover the full extent of potential residual value risk in any lease portfolio.

#### ■ Structural Analysis

While Fitch continues to focus our analysis on the credit of the underlying lease contracts and vehicles, as structuring alternatives available to issuers grow, all structural aspects of a lease securitization transaction, such as proposed payment priorities and waterfall and forms of available credit enhancement, are reviewed to ensure stressed cash flows are sufficient to pay investors in full.

#### Credit Enhancement

Credit enhancement is needed to protect noteholders against the realization of losses due to poor collateral performance. The primary forms of credit enhancement used in auto lease securitizations are similar to auto loan transactions, including excess spread, reserve accounts, subordination and overcollateralization (OC). These forms of credit enhancement are generally referred to as internally generated enhancement, as the credit protection is provided from pool-generated cash flows.

Securitizations can also benefit from external sources of credit enhancement, such as bank-provided letters of credit, residual value insurance (discussed in further detail herein) and monoline insurance policies. Transactions that use guaranties from the monoline bond insurers derive their ratings directly from the ratings of the monoline bond insurers that guarantee full repayment of principal and interest due on the bonds. In these cases, Fitch reviews the policy to ensure its integrity and the irrevocable and unconditional nature of the guaranty. Fitch also conducts a full review of the collateral to provide investors looking through the protection with an assessment of the assets and internal enhancement.

#### *Excess Spread*

The percentage of available excess spread in a lease securitization is approximately equal to the lease

pool's weighted-average implicit lease rate, or APR, less the duration weighted-average bond coupon, servicing fees and other periodic reoccurring transaction expenses. In many lease securitizations, issuers will artificially create excess spread by discounting future lease cash flows, including residual values, at a predetermined discount rate. This discounting effectively serves to reallocate a portion of the lease pool's future cash flow that normally would be considered principal payments to interest payments, increasing the pool's yield from its underlying weighted-average implicit lease rate to the applied discount rate.

Lease securitizations are generally structured such that monthly excess cash flow generated due to excess spread is the initial form of credit enhancement available to cover periodic collateral losses. The amount of credit given for excess spread as credit enhancement in Fitch's stress scenarios is influenced by several factors.

#### *Delinquent Interest*

The effect of delinquent borrowers on a pool's weighted-average stated lease rate is assessed for every issuer. Payment delinquency creates a delay in cash flows available to securityholders, creates liquidity concerns and decreases periodic available excess cash flow. While servicer advances help alleviate this problem and provide needed liquidity, Fitch generally does not give credit for servicer advances. They usually are the first item to be paid out of the waterfall in subsequent collection periods and, thus, provide no real credit protection.

Fitch analyzes historical delinquency trends and their effects on the lease rate by reviewing static pool delinquency reports and an issuer's historical managed portfolio delinquency performance. The results of this analysis are used as a starting point and incorporated into cash flow models. Under stresses, as credit defaults grow, delinquencies also increase. The two are linked and vary by rating category. As would be expected, delinquencies are a precursor to losses and, therefore, are similarly distributed. Delinquencies tend to be highest in the first year or two of a pool's life and diminish soon after.

#### *Weighted-Average Lease Rate Compression*

Similar to loan securitizations, lease securitization can experience compression in the average lease rates through the life of the securitization. Changes in lease rates are typically a factor of underlying credit

characteristics of the pool. Lessors with substandard credit characteristics may qualify for a lease but at an implicit lease rate higher than a lessor with strong credit characteristics.

An analysis of the receivables pool and servicing reports allows Fitch to identify pools of leases that may be vulnerable to weighted-average lease rate compression. Fitch has observed that pools with high concentrations of leases in lower credit tiers exhibit rate compression due to refinancings. Overtime, the default and renegotiation of lower credit quality contracts tend to move the portfolio's overall weighted-average implicit lease rate closer to that of the standard or market rate leases, resulting in less available excess spread to cover losses. This form of rate decrease is obviously not evident in lease transactions where the issuer is applying a discounting rate to the pool's cash flows and each lease is discounted at the same discount rate.

#### Collateral Average Life

High stress multiples decrease the average life of the pool, reducing excess spread over the life of the transaction. Since prepayments are held relatively constant, average life is reduced primarily through high defaults and early terminations due to incentive programs.

#### Trapped Excess Spread

Excess spread is modeled on a "use it or lose it" basis unless the structure specifies different uses. Fitch will consider initial and target reserve fund and OC levels, where monthly available excess spread can be used to build credit enhancement over the life of the transaction. The initial levels are of greater importance, however, since under stress scenarios, excess spread usually is exhausted, preventing a transaction from reaching target levels.

