Rating Equipment Lease Securitizations

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Lease Securitization Analysis

- Lease composition by type (finance versus operating)
- Outstanding lease balances
- Original equipment cost distribution
- Lease term distribution (original and current)
- Lease yield distribution
- Lease seasoning
- Lease payment status
- Lessee concentration
- Equipment type
- Geographic concentration
- Vendor/manufacturer distribution
- Industry distribution
- Repossession and disposition history
- Residual realization history
- Prepayment terms
- Historical portfolio performance (aging, gross/net losses, and recoveries)
- Credit underwriting policies and procedures
- Billing and collection practices

This report updates Fitch IBCA Research "Rating Lease Securitizations," dated June 17, 1996, and is available on Fitch IBCA's web site at www.fitchibca.com.

Summary

Equipment lease securitization volume continues to grow, representing a larger percentage of the asset-backed market each year. In 1997, more than $7 billion of equipment lease-backed deals were completed, and Fitch IBCA expects volume to continue to grow over the next few years. The market has developed substantially since its inception, and these transactions are now widely accepted by most major investors. This is evidenced by improved pricing, lower credit enhancement, and the inclusion of various structural features that were not previously available to these issuers. In addition, while in the early 1990s most equipment lease transactions were private placements, a large percentage is now offered publicly.

In 1997, Fitch IBCA rated more than $3.2 billion of equipment lease-backed transactions, excluding aircraft transactions, of which more than 80% represented publicly issued securities. Major rated issuers included Advanta Business Services Corp., AT&T Capital Corp., Copelco Capital Funding Corp., Heller Financial, Inc., Greentree Financial, Corp., and DVI Financial Services Group. Fitch IBCA has analyzed a wide variety of lease transactions in terms of structure, size, and equipment type. Equipment types include small-ticket office, computer, telecommunications, large ticket medical, construction and industrial equipment, and aircraft.

Reflecting changes in this market and expected growth over the next few years, Fitch IBCA continues to refine its criteria for rating lease-backed transactions. Highlighting this refined approach is Fitch IBCA's ability, on a case-by-case basis, to give credit to residual values as a form of credit enhancement or an additional cash flow to be monetized. Fitch IBCA's ratings approach to lease securitizations includes the analysis of management/company review, characteristics of the underlying assets, types of receivables, pool characteristics, historical portfolio performance, credit underwriting and servicing, projected cash flow, and legal structure. This report details Fitch IBCA's criteria, describes the various financial and legal structures, and provides an overview of originator and servicer reviews.

Industry Background

Leasing offers business owners several advantages, primary of which is the ability to match lease terms with equipment needs, minimizing monthly payments, managing cash flow, and, depending on the lease structure, avoiding technological obsolescence risk. According to the U.S. Department of Commerce, in 1997, more than $580 billion of business investment in equipment occurred and in excess of 31%, or $180 billion, was

Lease Securitization Transactions

	Copelco Capital Funding 1997-A	Capita Equipment 1997-1	DVI Receivables V L.L.C.	Heller Equipment 1997-1
Closing Date	June 19, 1997	Dec. 3, 1997	Sept. 12, 1997	Oct. 30, 1997
Type of Company	Small Ticket	Small Ticket	Big-Ticket Medical	Mid-Ticket
Size of Transaction ($)	568,700,000	1,200,000,000	195,300,000	274,800,000
Deal Size/Ratings ($)	142,197,000/'F1+/AAA'	272,500,000/'F1+/AAA'	180,600,000/'AAA'	62,980,096/'F1+/AAA'
	54,182,000/'AAA'	252,000,000/'AAA'	N.A.	191,678,552/'AAA'
	211,495,000/'AAA'	153,000,000/'AAA'	N.A.	N.A.
	126,667,000/'AAA'	261,210,000/'AAA'	N.A.	N.A.
	N.A.	105,000,000/'AAA'	N.A.	N.A.
	22,746,000/'A+'	68,820,000/'A+'	10,500,000/'A'	8,214,795/'A+'
	11,314,085/'BBB+'	34,410,000/'BBB+'	4,200,000/'BBB'	5,476,530/'BBB'
Credit Enhancement (%)				
'AAA'	15.00	16.25	15.00	8.00
'A'	11.00	10.25	10.00	5.00
'BBB'	9.00	7.25	8.00	3.00
Portfolio Characteristics				
Number of Contracts	36,181	75,651	353	1,841
Average Discretionary Lease Balance ($)	15,634	15,161	399,365	149,270
Portfolio Seasoning (Months)	8.0	7.1	N.A.	22.0
Top Five Obligors (%)	N.A.	N.A.	11.39	8.00
Base Case Net Loss (%)	2.12	3.39	< 1%	< 1%
Equipment Concentration (%)	Copiers (51.30)	Telecommunications (46.80)	Medical Resonance (25.45)	Printing (27.10)
	Other (13.40)	Manufacturing (19.00)	Medical Equipment (16.65)	Machine Tools (12.50)
	Electronics (10.90)	Computers (15.60)	Facilities (14.33)	Computer Hardware (9.90)
Geographic Concentration (%)				
State 1	California (18.80)	California (14.70)	New York (19.83)	California (17.70)
State 2	New York (13.20)	New York (10.50)	California (15.86)	New York (7.80)

