

Asset-Backed Special Report

Under the Hood: Automobile Lease ABS Uncovered

Analysts

Chris Mrazek
1 212 908-0667
chris.mrazek@fitchratings.com

Fitch Rated Automobile Lease Securitization Issuers

Falcon Auto Lease Securitization
FELCO Funding
Honda Auto Lease Trust
Provident Auto Lease ABS Pass-Through
Trusts
World Omni Automobile Lease
Securitization Trust

■ Summary

Leasing continues to be an important segment of the automobile finance market, accounting for nearly one-third of all new retail vehicle sales over the past two years. Once, leasing was a way to finance new high-end luxury cars; 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 car prices in the late 1980s and the 1990s, as leases allow consumers to drive cars that ordinarily would be too expensive to purchase and puts them in new cars every few years.

Despite the increased consumer demand for auto leasing, the securitization of auto leases has been somewhat limited relative to the large dollar volume of lease contracts written. Lease securitizations have accounted for an increasing percentage of total public auto asset-backed securities (ABS) issuance, rising from 5.5% in 1994 to 11.1% in 1999. A major factor in the relatively minimal amount of auto lease securitization activity is residual value risk. Throughout the 1990s, many leasing companies competed by offering high residual values on their leases. While this lowered monthly payments for lessees, it raised the specter of increased end-of-lease vehicle returns and concurrent residual value losses stemming from sale of the turned-in vehicle. Industrywide turn-in rates and residual value losses have increased significantly in recent years due to inflated residual values on leases. Fitch views the current industry environment as more stressful than a base case and expects turn-ins and residual value losses to remain high but to moderate as maturing lease volumes plateau in coming years. Fitch also believes there is significant growth potential for public term securitizations given recent record new vehicle sales levels and consumer demand for leasing, provided investors gain more understanding of and comfort with the risks posed by residual values in a securitization.

This report covers all aspects of Fitch's auto lease securitization rating criteria, including collateral evaluation, credit analysis, structural considerations, and legal issues. Particular emphasis will be placed on the key elements that differentiate auto lease securitizations from auto loan securitizations, including vehicle titling and residual value risk.

For a discussion of Fitch's prime auto loan rating guidelines, see Fitch Research on "A Map to Rating Auto Loan-Backed Securitizations," dated June 11, 1999, available on Fitch's web site at www.fitchratings.com.

■ Industry Background

History and Growth

In recent years, auto leasing has become increasingly popular with consumers, manufacturers, and finance companies as evidenced by the fact that approximately one-third of all new retail vehicle sales in 1999 were leases. Two major factors contributed to the growth in

leasing — rapid increases in new car prices and the late 1980s tax law changes that eliminated the tax deductibility of interest on car loans. As a result, people sought ways to make automobile purchases more affordable, and, in response, manufacturers and finance companies developed consumer lease programs. The growth in auto leasing is evident in its share of retail new car sales. Leasing accounted for approximately 30% of retail auto purchases in 1999, compared with less than 10% in 1990, as shown in the chart below.

Fitch expects lease penetration to remain relatively stable at about one-third of new retail vehicle sales. Reasons for this slowdown in growth include manufacturers backing away from the aggressive lease subvention that characterized competition in the industry in the mid-1990s and certain finance companies scaling back or exiting the leasing business altogether in the face of higher vehicle turn-ins and substantial residual value losses.

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:

- 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

Calculation of a Lessee's Monthly Payment

(\$)	
Manufacturer's Suggested Retail Price (MSRP)	25,000
Negotiated Purchase Price	22,500
Down Payment	500
Taxes and Fees	800
Net Capitalized Cost	22,800
Residual Value at 65% MSRP	16,250
Lease Term (Mos.)	36
Money Factor	0.00316
Monthly Payment	305.53
Approximate Annual Percentage Rate (%)	
	7.60

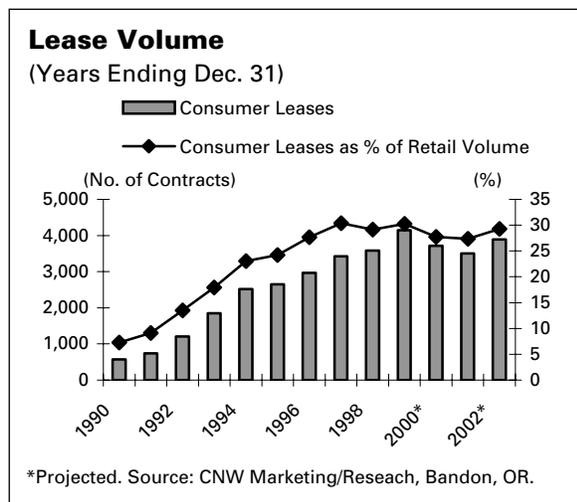
the inception of a lease contract and represents an estimate of a leased vehicle's resale value at the end of a lease, typically figured as a percentage of the manufacturer's suggested retail price. Methods of residual valuation and its significance in auto lease securitizations are discussed later. 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 2400. This approximate APR is not directly comparable with auto loan APR's 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 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.

Advantages to Leasing

Auto leasing provides numerous advantages to consumers, manufacturers, and finance companies. 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 car for their money and drive a new car every two to four 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 headaches, 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.

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 Originator Evaluation section on page 10. 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.

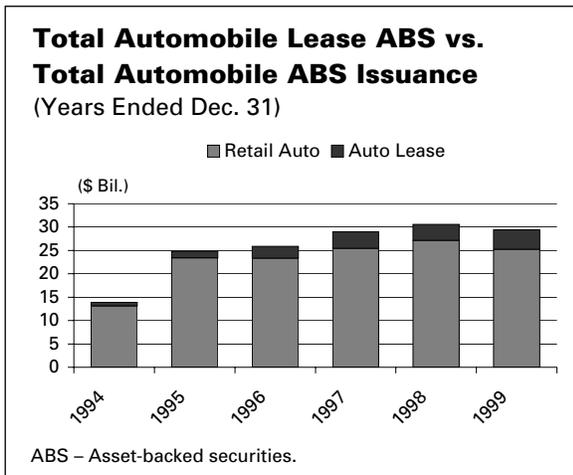
Auto leasing benefits finance companies by providing higher finance charges than traditional auto lending — primarily because rent charges on a lease are calculated from the adjusted capitalized cost over the life of the contract, whereas interest on an auto loan is based on the amortizing balance of 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 detail in the Roadblocks to Securitization section on page 4.

Who Are the Lessors?

The major players in the auto lessor market include the captive finance subsidiaries of major manufacturers, banks, and independent leasing companies. The captives have traditionally dominated auto leasing with more than two-thirds of the market; however, banks and independents have recently gained market share.

Any company involved in auto leasing may end up involved in the used car 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-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.