#### *Reserve Account*

Most auto lease securitizations use spread or reserve accounts, which typically are funded with an initial deposit and trap excess spread up to a required amount. Reserve accounts are useful for meeting transaction expenses and providing liquidity, which may be strained during periods of high credit or residual losses, or on the back end when few contracts remain outstanding. As mentioned previously, Fitch's main focus in reviewing spread account sizing is on the initial deposit and not the target amount, as the initial deposit typically dictates

the minimum level of losses a securitization can withstand at closing when the rating is assigned.

Although most reserve accounts are sized to reach their target in 6–9 months under base-case cash flows, under high-loss scenarios in which credit losses are front loaded, excess spread often is depleted before the reserve account reaches its target. Generally, for each month the securitization performs at or better than the base-case projection, loss coverage multiples improve. If the reserve account target is reached, a greater amount of credit enhancement is available to cover expected remaining losses. A nondeclining reserve account will boost available credit-enhancement as the transaction de-levers. Fitch assigns its ratings based on the level of loss protection available at day one and available excess spread trapped.

#### *Subordination and Overcollateralization*

Subordination and OC are considered together as they both represent an ownership interest in the underlying receivables and, from a cash flow perspective, behave similarly. If an investor's pro rata share of collections is insufficient to make scheduled payments, funds otherwise payable to the issuer or to junior bondholders are used to pay senior bondholders.

The strongest form of OC, generally considered the first-loss piece, consists of an ownership interest in the receivables and is often retained by the sponsor. There generally is no coupon expense associated with OC. Subordinate tranches typically have coupon expenses and, therefore, will result in less cash for senior bonds than OC. Both generally will offer less credit protection than a cash reserve account, since they depend on asset performance and available collections.

Whatever the form of credit enhancement chosen, detailed cash flow modeling is essential to evaluate each structural enhancement properly and measure whether or not the amount of losses covered under each scenario is appropriate for the assigned ratings.

#### *Residual Value Insurance*

A number of earlier auto lease securitizations employed a residual value insurance policy as a method of mitigating residual value risk. A typical residual value policy covers the difference between the stated residual value of a vehicle and the realized proceeds upon disposition for those lease contracts that reach full maturity. Therefore, the residual values

of leases that default or prepay are not covered by the policy. Additionally, the residual value amount covered is generally subject to a maximum. Fitch evaluates several factors in reviewing the insurance policy including the following:

- The claims-paying ability of the insurer.
- Whether the residual value covered is the contractually stated residual value.
- Whether there is an enforceability opinion.
- Whether the policy is noncancelable.
- The simplicity of the claims process.
- The policy exceptions.
- Whether the indenture trustee is named as the insured.

As in the case for monoline policy providers and in conjunction with Fitch's Financial Institutions group, all insurance providers of residual value risk are evaluated for their financial strength and claims-paying ability. Insurers for which there is no Fitch rating are assessed internally. A downgrade of the insurance company would result in either the replacement of the policy from an insurance company acceptable to Fitch, the funding of a reserve sufficient to maintain the outstanding rating on the securities or the review of the transaction for a possible downgrade. Mitigating residual value risk with an insurance policy can be expensive and, therefore, is not currently a popular form of credit enhancement.

## ■ Structural Trends

To accommodate a wide variety of investor needs, auto lease securitizations continue to incorporate a number of innovative features.

### Revolving Periods

Although not new to ABS, auto receivable related securitizations have begun to use revolving periods more regularly. For a specified period, typically 12 months, all principal payments and excess interest are not passed through to bondholders but instead used to purchase additional lease receivables. Fitch recognizes the risk inherent in revolving pools, namely a weakening of the overall collateral. As such, prior to providing a rating, Fitch will review the specified parameters used to add new collateral and will monitor collateral characteristics through the termination of the revolving period. Key attributes, such as credit scores, implicit lease rates, terms, vehicle age, vehicle make and model, and geographic dispersion, will be examined and compared relative to the originally presented lease pool. Additionally,

many transactions will incorporate triggers based upon periodic delinquency, net loss and residual realization performance, which, if surpassed, would terminate any revolving period and possibly initiate an early amortization.