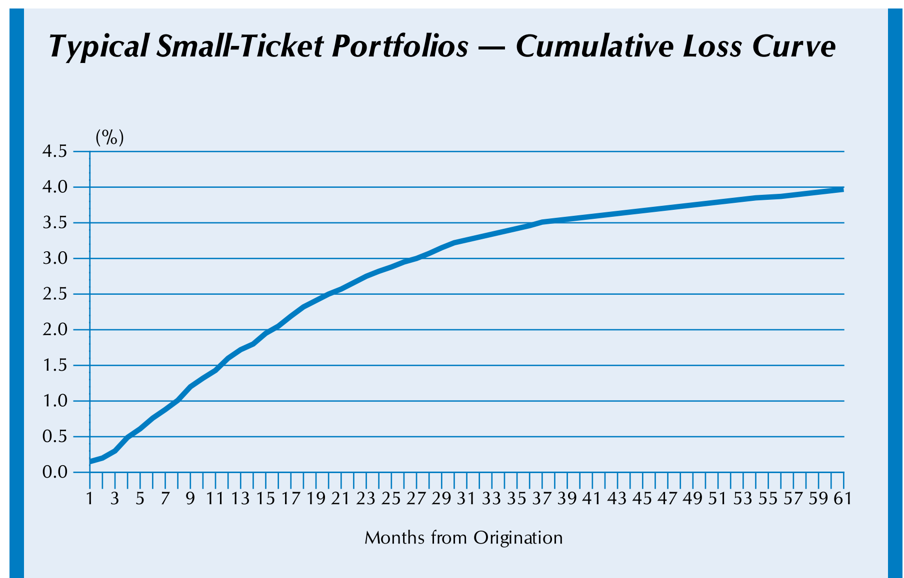
N.A. – Not applicable.

financed through leasing. More than 80% of all companies lease a portion of acquired equipment. Currently, more than 2,000 companies in the U.S. provide equipment leasing services, including independent leasing companies, banks, and captive subsidiaries of major manufacturers.

A leasing company's funding strategy is an important factor in its ability to compete successfully within its niche market. The cost, diversity, and dependability of a lessor's funding sources can directly affect its competitive position. Securitization can provide several benefits to equipment lessors, most important of which is an alternative source of funding. Securitization can help reduce a lessor's cost of funds, as the interest rates associated with the issued notes are typically lower than the borrowing costs of bank credit facilities. Depending on the selected structure, if a transaction is treated as a sale for generally accepted accounting principles purposes, the transfer of risk through off balance sheet treatment can be obtained, thereby lowering leverage and improving profitability through an acceleration of income. This would provide a leasing company with more flexibility to manage its balance sheet and its earnings. Most securities issued are fixed rate and, as a result, would provide interest rate protection to the lessor. Finally, unlike most traditional bank credit facilities, securitizations typically contain fewer covenants, thereby providing more flexibility.

There are three types of leasing portfolios — small ticket, midticket, and large ticket. Small ticket leasing portfolios typically consist of leases on equipment with a cost basis of less than $50,000, including office equipment, computers, and copiers. Because of the reduced cost of the equipment, a small-ticket leasing company generally leases to many different obligors in various

industries. This obligor and industry diversity allows Fitch IBCA to rely on the originator's credit underwriting policies and historical portfolio performance to estimate future performance. Mid-ticket lease portfolios typically contain equipment with an original cost of $50,000–$250,000, such as commercial and industrial equipment, graphics, and printing equipment. Large-ticket equipment pools include MRIs and other medical equipment with an original cost exceeding $250,000 or large computer systems. If the pool contains any concentration by obligor, industry, equipment, lease balance, vendor, or lessee locale, Fitch IBCA increases the required enhancement to reflect the additional risk. Expected, or "base case," portfolio loss assumptions are then stressed to reflect the appropriate rating category for the transaction.