Who Securitizes?

The World Omni 1994-A Automobile Lease Securitization Trust transaction marked the first public term securitization backed by auto lease contracts. Since the debut of this asset class, World Omni, as well as Ford Motor Credit Co. (Ford Credit), American Honda Finance Corp. (Honda), and Toyota Motor Credit Corp. (Toyota) have completed additional public securitizations. These four issuers have brought 15 publicly offered lease transactions to market since August 1994, totaling approximately \$15.7 billion. While auto lease securitization's share of the total auto ABS market has been limited, it has grown from approximately 5.5% of total prime public auto ABS issuance in 1994 to 11.1% in 1999, as shown in the chart above.

Fitch believes the developing growth in the auto lease ABS market is bound to continue and, in all likelihood, accelerate as additional participants develop the requisite infrastructure and are able to take advantage of the economic benefits of lease securitization. Continued growth in this segment will come primarily at the expense of the auto loan market, resulting in increased competition for the same customers. As such, care must be taken to ensure the drive for market share does not lead to irrational pricing or deterioration in lessee credit quality.

■ Roadblocks to Securitization

Historically, three issues have hampered the securitization of auto leases:

- Vehicle titling.
- Residual value risk.
- Conflicting tax and accounting goals of issuers.

Roadblock One: Vehicle Titling

The largest hurdle in securitizing auto leases relates to the difficulty in effecting a true sale of the assets to be securitized. In the securitization of auto loans, which are considered financial assets, transfer of the ownership of the loans is achieved by selling them to the trust issuing the ABS. Under the Uniform Commercial Code (UCC), which is recognized in every state, the trust has an ownership interest in the loans, resulting in isolation of the assets from the bankruptcy estate of the originator.

However, in the case of auto lease securitizations, both the vehicle and the lease contract (typically an operating lease) constitute the asset sold to the trust. Thus, the asset is not considered financial, and, unlike other consumer assets, the UCC is not applicable to the ownership and transfer. Rather, the vehicles must be titled in the name of the owner, with any applicable liens registered with the motor vehicle department in each state. 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. Without formal legal transfer of ownership of the vehicle from the lessor to the issuing trust through retitling, the risk of such a transfer not constituting a true sale remains high.

Titling Trusts: The origination, or titling trust, a special purpose entity (SPE) created by the lease originator to effect the purchase of lease contracts and the related vehicles directly from dealers, was developed to overcome vehicle titling problems. World Omni pioneered the titling trust concept with its 1994-A securitization. The titling trust removes most of the costs and burdens of retitling vehicles, transfers economic ownership of the leases and vehicles to a third party, and maintains a true sale of assets from the lessor.

Although the titling trust, rather than the originator, is listed on the certificate of title, the titling trust transfers to the originator a beneficial interest in all vehicles and leases owned by the titling trust. This beneficial interest is sometimes referred to as an undivided trust interest (UTI). The holder of the beneficial interest obtains the economic value for tax purposes (i.e. depreciation), but not ownership for accounting purposes, of the assets in the titling trust.

It is possible to create a true sale of the assets and reduce the risk of substantive consolidation in a voluntary or involuntary bankruptcy since the purchase of the lease assets directly by the titling trust eliminates the ability to consolidate with the originator. Furthermore, the use of a separate SPE to purchase the beneficial interests in the titling trust for subsequent sale to the securitization trust allows for the transaction to be classified as a true sale rather than a financing.

The assets underlying the beneficial interest/UTI can be carved up and segregated into a certificate of beneficial interest, frequently referred to as a special unit of beneficial interest (SUBI), which can then be transferred to the seller, typically another SPE. The seller then transfers the certificate of beneficial interest/SUBI in a true sale to a securitization trust that also obtains a perfected security interest in both the certificate of beneficial interest/SUBI and the cash flows from the leases. The titling trust can create multiple certificates/SUBIs and transfer them to multiple securitization trusts.

Although the use of a titling trust reduces the long-term impediments associated with securitizing auto leases, the initial costs of creating one are somewhat onerous. To reduce or eliminate the need to retitle a vehicle, 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 indenture trustee to be the titleholder of record. The titling trust structure also gives rise to other concerns, including issues relating to the Employee Retirement Income Security Act of 1974 (ERISA) and vicarious tort liability.

ERISA Issues: The sale of the certificate/SUBI, rather than the leases, vehicles, or titles, 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. Therefore, there is potential perfection of other, superior liens on the vehicle, such as tax liens, mechanics' liens, and liens imposed under state or federal statutes like ERISA.

Fitch believes the most problematic of these liens arises from the potential for the Pension Benefit Guaranty Corp. (PBGC) to subject the titling trust to liens to satisfy any unpaid ERISA obligations of any

member of an "affiliated group." If any of the SPEs in a lease securitization were included as part of the affiliated group of the originator, the PBGC could look to the vehicles and leases to fund the originator's ERISA obligations in the event of an originator bankruptcy. Therefore, issuers must satisfy any unfunded pension liabilities or prove that the lease assets are truly outside the affiliated group. Fitch generally requires quarterly certification that all ERISA liabilities of the originator and its affiliated groups are fully funded.

Vicarious Tort Liability: Another risk associated with a titling trust is the potential claim against the titling trust arising through vicarious tort liability. Although the lessee is the operator of the vehicle, anyone suffering injury as a result of the operation of the leased vehicle could file a liability suit against the owner of the vehicle, the titling trust. This risk can be mitigated by the purchase of a contingent and excess liability insurance policy to indemnify the trust for any liability arising from the operation of the vehicles in excess of the insurance maintained by the lessee. Fitch thoroughly reviews such policies to ensure adequate coverage is provided. This risk may be further reduced by actively monitoring the insurance status of the lessee to ensure adequate coverage is maintained at all times. A prompt repossession policy for lessees unable to obtain replacement insurance coverage in a timely manner can also reduce this exposure. To date, all securitizations rated by Fitch have overcome vicarious tort liability concerns through acceptable insurance policy coverage.

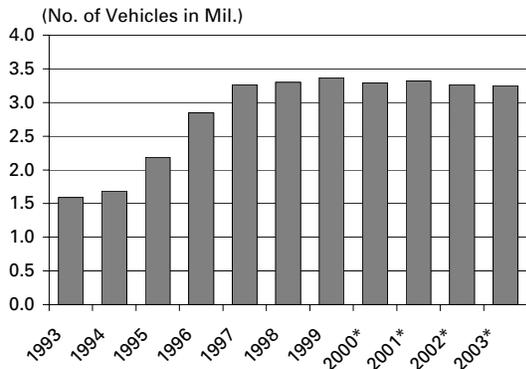
Roadblock Two: Residual Value Risk

The second hurdle to securitization is residual value risk. One of three things can occur to a leased vehicle at the maturity of a lease contract:

- The lessee can purchase the vehicle for the stated residual value.
- The lessee can return the vehicle to the dealer, and the dealer can subsequently purchase it.
- The lessee can return the vehicle to the dealer, and the dealer can choose not to purchase it, in which case the vehicle must be disposed of at auction or in the used car market by the lessor. This scenario results in the greatest residual value risk.