### Prefunding

While very prevalent in auto loan backed securitizations, the use of prefunding is also available to auto lease securitizations. A prefunded transaction is a securitization that initially closes with less receivables than are pledged to the trust. The issuer then uses the proceeds of the bond sale to purchase additional collateral during the prefunding period. This period usually lasts from 3–6 months. Fitch will review analyses to ensure that interest shortfalls between the yield on investments in the prefunding account and the required monthly bond coupon are sufficiently covered with either excess cash flow or the use of a capitalized interest account.

If the collateral is not added by the end of this period, the remaining cash is passed through to bondholders. Issuers often use a prefunding period to maintain an issuance schedule or to lock into favorable bond funding rates. Fitch expects the additional collateral to adhere to specific tolerance bands in an effort to maintain the integrity of the overall pool. Since there can be a shifting pool composition due to prefunding, the amount to be prefunded is generally limited to 20%–25% of the entire pool.

### Specified Payment Period

Most transactions are structured to pay bondholders in different classes either pro rata, based on bond size; sequentially, based on seniority; or modified pro rata, where cash is diverted first to pay down a single class, typically a short-term money market class, before being allocated among the remaining bond classes pro rata. Some structures include a shifting pay mechanism. This feature is designed to assure parity between the senior notes and the collateral balance. If at any time the senior classes become undercollateralized, primarily due to excessive losses, cash that would normally be allocated to pay interest to subordinated classes is diverted to senior classes.

### Floating-Rate Debt

Before the past few years, almost all auto receivable-backed securitizations were issued with fixed-rate bond classes. However, given the favorable interest rate environment, investors have exhibited greater demand for floating-rate debt. Accordingly, auto

lease issuance has included variable-rate classes tied to the one-month London Interbank Offered Rate (LIBOR). To mitigate against interest rate risk, trusts have entered into swap agreements with highly rated financial entities. Prior to issuing a rating, Fitch reviews these agreements and the credit strength of the swap counterparty for conformance with our counterparty criteria.

(For further information, please see Fitch's criteria report, "Counterparty Risk in Structured Finance Transactions: Swap Criteria," dated Sept. 13, 2004, and special report, "Interest Rate Risk in Structured Financed Transaction: USD LIBOR," dated May 15, 2006, both of which are available on Fitch's Web at [www.fitchratings.com](http://www.fitchratings.com).)

## ■ Operational Analysis

As part of the initial and ongoing rating maintenance process, Fitch regularly assesses the operational capabilities of ABS sponsors. The evaluation is divided into three broad segments: corporate performance, origination and servicing. For a complete discussion of Fitch's approach to rating ABS seller/servicers, please see the criteria report "Rating U.S. ABS Seller/Servicers," dated April 20, 2006, and available on Fitch's Web at [www.fitchratings.com](http://www.fitchratings.com).

### Corporate Performance

An understanding of the corporate history, structure and future directions, as well as the company's standing in the market place is essential elements in the Fitch analysis. This understanding establishes the basis for evaluating an organization's stability, as well as its ability to meet present and future business objectives. Fitch will evaluate management's commitment to providing direction and devising strategies to fulfill origination and servicing objectives. Legal structure and ownership, management tenure and depth, operating history and experience, portfolio characteristics and future competitive strategy are factors considered in the examination. Portfolio growth and fluctuations affect a company's ability to meet growth targets. Fitch will review merger/acquisition activity, expansion plans and intentions to exit or scale back business lines or niches that could influence operation performance.

Audited financials are reviewed to understand a company's funding alternatives, existing corporate debt structure, warehouse and bank facilities and the underlying motive for securitization to assess a

transaction's viability. The company may also be compared with its peers to determine its industry position and the effectiveness of its marketing strategies to address competition and its business goals.

### Originations

Fitch conducts a review of each originator's underwriting and residual value setting policies and procedures, as well as channels for originating lease contracts. The complete platform used in the lease origination process is thoroughly reviewed to ensure both quality and consistency in the origination process.

### *Underwriting Policies and Procedures*

The underwriting review includes evaluation of the underwriting strategy and origination policies and procedures. It also incorporates an assessment of the information systems utilized in the origination process.

As in auto lending, many lease originators use credit score cards to assist in the underwriting process. Credit scoring is a method by which a large sample of defaulted lease contracts is analyzed to determine which variables are statistically significant predictors of default. Scoring allows for efficient and accurate credit assessment of a large number of applicants.