Lease Receivables

Leases can be structured as finance or operating leases. In both cases, the lessor purchases the equipment and leases it to a lessee under a lease contract, which obligates the lessee to a set of scheduled payments for a specific period. Payment streams can be structured on a monthly, quarterly, semiannual, or seasonal basis, reflecting the lessor's business needs and cash flow cycles. Payments may be fixed or variable over the lease term.

Full payout or finance leases, primarily originated by small-ticket lessors, are structured so that the net present value of the lease payments covers at least 90% of the original equipment cost (for new equipment) or the fair market value (for used equipment). At the end of the lease term, the lessee is entitled to the equipment at a nominal purchase price, generally either the remaining fair market value of the equipment or 10% of the original equipment cost. Because the lease term for new equipment covers at least 75% of the useful life of the equipment, the lessee is essentially purchasing the equipment on a monthly payment plan.

In contrast, payments on operating leases, commonly used for larger ticket items, cover only a portion of the equipment cost (less than 90%). The remaining value of the equipment is referred to as the residual. At the end of the lease term, the residual value can be realized by the lessee purchasing the equipment at the originally stated value or, in the event the equipment is returned to the lessor, the sale of the equipment. Other options include the lessor extending the lease for a short period at the original lease rate to the original lessee or re-leasing the equipment to the same or different lessee at a renegotiated lease rate. Each option allows the lessor to recoup at least a portion of the residual value.

Generally, for leases to be included in a securitization, the following eligibility criteria must be satisfied:

- At least one month seasoning (the greater the seasoning, the higher the likelihood that the leases will perform).
- No receivable more than 30 or 60 days past due at closing.
- No lessee can be bankrupt.
- Leases must be "hell or high water" and triple net.
- Leases must be assignable.

A lessee typically does not have the option to prepay a lease. However, many lessors allow early termination of a lease to upgrade equipment or if the lessor has the opportunity to realize its residual earlier. The required prepayment amount normally includes the net present value of all payments remaining due on the lease from the time of prepayment until the conclusion of the lease term, including any residual value.

Structural Features

Lease transactions have traditionally been structured as term deals. With a term structure, the deal's maturity is a function of the longest lease included in the transaction plus a remarketing period for some large-ticket items.

Revolving Structure

As lease transactions have proven themselves to investors and rating agencies in terms of performance, additional structures and provisions are now available to equipment lease securitizations that were not previously offered on such deals. Many lease transactions now incorporate nine- to 12-month re-

volving periods. A revolving structure extends the term of the transaction, depending on the length of the revolving period. During this period, all principal collections on lease receivables are used to purchase newly originated lease receivables. Once the revolving period ends, the transaction begins to amortize, and all collections on the leases are used to pay down bondholders. However, if a seller bankruptcy, a material breach of representations and warranties, a servicer default, or a significant deterioration in portfolio performance occurs, the deal will begin to amortize early.

Prefunding Account

Alternatively, some transactions contain prefunding accounts. At closing, the issuer deposits a portion of the proceeds it receives into a prefunding account, and the funds are subsequently used to purchase additional receivables from the seller for a certain period (usually 90–120 days for lease transactions). At the end of this period, to the extent any funds remain in the prefunding account, such funds are used to amortize the securities, which could lead to a prepayment. Prefunding periods allow issuers to lock in rates and increase the transaction size. An issuer must demonstrate its ability to generate sufficient volume to support this feature without jeopardizing credit policies. To eliminate the potential negative carry on the cash held, given that the bond coupon is higher than the interest rate earned on the funds in the prefunding account, some type of capitalized interest account is established at closing, which decreases as the amount in the prefunding account declines. The initial deposit for the capitalized interest account was established under the assumption of no additional lease purchases during the prefunding account.

Substitution Repurchase

Most transactions contain provisions allowing some type of lease substitution and/or repurchase of leases due to breach of representations and warranties, prepayments, or defaults. This is typically limited to 10% of the initial deal size. As long as these provisions are structured and documented as options of the seller, as opposed to obligations, the risk that this provision could be considered recourse and a threat to the true sale of the receivables is minimized.