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

Leased Vehicle Turn-Ins (Years Ending Dec. 31)



*Projected. Source: CNW Marketing/Research, Bandon, OR.

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%–70%, realization of residual values emerges as the primary risk in an auto lease securitization.

Although it seems that, by definition, vehicles returned to the lessor will always have a market value less than the stated residual value, this is not always the case. Fitch observed that even though the vehicle is "in the money," some consumers may choose not to exercise their purchase option due to extraneous factors, such as comfort, cargo capacity, fuel efficiency, service record, or new product offerings. Additionally, some consumers may elect to purchase vehicles that are slightly "out of the money" because they prefer purchasing a used car they are familiar with rather than a used car they know little or nothing about.

The proportion of lessees who do not purchase their vehicle at the end of the lease contract is measured by the turn-in rate, defined as the number of vehicles returned to the lessor at lease termination as a percentage of the number of lease contracts that were scheduled to mature during the same period. As shown in the chart at right, average portfolio turn-in rates for the four issuers of public lease securitizations have been rising significantly over the past several years, growing from 10.1% in 1994 to an estimated 50.0% in 1999. According to CNW Marketing/Research, off-lease vehicle turn-ins are forecast to reach 75% of

scheduled maturities in 2000. Fitch expects turn-ins and residual value losses to moderate as maturing lease volumes plateau in coming years.

With the increasing trend of vehicle turn-ins, accurate estimation of residual values is of the utmost importance in auto lease securitizations. The actual residual value of an off-lease vehicle is determined by several factors, including:

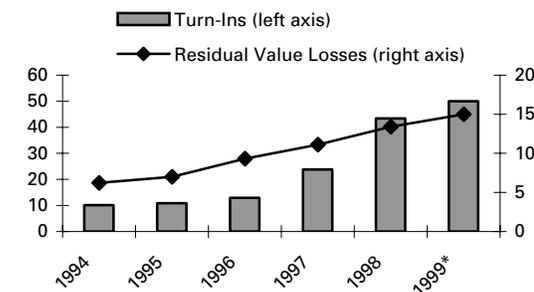
- Condition of the vehicle.
- State of the used car market, including supply of off-lease vehicles.
- Demand for the particular vehicle make and model.
- New car prices.
- General economic conditions, both regionally and nationally.

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.

How, then, are residual values estimated? Many leasing companies develop proprietary models to estimate the residual value for each lease. Automotive Lease Guide (ALG) residual value estimates also are utilized to highlight inconsistencies and validate the estimates of the proprietary models (see *Automotive Leasing Guide* box, page 7). Some finance companies are limited in their residual value estimates by insurers that cap residual values at a certain percentage over ALG or the National Automobile Dealers Association (NADA). Fitch thoroughly reviews each issuer's residual valuation methodology, as well as historical performance of proprietary models and residual value realization data (see *Residual Valuation and End-of-Lease Procedures*, page 10).

Residual Value Losses Escalate as Turn-In Rates Rise

(%, Years Ended Dec. 31)



*Estimated.

Automotive Lease Guide

Originally founded in 1964, Automotive Lease Guide (ALG) began as a purchaser of auto lease contracts. These purchases required the company to generate standard residual values for publication and distribution to local dealers, originally on mimeographed sheets. After eight years of successful lease purchases, the founder, Doug Aiken, Sr., sold the business to Security Pacific Bank, while retaining the rights to the computer system and the ability to determine estimated residual values.

ALG's residual value estimates gained legitimacy throughout the 1970s and 1980s when the estimates were used by insurance companies as a basis for developing and pricing residual value insurance. In 1982, ALG was selected by General Motors Acceptance Corp. to provide residual value estimates for General Motors' auto leasing program, solidifying ALG's role within the auto leasing market. Currently, ALG disseminates residual values to clients in hardcopy and electronic formats on a bimonthly basis.

ALG uses a process blending 34 years of quantitative history with a qualitative review of multiple factors to determine a car's average condition and open market and wholesale auction value by make, model, and year. Used car data is compiled from a combination of auction reports and vehicle price guides. Auction data is a reliable source of current used vehicle prices and provides more conservative estimates, as certain adverse selection bias is introduced into the estimate process since the vehicle sent to auction:

- was not wanted by the prior owner.
- was repossessed and is being liquidated in a manner that sacrifices recovery value in the interest of expediency of sale.

- was not wanted by the dealer.
- was in poor condition.

The used car price information is used to develop price depreciation curves for cars of specific make, model, and year. Future values of current models are determined by evaluating used car price data in conjunction with the original manufacturers' suggested retail price, adjusted for any vehicle options (options can cause a vehicle's price to vary by up to 15%). Concurrently, ALG evaluates industry and macroeconomic data to estimate the relative trend in used vehicle prices and adjusts depreciation curves accordingly. Qualitative adjustments are made to the final estimate to reflect additional information obtained through industry sources.

New model types are evaluated utilizing a comparable estimation process. Rather than compare the vehicle to prior model years, ALG develops peer groups by vehicle type and makes adjustments to reflect the availability of options. Qualitative adjustments are made to reflect the residual experience of a particular manufacturer and arrive at the final residual value estimate. ALG works closely with manufacturers to understand future products and production schedules and the impact these will have on vehicle depreciation.

Fitch's review of ALG found the residual value estimation methodology to be rigorous in depth and scope. An analysis of ALG's historical estimates to actual residual values indicates that some volatility exists, but the margin is small enough to maintain a significant level of reliability. Fitch meets with ALG regularly to understand changes in its methodology.