The information used in the score cards can be gathered from either the lessee's credit report or the lease application; however, many lenders rely solely on information derived from the credit bureau report, as this information tends to be more accurate and reliable than application data. The variables and weightings are used to determine a credit score for each applicant, which is typically combined with the judgment of an experienced credit analyst who makes the final decision. Generally, those individuals scoring above a predetermined cut-off score are recommended for acceptance and those scoring below are recommended for denial. Lessors also may use multiple score cards to analyze performance among different geographic regions or compare the performance of first-time vehicle lessees and repeat customers.

Fitch analyzes the variables constituting each lessor's score card and considers how and why these variables have changed over time. Fitch also considers how often score cards are validated to ensure the cards maintain predictive validity.

Furthermore, Fitch looks at how often the credit score dictated decision is overridden and the process to evaluate and monitor exceptions. Overrides can occur in two ways: individuals who score below the cut-off score but are accepted and individuals that score above the cutoff but are rejected. The reasons for the overrides should be well-documented and the performance monitored over time. This data should then be used to refine acceptance criteria. Generally, such exceptions are limited to not more than 5% of originations and often less than 1%.

### *Residual Value Setting*

As discussed earlier, Fitch evaluates the methodology used by a lessor to establish residual values for leased vehicles. In addition, the ratio of realized residual values to stated residual values is analyzed to determine the company's efficiency in managing residual value risk and ability to liquidate off-lease vehicles.

As previously stated, establishing accurate residual values is of the utmost importance in lease securitizations since the securitized balance of a lease contract includes the stated residual value. An overly aggressive residual valuation policy (i.e., setting residual values too high compared with vehicle depreciation) is likely to result in losses to the trust upon lease maturity and vehicle disposition.

A variety of methods exist to estimate the residual value of a vehicle at lease termination, ranging from the highly quantitative to the highly qualitative. Fitch examines the historical performance data underlying each lessor's estimation process and compares sample residual value estimates with third-party residual studies, such as ALG reports, to estimate and assess reasonableness of residual value setting policies.

The review of estimation methodology is only part of Fitch's evaluation of a leasing company's residual policy, since the effect residual values have on a securitization is dictated largely by the turn-in rate. Fitch assesses the leasing company's strategy for affecting the early termination of lease contracts, thereby avoiding any residual value risk by collecting the full stated residual value of a leased vehicle. Each company's strategy to realize early lease terminations is evaluated in conjunction with historical performance. Fitch research indicates that fewer lessees participate in early termination programs during periods of economic stress. Therefore, the

number of early termination leases is adjusted based on the rating category.

Finally, to the extent the lessor is unable to accomplish early termination, the realized residual value for those leases going full term is affected by the ability of the company to manage the remarketing of returned vehicles efficiently. This ability is evaluated by analyzing the ratio of realized residual values to stated residual values.

### *Dealer Network*

The majority of auto leases are generated indirectly through a network of often hundreds of independent or affiliated dealers located across the country. Building and maintaining issuer/dealer relationships is a vital link in the origination chain. The nature of the association is twofold, involving both credit and business aspects. From a credit perspective, dealers should have a good working knowledge of the issuer's credit criteria, lease rates, residual value setting policy and buying profile. This will expedite the lease approval process, limit unnecessary contact with underwriters, reduce negotiating and help ensure higher approval rates.

Currently, dealers have alternatives in choosing financing sources. From a business perspective, dealers are compensated from the profit they receive selling the vehicle to the lessor, manufacturer rebates and/or incentives, as well as from lease fees paid upon inception of the lease. Given this structure, it is possible for credit and business objectives to be at odds. Issuers generally maintain a certain separation between the two to minimize inherent conflicts. Business development and negotiations are also generally conducted by managers distinct from the underwriting functions.

### *Servicing*

In most lease transactions, the seller and servicer are almost always part of the same company, and the financial strength of these entities always plays a pivotal role in every structured finance transaction. Audited financials are reviewed by Fitch's Structured Finance and Financial Institutions analysts to assess each party's financial strength and stability.

A full onsite review with company management is then performed by a team of analysts from both groups. If the company is not explicitly rated by Fitch, an internal assessment will be provided to the ABS group by the Financial Institutions group and

monitored on an ongoing basis. In this context, it is important to understand the fundamental objectives behind the securitization and whether it is part of an ongoing strategy or a means of entrance or exit. The composition relative to the overall portfolio is

also considered. In making their assessment, Fitch's analysts examine the pool selection criteria to determine if assets are being "cherry picked," potentially leaving unsecured debtholders in a weaker position.

Copyright © 2007 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004.

Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from USD1,000 to USD750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from USD10,000 to USD1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.