Performance Triggers

Lease securitizations commonly contain performance triggers that, when hit, would typically capture any release of cash and may turbo pay the bonds in a sequential manner. These triggers usually take the form of delinquency and default or loss tests.

Analysis

In lease securitizations, the value of each contract sold to the trust is the sum of the net present value of the remaining lease payments due on the contracts. If any monetization of residuals is involved, the aggregate value of booked residuals would also be included. Notwithstanding any concentrations, credit enhancement for a lease securitization must be adequate to cover any defaults and losses on the leases during the life of the deal, plus any loss on equipment at the end of the lease term.

For operating and finance leases, several factors influence the level of defaults that occur during the lease term. Fitch IBCA believes that the primary default driver is lessee credit quality. Lessee defaults are best mitigated by conservative underwriting standards that encompass a review of each borrower's willingness and ability to pay, as well as the borrower's overall operation. The equipment should be integral to the core functions of the lessee's business, and active maintenance programs should be in place.

Seasoning also plays a role in mitigating defaults. A lessor's seasoned portfolio will experience fewer defaults relative to its unseasoned portfolio because the lower quality credits are already removed from the pool due to their early default. Consequently, the more seasoned the leases are, the better the quality. Fitch IBCA looks more favorably on seasoned payment streams when determining credit enhancement levels. In addition, if the lessor, by providing static pool information, can prove the timing of defaults and recoveries through historical loss curves, Fitch IBCA can give credit to seasoning.

Recoveries on repossessed equipment primarily reflect the equipment's liquidity, the historical volatility of the used equipment market, and the lessor's access to that marketplace. To the extent that the market for a particular type of equipment is liquid and relatively stable and the lessor has good access, recoveries will be higher and more predictable. In addition, vendor or manufacturer remarketing support is viewed favorably.

To assess concentration risk, Fitch IBCA examines the pool by lessee, industry, geographic, equipment type, and vendor/manufacturer concentrations. To the extent that the pool has any significant concentrations, Fitch IBCA evaluates the rating and financial condition of those lessees, as well as the market conditions to which they are subject. At a minimum, credit enhancement must be sufficient to cover default of the five and six largest obligors for an 'AAA' rating, the four to five largest lessees for an 'AA', the three to four largest for an 'A', and the two to three largest for a 'BBB'. This approach is used less frequently as diversification within transactions improves. If the pool is concentrated in a single industry or geographic area, Fitch IBCA reviews the historical volatility of that industry and economic region. If most leases relate to a specific type of equipment or manufacturer, Fitch IBCA reviews the equipment performance and long-term viability of the manufacturer. To the extent that there

are any significant vendor/manufacturer concentrations where the lessor depends on the vendor for remarketing assistance or if the vendor is providing any loss recourse, Fitch IBCA will conduct a full analysis of the vendor's credit quality and the details of the vendor agreement.

Fitch IBCA also evaluates the structure of the leases included in the pool. Leases structured with a hell-or-high-water clause (which obligates the lessee to make payments regardless of the default of the manufacturer or lessee or the obsolescence or failure of the equipment) that are also noncancelable and triple net (mandating responsibility for all maintenance, taxes, and insurance with the lessee) are viewed favorably.

To establish expected base case cumulative net loss levels for the securitization, Fitch IBCA reviews the following:

- Contractual delinquencies.
- Defaults and recoveries or net losses on a static pool basis (three to five years of history).
- Residual realization (three to five years of performance).
- Lessee concentrations.
- Vendor/manufacturer concentrations.
- Geographic distribution.
- Diversification of equipment types.
- Industry distribution.
- Portfolio seasoning.
- Lease balance.

Residual Values

For lease pools in which the lessor has substantial residual realization history, Fitch IBCA may give credit for residuals sold to the trust on a case-by-case basis as a form a credit enhancement or an additional cash flow to be monetized at the onset of the deal. Fitch IBCA reviews the lessor's residual realization history by type of equipment (for a minimum of three years but usually five to 10 years) and by method of disposition on a booked versus actual basis. Fitch IBCA also reviews the company's method for determining booked residual values. If it appears that the company is aggressively booking residuals, Fitch IBCA will assume lower recoveries.

Residuals can be realized in one of four ways — the exercise of purchase options by the original lessee, month-to-month lease extensions, re-leasing, and remarket and sale of equipment in the secondary market.