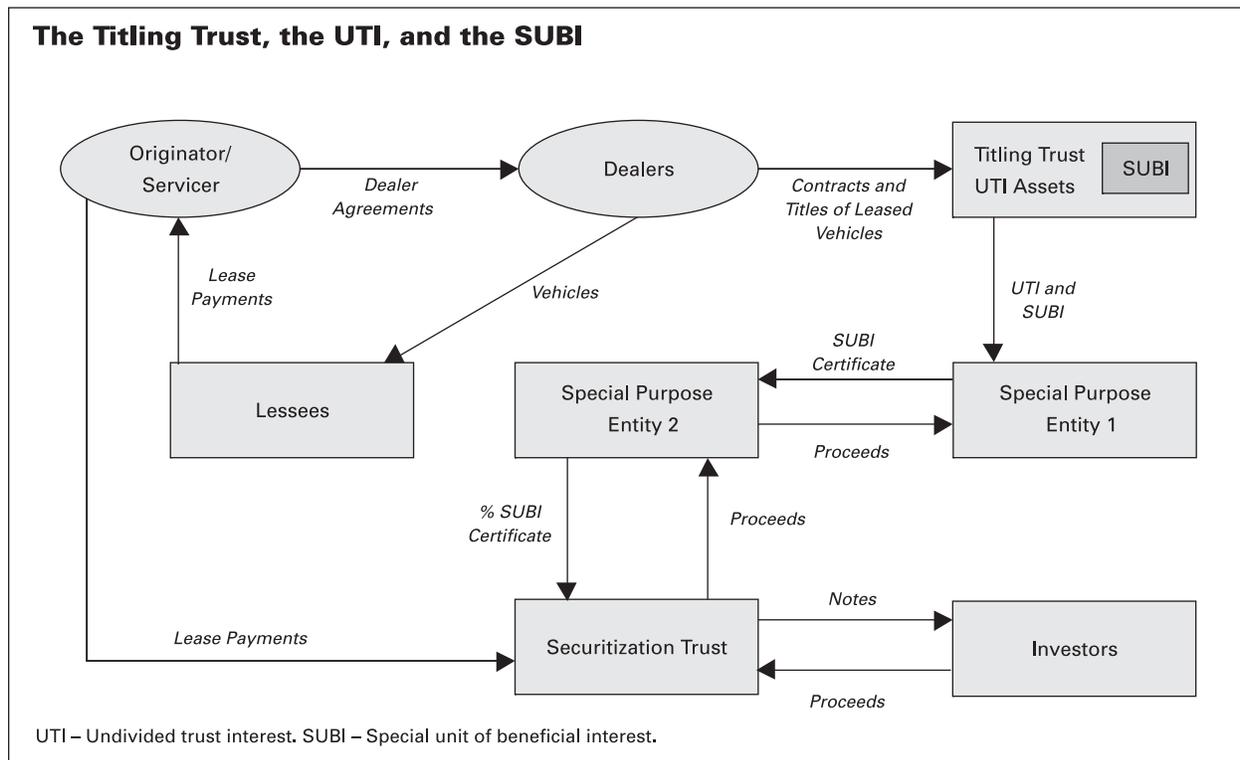
Residual Value Insurance: The most common method of mitigating residual value risk is through the purchase of a residual value insurance policy. A typical residual value policy covers the difference between the stated residual value of a vehicle and the realized proceeds upon disposition for those lease contracts that reach full maturity. In other words, 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 (*for additional information on Fitch's requirements for residual value insurance policies, see Sources of Credit Enhancement, page 17*).

A residual value policy has the additional effect of converting the securitized leases from operating to finance leases, which then become subject to Financial Accounting Standards Board (FASB) 125

in determining their accounting treatment (*see Roadblock Three: Accounting vs. Tax Treatment below*). This allows issuers to use loan securitization structures to achieve off balance sheet treatment for a lease securitization. However, bankruptcy concerns remain, and the lease contracts and vehicles must be removed from the bankruptcy estate of the originator to be considered a true sale. The aforementioned titling trust structure and transfer of beneficial interests achieves this.

Roadblock Three: Accounting Versus Tax Treatment

The classification of a lease as an operating or a finance lease determines its accounting treatment. FASB 13 provides criteria for determining whether a lease is an operating or finance lease for accounting purposes. FASB 13 also covers accounting treatment



for the sale or securitization of operating leases, while FASB 125 covers finance leases.

Under FASB 13, a lease is considered a finance lease if any of the following conditions are met:

- The present value of all lease payments is greater than 90% of the cost of the vehicle.
- The lease term covers at least 75% of the vehicle’s useful life.
- The lease offers the lessee a discount purchase option at lease-end.

If all three of the above conditions are not met, the lease is considered an operating lease, and the vehicle must be sold at lease termination to recoup the total initial investment. In contrast, finance leases effectively return almost all the entire leased vehicle’s cost, plus an implied interest rate, to the lessor. In general, consumer auto leases are almost entirely operating leases subject to FASB 13.

A securitization must obtain a true sale opinion for accounting and bankruptcy purposes to minimize the potential for the assets to become part of the bankruptcy estate should the originator be placed into voluntary or involuntary bankruptcy. This can be accomplished by either converting the operating leases to finance leases so that their transfer will be subject to FASB 125, or by using a sale/leaseback structure and obtaining accounting sale treatment

through Emerging Issues Task Force (EITF) 93-8. However, the roadblock in securitizing auto leases is the conflicting goal of obtaining a true sale opinion for accounting and bankruptcy purposes while retaining enough ownership to receive the tax benefits of depreciation. Fitch does not view this impediment as a credit issue, provided a true sale for bankruptcy purposes is achieved.

■ The Securitization Process

Upon the accumulation of a sufficient amount of leases in a titling trust to complete a securitization, the servicer will direct the origination trustee to segregate a pool of leases and the related vehicles. Three methods have been used to transfer the beneficial interest in the segregated leases to the securitization trust, each of which results in the transfer of the rights to the cash flows from the segregated lease contracts and corresponding vehicles to the securitization trust.

Undivided Trust Interests and Special Units of Beneficial Interests

The more common method, used by Honda, Toyota, and World Omni, involves the creation of an UTI and a SUBI, as illustrated in the chart above. The UTI represents a beneficial interest in all the unallocated assets of the origination trust and is sold to an SPE. A separate portfolio within the origination trust is

created from the existing lease contracts and vehicle pool. A SUBI in the newly formed subset is sold in a true sale to the securitization trust. After the sale, the “discrete portfolio” is no longer part of the origination trust’s assets encumbered by the UTI. Multiple SUBIs may be created from a single origination trust, as directed by the SPE, which represent beneficial interests in unique asset pools as collateral for individual securitizations. Each SUBI only has a claim on the assets associated with it and has no claim on any other SUBIs, the remaining assets of the origination trust, or the UTI.

Sale/Leaseback Structure

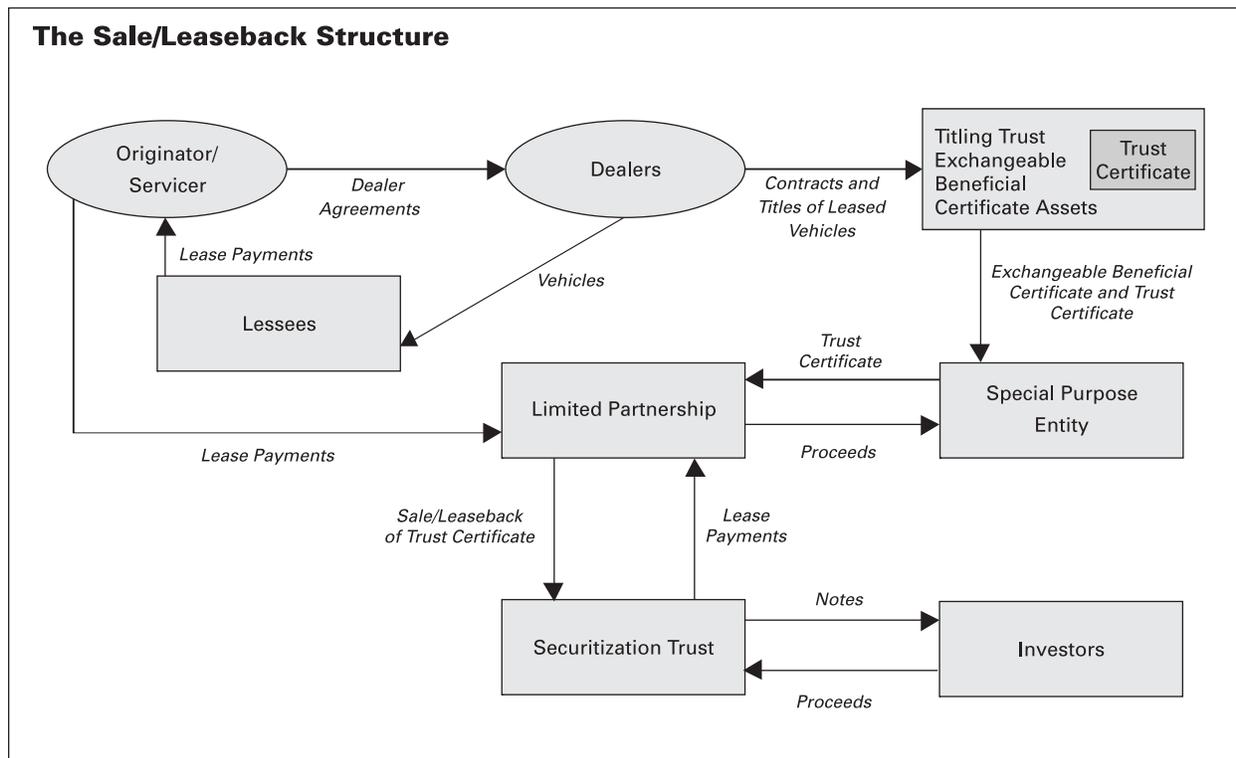
The second method, used by Ford Credit and The Provident Bank, involves a sale/leaseback structure, as shown in the chart below. For example, under Ford Credit’s structure, unallocated leases represented by exchangeable beneficial certificates (EBC), equivalent to the UTI, are segregated into individual trust certificates for each securitization. Each of these trust certificates is then sold in a true sale to a Red Carpet Lease (RCL) trust, an SPE created by Ford Credit for each securitization. Each RCL trust then enters into a sale/leaseback transaction with the securitization trust. This transaction is effected through the sale of the trust certificate to the securitization trust. A simultaneous agreement is made constituting a program operating lease between the specific RCL and the securitization trust, whereby all cash flows relating to the lease

contracts and leased vehicles are paid by the particular RCL trust to the securitization trust.

Leveraged Lease Structure

Some auto lease originators, including Provident Bank, find themselves in a position where they are unable to take full advantage of the tax benefits associated with the depreciation of the leased vehicles because they either have more deductions than income or are subject to the alternative minimum tax. In response, the concept of leveraged lease transactions was developed. A typical asset-backed leveraged lease transaction is very similar to a sale/leaseback structure, with the exception that a portion of the purchase price of the lease contracts and related vehicles is financed by equity investors and a portion with debt.

Just as in a standard auto sale/leaseback securitization, the assets to be securitized must be isolated from the bankruptcy risk of the originator. The standard methods of a true sale to an SPE that engages in a sale/leaseback transaction with an issuing trust are used to achieve this end. The SPE then pledges additional collateral to secure its obligations under the sale/leaseback transaction in the form of a collateral SUBI. This collateral SUBI represents rights to and interests in additional lease contracts and the related vehicles. Since the ABS issued by the issuing trust



have the benefit of the equity piece and the collateral SUBI as credit enhancement, just as in any asset-backed transaction, an asset-backed leveraged lease transaction can obtain a rating higher than that of the originator/seller. However, the main benefit is that the tax benefits of the depreciation on the leased vehicles have effectively been transferred from the originator to the equity investors.

To maximize the depreciation benefits for equity investors, like-kind exchanges (LKEs) are incorporated into leveraged lease transactions. Under an LKE, maturing leases are replaced with newly originated leases and the related vehicles in an amount equal to the fair market value of the terminating leased vehicles. The transfer of these assets is accomplished in the same manner as in the original transaction. This results in an extended revolving period during which the collateral composition could change substantially. However, Fitch places restrictions on LKEs to guard against adverse changes in the collateral pool.

In addition to the typical true sale, perfection, and nonconsolidation opinions, Fitch requires an opinion of counsel to the effect that the lessor trust's (the SPE's) assets would not be consolidated with the equity investor's assets in the event of the equity investor's bankruptcy.

■ Rating Methodology

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 seven key areas: originator evaluation, servicing review, collateral risk assessment, static pool data and credit analysis, cash flow sources and modeling, securitization structure, and legal issues.

Originator Evaluation

Fitch conducts a full financial and operational review of the lease originator/servicer focusing on underwriting policies, residual valuation methodology, servicing, and end-of-lease procedures, as these factors play a pivotal role in collateral performance from both a loss frequency and severity perspective.

The majority of lease originators/servicers maintain strong investment-grade ratings by Fitch. In cases where the originator/servicer is not rated by Fitch, 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 management team also is evaluated to determine its experience and stability, risk

tolerance, growth strategies, incentive compensation, and succession plans. The company may also be compared with its peers to determine its position within the industry and how well its marketing strategies address competition and business goals.

Underwriting Policies and Procedures: The procedures used in the lease origination process are reviewed to ensure both quality and consistency. This analysis includes an evaluation of the underwriting strategy and incorporates an assessment of the information systems utilized in the origination process.

As in auto lending, many lease originators use credit scorecards 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 scorecards 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 cutoff score are recommended for acceptance, and those scoring below are recommended for denial. Lessors also may use multiple scorecards to analyze performance among different geographic regions or compare the performance of first-time car lessees and repeat customers.

Fitch analyzes the variables constituting each lessor's scorecard and considers how and why these variables have changed over time. Fitch also considers how often scorecards 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 cutoff 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 Valuation and End-of-Lease Procedures:

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 exists 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 ALG estimates to assess reasonableness.