For small-ticket leasing companies, 80%–90% of residuals are realized from the original lessee either exercising a purchase option or by a month-to-month lease extension. Most lease documents contain clauses stating that a lease will be extended automatically for four months to one year at the original lease rate if the lessee fails to notify the lessor 90 days prior to the lease termination date as to whether it wishes to buy the equipment or renew the lease.

Booked residuals are usually realized by the fourth month on an extension. Under those instances when the equipment is returned, Fitch IBCA analyzes the process for remarketing the equipment. Some lessors have in-house refurbishment units, whereas others outsource this function or sell the equipment "as is." Fitch IBCA is particularly concerned about leases secured by equipment that is subject to technological obsolescence, low quality, and not supported by its manufacturer or vendor. Fitch IBCA supports the use of equipment-upgrade programs that mitigate forfeitures at the end of the lease term. The amount of time it takes to realize the residual is an important factor if the issuer is monetizing any portion of the residuals in the structure of the transaction.

Equipment recoveries primarily reflect the originator's refurbishment and remarketing programs. If the lessor has good access to the used equipment marketplace, as well as the ability to refurbish the equipment, recoveries will be higher. Fitch IBCA also considers the historical price volatility of the various equipment markets to the extent applicable. If the used market for a particular equipment type has been very stable, Fitch IBCA gives more credit for residual values; volatile markets require more caution. Some lessors have asset management groups dedicated to the realization of residual values, even to the extent that compensation is based on gains over booked residuals. Knowing that the company is dedicated to recouping that cash flow provides an additional level of comfort.

If a lessor can demonstrate that it has consistently generated a strong gain over booked residuals in a timely manner, this additional cash flow can be factored into the rating analysis to support the transaction.

Fitch IBCA's stress factors that are applied to booked residuals differ by rating category as indicated in the table below.

Residual Advance Rates

Rating Category	(%)
'AAA'	40–70
'AA'	60–75
'A'	70–80
'BBB'	80–90
'BB'	90–100

For example, if the historical residual realization average for an issuer is 140%, Fitch IBCA would apply a 60% advance against 100% of the booked residuals. Based on the 140% historical average, the stress correlates to a 43% advance against the actual historical average, which is quite conservative.

For those transactions where residuals are used as a form of credit enhance-

ment, there are usually triggers called "residual events" that would capture the residual cash flow into the deal. Typically, when a deal is performing as expected, the residual cash flow is available in that payment period, if needed to offset any shortfalls, but if the cash flow is not used it is released to the seller. The residual events are usually a combination of triggers (delinquency, default, or residual realization), that when hit would stop the release of that cash flow and trap it into a trust account.

Cash Flow Stress Tests

Once a base case cumulative static net loss number is determined, the following multiples are applied to stress losses for the various rating categories: 4.5 times (x) to 6.0x for an 'AAA' rating; 4.0x–5.0x for 'AA'; 3.0x–4.0x for 'A'; 2.0x–3.0x for 'BBB'; and 1.5x–2.0x for 'BB'. For small-ticket lessors, static net losses typically range from 2.5%–4.5%; whereas for mid- to large-ticket essential-use equipment lessors, it is not uncommon to see static net losses under 1%. Fitch IBCA will review transaction cash flows to evaluate the adequacy of the financial structure, incorporating the payment structure of the leases; delinquency, default, and recovery expectations during the lease term; prepayment assumptions; and residual value realization and timing.

Credit Enhancement

Credit enhancement is determined by analyzing two approaches previously mentioned — the concentration approach and the cash flow loss multiple method. The approach that requires the highest level of support will typically drive the credit enhancement. Internally provided credit enhancement on lease-backed transactions has historically included reserve funds or cash collateral accounts, overcollateralization, subordinate bonds, and trigger events. External credit enhancement includes surety bonds and bank letters of credit. It is now more common for those lessors with proven long-term residual realization track records to use some portion of booked residuals as part of the required credit enhancement.

In the early 1990s, it was not uncommon to see transactions with 25%–30% credit enhancement for 'AAA' ratings. Recent deals have had 'AAA' credit enhancement requirements as low as 8%–15%. This reflects a combination of lessors being able to produce better quality historical data and more diversified pools, as well as Fitch IBCA becoming more comfortable with the predictability of future losses. Public transactions tend to have lower credit enhancement because these companies are usually larger and have more readily available historical performance data — specifically, reliable static data — due to better lease management systems.