The review of estimation methodology is only part of Fitch's evaluation of a leasing company's residual policy, since the impact residual values have on a securitization is dictated largely by the turn-in rate. As a result, Fitch places great emphasis on the analysis of the issuer's ability to minimize turn-ins and realize high residual values. Fitch assesses the leasing company's strategy for effecting 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 rating category (see *Cash Flow Modeling, page 16*).

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 efficiently manage the remarketing of returned vehicles. This ability is evaluated by analyzing the ratio of realized residual values to stated residual values.

Servicing Review

Servicing is one of the most critical aspects of Fitch's analysis of an auto lease securitization. The evaluation of a servicer's collections infrastructure, chargeoff policies, and repossession and disposition processes is substantially similar to Fitch's analysis for auto loan

securitizations (see *Fitch Research on "A Map to Rating Auto Loan-Backed Securitizations," dated June 11, 2000, available on Fitch's web site at www.fitchratings.com*).

Portfolios originated with nearly identical underwriting criteria may have vastly different loss performance due to disparities in the ability of the servicer. Moreover, a disruption or transfer in servicing, no matter the length, will impair performance. Consequently, careful attention is paid to a servicer's financial strength and ability to accommodate growth, as well as collection, repossession and disposition procedures, and chargeoff policies.

Collections: Generally, the collections process should be flexible enough to allow the lessee sufficient time to correct whatever problem led to delinquency, yet must provide that repossession commences quickly when nonpayment becomes inevitable. Most collection departments are organized in one of two ways — stage-of-delinquency or cradle-to-grave. Departments organized by stage-of-delinquency typically have junior collectors on early stage delinquencies and senior collectors for more serious late stage delinquents. These senior collectors are usually the last chance the lessee has to work out the problem before repossession. Departments organized with a cradle-to-grave philosophy will have one collector work an account from its earliest stage of delinquency all the way up to assignment for repossession. The thought behind such a structure is that the collectors will develop a rapport with the lessee, become familiar with his or her individual circumstances and, therefore, be more likely to come up with a cure for the delinquency. While this argument may have some merit, it has been Fitch's experience that more seriously delinquent accounts require the skills of experienced, seasoned collectors to bring the account current.

Lease extensions or payment deferrals are occasionally used to cure delinquencies for borrowers who have suffered temporary unemployment or some other unexpected financial hardship. Fitch is aware of the pitfalls associated with using extensions or modifications as a short-term fix for delinquencies and thoroughly scrutinizes the extension policies of each lessor. Extensions allow the lease to become current by adding another month to the remaining term. To qualify for an extension, lessees usually must not have been delinquent for the past six months. Lease extensions are also typically limited to one extension for each 12 months of original contract term. Thus, a 48-month contract could receive no more than four one-month extensions over its life. Extensions and deferrals must be used only where there are valid and extenuating circumstances. In

securitized pools, extensions typically account for less than 5% of the receivables.

Chargeoff, Repossession, and Disposition: The performance of auto lease securitizations depends heavily on an efficient repossession and disposition process, particularly in light of the inherent residual value risk. The documentation supporting each securitization trust specifies when a lease is deemed defaulted and the full contract balance then due to the trust. It is imperative that the originator's and servicer's internal policies and procedures be consistent with the trust documentation to minimize delays in repossessing and liquidating a vehicle. Such delays may result in a full balance chargeoff of the entire outstanding lease contract balance. A full balance chargeoff results in the use of excess servicing and other credit enhancement to fund the temporary shortfall. If full balance chargeoffs are a high percentage of total defaults, excess servicing strains and credit enhancement draws could pressure transaction liquidity and impair payments to bondholders. Increased risk of not realizing the full residual value on repossessed vehicles exacerbates the situation.

Fitch stress scenarios anticipate and provide for this occurrence. As a general rule, Fitch assumes delays in recoveries associated with charged-off leases. The assumed delays vary by issuer but generally range between three and five months.

Additionally, the aforementioned ability of the servicer to collect the full stated residual value on maturing lease contracts is paramount in ensuring strong collateral performance. Fitch thoroughly reviews the servicer's strategy regarding early lease termination programs and vehicle remarketing initiatives to the extent such programs are not successful.

Collateral Risk Assessment

Fitch evaluates the characteristics of the lease contracts and vehicles securing a transaction to derive loss severity projections and determine necessary loss frequency adjustments. Fitch considers many variables when analyzing the collateral backing an auto lease securitization, including vehicle age, lease term and rate, residual value, vehicle make and model concentrations, and geographic diversification.

New Versus Used Vehicles: To date, only lease contracts on new vehicles have been securitized in public transactions. However, with the growing number of off-lease vehicles, Fitch expects to see some late-model used vehicle leases begin showing up in future securitizations. Issuers who 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, more accurate residual valuation, while still critical, should be easier to accomplish. Nevertheless, given the poorer performance of used vehicles in auto loan securitizations, Fitch views used auto lease collateral with skepticism unless detailed static pool data on credit and residual value losses prove otherwise.

Lease Terms: Fitch has observed that frequency and severity of default increase for leases with long 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 that these short-term leases also tend to have greater residual value risk. 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, typically achieved by lengthening the contract term. Another risk associated with longer term leases 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 car market five years, and even two years, from lease inception is very difficult to predict. Numerous factors can combine to adversely affect the used car market and result in significant residual value losses.

Perhaps 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 negatively affect bond cash flows 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 Rates: Fitch considers the weighted average lease rate of a pool, as well as the distribution of lease rates, in its analysis. In general, lessees with a higher risk profile are assessed a higher lease rate as part of a lessor's tiered pricing strategy. However, it does not directly follow that one pool is riskier than another if

the weighted average lease rate is higher. The lease rate charged the customer is also a function of the market environment, and, therefore, two otherwise identical pools originated by the same issuer may have different weighted average lease rates as a result of the market environment at the time of origination.

It is also important to consider the distribution of the lease rates. For example, leases with very low rates may result from incentive programs. Lease rate incentives or subvention provides for rates that are below market levels as a result of financial support provided by either the vehicle manufacturer or a finance company. Although these leases demonstrate excellent credit characteristics, they may decrease the availability of excess spread over time as higher rate leases prepay or default out of the pool. Also, it is important to examine the percentage of leases with high rates, as these could have been made to lessees of lower credit quality and may chargeoff at a much higher rate than the overall pool, thereby depleting excess spread.

Residual Value: The percentage of the original securitized balance represented by residual value is of particular importance to Fitch, both on an aggregate basis and an individual contract basis. This residual percentage provides an indication of the extent to which a lease or a pool of leases is exposed to residual value risk. Fitch has seen pool residual percentages of 75% and individual contract residual percentages as high as 85%. Lessors engage in residual incentive programs in addition to the aforementioned rate incentive programs. Under residual subvention, a vehicle's stated residual value is set above the expected value at lease maturity to reduce the monthly payment. Obviously, this could lead to a surge in end-of-lease vehicle turn-ins and put pressure on residual value realization rates. Additionally, excessive residual subvention is worrisome because a substantial portion of a securitization's cash flows becomes dependent solely on full collection of residual values.