Management/Company Review

Fitch IBCA performs a complete analysis of each issuer, focusing on the company's formation, growth, goals and objectives, marketing strategy, competitive position, financial health, depth and experience of management, and funding capabilities. All these factors affect the quality of the receivable underwritten. For each transaction, Fitch IBCA tries to access the financial strength and viability of the potential issuer if a formal rating does not exist. Fitch IBCA's Structured Finance group works closely with the Financial Institutions group, which has significant expertise analyzing leasing companies. Management is reviewed for depth and level of experience. Fitch IBCA tries to understand the company's history, organizational structure, strategies, and goals. Comparisons with competitors are done in some cases. The financial strength of the lessor, if it is acting as the primary servicer, is critical, since Fitch IBCA wants to be assured that the servicer will be operational during the life of the deal.

Originator Review

Credit Underwriting

The quality of the underwriting process is critical to the performance of the receivables. Fitch IBCA does not have preference regarding centralized or decentralized credit underwriting, since originators have demonstrated success with both approaches. However, Fitch IBCA believes lessors should demonstrate that formal credit policies and procedures are in place and are being followed, as this is essential to minimizing losses. Exceptions to credit policy are a concern, since they are usually an indication of possible portfolio deterioration. The tenure and experience of the credit analysts are reviewed, as is the structure of the credit department. Underwriters should have strong lease finance backgrounds, and a training process should be available to new hires. Lending authority should be designated by underwriter experience.

If leases are purchased through a vendor/dealer network, Fitch IBCA reviews the lessor's vendor/dealer approval and monitoring process. Vendors/dealers should be subject to initial background checks encompassing a review of their financial condition, bank and trade credit references, length of time in business, and the quality of their customer service programs, particularly as they relate to equipment maintenance. Delinquencies and chargeoffs should be reviewed for each vendor on an ongoing basis, with established procedures to eliminate vendors if warranted.

Each lease applicant should be subject to a full credit review, including an examination of trade references, bank and credit bureau reports, past payment history for repeat customers, and financial statements, if applicable. All data provided by vendors for vendor-initiated loans should be verified. In addition, the lease terms should be reviewed to ensure compliance with

the underwriting guidelines. For lessors that use a credit-scoring system, the methodology incorporated in the system is reviewed, including all inputs and assumptions. The approval/reject ratios (and rejection reasons) and range of scores are reviewed.

Quality control is also a critical factor in Fitch IBCA's review of lease originators. The lessor should review the portfolio periodically. Any exceptions to the underwriting criteria should be fully explained. The lessor should be able to make adjustments to its underwriting policies and procedures based on reviews of performing and nonperforming portfolios. In addition, an internal audit process should be in place to ensure compliance with all company and industry guidelines.

Servicer Review

The ability to properly service receivables in a timely manner directly affects the quality and performance of a transaction. As part of a due diligence review of the servicer, Fitch IBCA examines the servicer's billing and collections process. Collectors' experience and organizational skills are reviewed to ensure that the more experienced collectors are handling problem accounts. Borrowers should be contacted and counseled early in the delinquency period, with more experienced collectors calling higher balance accounts and longer term delinquencies. All collectors should have experience handling leasing customers, and a training program should be in place to add new collectors. The servicer's systems should track billings, receipts, nonpayments, insurance, Uniform Commercial Code (UCC) filings, and all borrower contact. The systems must also generate informative management reports regarding portfolio performance, as well as trustee/certificateholder reports. If a lease is deemed uncollectible, repossession should be initiated, if economically beneficial, and an asset disposition plan should be implemented for each equipment type where repossession is enacted to ensure that recoveries are as high as possible.

If the lessor has had less than three years' servicing these assets or less than $5 million–$10 million in equity, Fitch IBCA may require a "warm" or "hot" backup servicer to be assigned prior to closing, and all lease payments will be required to be sent directly to a segregated trustee lock-box account. If a hot backup servicer is required, Fitch IBCA reviews this entity as though it were the primary servicer.

Legal Structure

The legal structure must isolate receivables from the estate of the lessor, contain sources or funds to support any disruption in cash flows, and achieve desired accounting and tax treatment.