Vehicle Make/Model Concentrations: The primary risk of manufacturer and model concentrations lies in the potential for the occurrence of a negative event impacting the depreciation and marketability of those vehicles, thereby decreasing recovery and residual value realization rates. The used car market for any particular make or model could be adversely affected by factors not affecting other makes or models, such as changes in consumer tastes or discovery of defects. Any such adverse change could result in reduced proceeds upon the liquidation or disposition of the vehicle, leading to decreased residual value realization rates.

Although Fitch prefers diversified manufacturers and models within the collateral pool, some sizable concentrations may not be considered problematic. There is obvious manufacturer concentration in a lease securitization by a captive finance subsidiary. However, due to the size and stability of most of the major captive finance companies, Fitch would not require additional credit enhancement for such concentrations. Similarly, most manufacturer concentrations within an independent finance company's transaction tend to be among the larger domestic and international auto manufacturers and, therefore, would not necessitate additional credit enhancement. However, significant concentrations among smaller, more specialized, or international manufacturers without a noticeable U.S. market presence could result in increased enhancement requirements.

Fitch believes that concentration by vehicle type (sport utility vehicle, luxury sedan, sports car, minivan, and light van or truck, among others) also introduces risk to a securitization. A significant concentration in a particular vehicle type leads to increased event and market risk. Event risk results from the potential for some specific external event, such as increased gas prices, tougher emissions standards, or increased safety requirements, to decrease the popularity of a vehicle type. Similarly, market risk arises due to falling consumer demand for a particular vehicle type, unrelated to any external event, as illustrated by the migration from minivans to sport utility vehicles. Adequate distribution of vehicle types included in a lease securitization mitigates these risks.

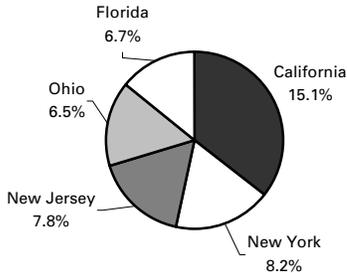
Geographic Distribution: A geographically diversified pool of lease contracts is desired to minimize the effect of adverse economic conditions in a particular region. Most lessors are aware of their portfolio's vulnerability to regional downturns and have customized their credit scorecards to compensate for this risk. Nonetheless, caution should still be used as state concentrations can impact 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 results 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.

The Geographic Concentrations chart on page 13 shows the top five state concentrations for the latest public term auto lease securitizations from Honda, Toyota, and World Omni.

Geographic Concentrations of Recent Automobile Lease Transactions

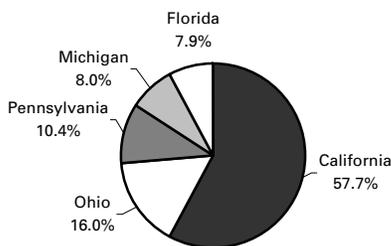
Honda Auto Lease Trust 1999-A

(As of June 30, 1999)



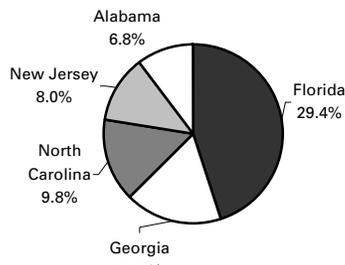
Toyota Auto Lease Trust 1998-C

(As of Nov. 1, 1998)



World Omni 1999-A Automobile Lease Securitization Trust

(As of April 1, 1999)



Static Pool Data and Credit Analysis

An integral part of Fitch's collateral review involves the analysis of static pool data and the derivation of base case expectations for performance variables such as credit defaults, voluntary prepayments, end-of-lease vehicle turn-ins and residual value losses.

Lessee Defaults and Voluntary Prepayments:

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 lies in static pool loss and prepayment data. Static pool data are useful in determining both the magnitude and timing of losses and prepayments and provide one of the best

indications of how the underlying collateral will perform in stress scenarios.

The sources of this information are 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 new and used vehicles, lease term, and credit score. This analysis is critical in helping Fitch understand the unique loss and prepayment 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.

In addition to historical loss experience, the prepayment history associated with a particular issuer is evaluated to determine the magnitude and timing of prepayments. Voluntary prepayments affect the availability of excess spread to absorb losses and, therefore, credit enhancement requirements — thus, the importance of accurately estimating prepayments in a lease securitization. Fitch has observed that voluntary prepayments for leases with more than one year remaining until maturity are lower than those for auto loans of similar term. However, voluntary prepayments for leases with less than one year to maturity could increase substantially should the lessor employ active early termination strategies.

While understanding prepayment history is important in deriving the contribution of excess spread to the overall credit enhancement level, prepayments also provide an indication of the risk posed by residual values. The greater the number of leases that prepay, 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

Residual Value Loss Estimation Worksheet

(%)

	Base Case	'AAA'	'A'
Fitch Expected Residual Value (RV) Loss	5.00	11.43	8.57
Assumed Turn-In Rate	35.00	80.00	60.00
Stressed RV Loss (% of Turn-In Rate)	—	24.71	16.80
Stressed RV Loss (% of Total RV)	0.00	19.77	10.08
Pool Residual Value	65.00	65.00	65.00
Loss as % of Original Pool Balance	3.25	12.85	6.55
Fitch Expected Net Credit Loss (% of Original Pool Balance)	1.00	4.00	3.00
Total Loss Coverage Required	4.25	16.85	9.55

prepaid, the risk of not realizing the booked residual value is largely eliminated.

As with the evaluation of static loss curves, the magnitude and timing of historical prepayments are used to derive Fitch's base case prepayment assumption and gauge the relative success of early termination strategies. After considering all factors, Fitch determines its base case credit loss and prepayment expectations for modeling purposes.

Stress Multiples: Fitch's base case level of cumulative net credit losses over the life of a representative pool of leases is generally associated with a 'B' rating category. 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. Fitch generally backs off standard credit loss multiples, as it is unrealistic to assume losses escalate to such a high degree while turn-ins are simultaneously skyrocketing. Fitch has used 'AAA' stress multiples ranging from 4.0 times (x) to 5.0x the base case loss estimate, and 'A' stress multiples have ranged between 2.5x–3.5x the base case.

Residual Value Losses: Fitch's residual value loss analysis is most concerned with end-of-lease vehicle turn-ins in which the dealer does not exercise its purchase option. There are two key components to estimating residual value losses on an auto lease securitization — vehicle turn-in rates and residual value loss rates. The former represents frequency of loss, while the latter represents severity.