Typically, the original lessor transfers a pool of lease contracts to a subsidiary that is a bankruptcy remote special purpose entity (SPE). The SPE then sells the lease contracts to an independent trust, which issues the securities. The trust becomes the new lessor, while the original lessor, now the trust's agent, continues to act as servicer. The original lessor and the SPE will provide appropriate representations and warranties relating to ownership of the leases, lease proceeds and rents, and underlying equipment, and all appropriate UCC filings will be made.

When the residual value of the equipment is relatively large, the original lessor may also transfer the residual interest by assigning the actual equipment, as well as the leases, to the SPE and, ultimately, the trust. For certain types of equipment (such as motor vehicles or aircraft), specific filings or other procedures may be required by applicable statutes.

When the leases are operating or true leases, the lessor should transfer the leases themselves, namely, all its rights (including the right to assume or reject the leases in the event of bankruptcy or insolvency) and obligations thereunder, to the SPE, so that the original lessor would not be able to reject the leases if it subsequently filed for bankruptcy. An opinion to that effect will be required unless the lessor also transfers the underlying equipment. However, if the leases are financing leases, which are documented as leases but are nevertheless treated as installment sales of the underlying equipment, the lessor may transfer only the receivables due under the leases rather than the leases themselves. An opinion will be required that the leases are not executory contracts or leases for purposes of the U.S. Bankruptcy Code.

The original lessor usually retains some type of soft recourse of up to 10% on the transferred assets by selling the assets at a discount to the SPE (which then transfers the assets to the trust at a similar discount) or by having an option to replace nonperforming leases with performing ones. If any recourse is retained, an opinion that the assets would not be included in the estate of the lessor should it file for bankruptcy (true sale opinion) will be required with respect to the transfer from the lessor to the SPE, and an opinion that either the assets have been truly sold to the trust or that the trust has a first perfected security interest in the assets will be required with respect to the transfer from the SPE to the trust. If the underlying equipment has also been transferred, the opinions should also cover the equipment for the lessor to receive credit for the residual interest. These opinions are intended to separate the assets from the credit of the lessor by ensuring that, if the lessor files for bankruptcy, the assets would not be included in the lessor's estate and, therefore, payments on the assets should continue to be made to the trust.

In a simplification of this structure, a lessor that does not wish to remove the

leases from its consolidated balance sheet may simply transfer them to the SPE, which then issues the securities, eliminating the subsequent transfer to a trust. As in the two-transfer structure, a true sale opinion will be required if the original lessor retains any recourse.

A nonconsolidation opinion will be required if the SPE is an affiliate of the original lessor to ensure that the SPE's assets would not be consolidated with the lessor's assets in the event of the lessor's bankruptcy. Such an opinion would not be required for the issuing trust unless the trust was also affiliated with the original lessor. If the trust is issuing secured debt, an opinion is required that the indenture trustee has a first perfected security interest in the pledged collateral.

Finally, the original lessor should disclose in the offering documents that it does not intend to cause the SPE to file for bankruptcy as long as the SPE remains solvent. It should also acknowledge that causing the SPE to file for bankruptcy while solvent would be an inappropriate use of the U.S. Bankruptcy Code.

Fraud

For each issuer, Fitch IBCA pays close attention to the company's policies and procedures to see that the risk of fraud from lessees, vendors, or the lessor itself is minimized. A company can take steps to try to reduce the risk of fraud but can never fully eliminate it. Isolated instances of fraud are usually undetectable; however, repetitive fraud can be avoided. Fitch IBCA does not police issuers but makes sure that they are monitoring themselves.

Lessors should be completing background checks on management for every deal and should be receiving recent audits and management letters. For transactions involving mid- and large-ticket equipment, the lessor should complete an on-site due diligence prior to funding the lease. Fitch IBCA usually requires one month of seasoning on all lease receivables, as fraud typically occurs early on. Fitch IBCA prefers the seller's continuous involvment (i.e. servicing). Tight eligibility criteria, such as prohibiting lessees that have ever been in bankruptcy, are essential. Fitch IBCA reviews employee compensation to see whether it is based on volume or end-of-lease profits.

To protect against double financing, the trustees should obtain all original leases prior to closing, and evidence of all UCC filings and UCC searches should be provided. Each lessor should have an internal audit system. Often, separate trustee lock boxes are required to avoid commingling with the lessors' funds. If a credit scoring system is used, Fitch IBCA prefers one that has been audited. Fitch IBCA will conduct a sampling of lease credit and documentation files to ensure that credit policies are being followed. Finally, rating agencies must rely on representations and warranties included in each deal's documents.

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