Turn-in rates can be affected by a variety of factors, including the condition of new and used vehicle markets and lease terms. Fitch has observed that shorter term leases usually result in higher turn-in rates, while longer term leases usually result in lower turn-in rates. As previously stated, the percentage of

the securitized value represented by residual values of the vehicles provides an indication of the extent to which a transaction is exposed to residual value risk.

Fitch reviews static pool data with respect to vehicle turn-in and residual value loss rates to develop base case estimates for each variable. If static pool data is limited or unavailable, Fitch turns to portfolio turn-in rates and residual value losses, as well as residual valuation studies of the securitized pool performed by ALG or NADA.

A hypothetical example will illustrate the process Fitch uses to develop stressed turn-in and residual value loss assumptions. The Residual Value Loss Estimation Worksheet table above demonstrates the calculations that follow. Assume a pool of lease contracts with a base case vehicle turn-in rate of 35% and residual value losses of 5%. Also assume that 65% of the aggregate principal balance of the lease contracts represents residual value.

Under 'AAA' assumptions Fitch typically assumes that 80% of leased vehicles will be returned to dealers at the end of the lease contract and that the residual value loss upon sale of the leased vehicle will be higher than current levels experienced by the originator/servicer. If 80% of the vehicles are turned in at maturity, the residual value loss on the hypothetical pool is 11.43% of the turned-in vehicles (the 5% base case loss at a 35% turn-in rate scaled for an 80% turn-in rate). This translates into a residual value realization rate of 88.57% (100% minus 11.43%). A realization haircut is then applied to determine the stressed realization rate. Assuming a hypothetical 15% haircut, the realization rate becomes 75.29%. This is equivalent to a stressed residual value loss of 24.71% on the turned-in portion of the portfolio residual value (100% minus 75.29%). The loss on the total residual value would then be 19.77% (24.71% times the turn-in rate of 80%). This

is the residual value loss number used in Fitch's cash flow modeling (see *Cash Flow Modeling*, page 16).

To compare credit losses and residual value losses on the same basis, the 19.77% residual value loss is converted to a loss as a percentage of original collateral balance by multiplying by the pool residual percentage, in this case 65%. This results in a 12.85% loss of the original securitized balance. 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.

Avoiding Overstressing of Losses: Prepayments and credit losses must be considered to avoid applying a residual value loss on a prepaid or defaulted contract or double counting 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. Therefore, Fitch adjusts for the effect of prepayments and credit defaults in cash flow models, as outlined below.

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. In this instance, the securitization trust receives 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 of the vehicle may be less than the remaining lease contract balance, resulting in a credit loss to the trust.
- The lessee can default on the lease. Here, 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 car 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 due to the trust. In the rare event a vehicle is sold for more than its residual value, only the residual value amount is 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's proprietary cash flow model, which incorporates all aspects of the lease securitization structure, is customized to replicate the nuances of each transaction analyzed.

For modeling purposes, Fitch requires base case lease cash flows on a zero prepayment, zero default basis be provided. Each monthly cash flow should be broken out by principal, interest, and residual value payment portion.

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 for the particular originator being analyzed. 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 three to five 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 three cash flow scenarios:

- 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 car 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.

The desired rating scenarios are each run using all three of the above model scenarios. 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 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, an 80% turn-in rate is typically targeted. Prepayments are adjusted until the aggregate dollar amount of residual principal received equals 80% of the original pool residual value.

Once the targeted turn-in rate is achieved, residual value losses are applied. Continuing the example from page 15, under the 'AAA' scenario, Fitch assumes that 24.71% of the residual payment received each month is a residual value loss and, therefore, unavailable as collections to the transaction.

By applying residual value losses in this way, Fitch is able to more realistically model the speed with which residual value losses are likely to occur on the pool and also avoid double counting credit and residual value losses since the effects of prepayments and credit losses have already been factored in to the expected monthly residual value payment. It is important to note that in Fitch's modeling, rates of vehicle returns are significantly higher than the current experience of the originators 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.

Securitization Structure

Fitch has analyzed a multitude of structures and is generally able to approve most structures where credit and residual value loss coverage is consistent with the desired rating. As the structuring alternatives grow, Fitch focuses its analysis on the credit of the underlying lease contracts and vehicles and allows the issuer to determine the most efficient structure.

Sources of Credit Enhancement: The primary forms of credit enhancement used in auto lease securitizations are similar to auto loan transactions, including subordination, overcollateralization, reserve accounts, and excess spread. The one area in which Fitch's credit enhancement analysis differs between auto loan and auto lease securitizations is residual value insurance.

Fitch evaluates several factors in determining whether to assign full credit to a residual value insurance policy in a securitization including:

- Strong policy provider — including claims-paying ability, experience in residual value insurance business, and experience with the issuer.
- Enforceability opinion — stating that the policy is a valid and binding obligation of the insurer.
- Noncancelable — ensure the policy is not cancelable by the insurer or the issuer.
- Simplicity of claims process.
- Limited policy exceptions.
- Single, upfront premium payment in an amount commensurate with expected residual value loss.
- Indenture trustee named as insured.
- Prompt payment of claims, with disputes worked out after claim is paid.
- Clarity of details, including that the residual value covered is the contractually stated residual value.

Fitch's insurance group evaluates all companies providing third-party residual value insurance to determine claims-paying ability and experience with residual value insurance. Insurance companies for which a public Fitch rating is not available are reviewed and assessed internally. The credit given to the transaction with respect to the insurance policy is provided only up to the claims-paying ability rating of the insurance company. A downgrade in the claims-paying ability of the insurance company would result in either the replacement of the insurance 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.

For securitization purposes, residual value risk mitigation through insurance policies can be prohibitively expensive for issuers, particularly if 'AAA' ratings are sought. As such, several recent issuers have completed auto lease securitizations without the trust having the full benefit of residual value insurance proceeds. For example, the World Omni 1999-A Automobile Lease Securitization Trust used partial residual value insurance, while the Honda Auto Lease Trust 1999-A relied entirely on other forms of credit enhancement to mitigate

residual value risk to the securitization. Fitch expects the trend toward more limited use of residual value insurance to continue due to the relatively high cost of obtaining suitable coverage commensurate with 'AAA' rating requirements.

Legal Issues

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 involved in the transaction (auto lease originator, servicer, and/or seller). However, unlike a typical auto loan transaction in which the loans are transferred to one or more SPEs, the actual lease contracts and vehicles remain with the origination trust, itself a bankruptcy-remote SPE. The beneficial ownership interests in a pool of lease contracts and leased vehicles, represented by a SUBI, are transferred from the origination trust 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 investors.

In cases where a Federal Deposit Insurance Corp.-insured bank or another bankruptcy-remote entity is transferring the SUBI to a bankruptcy-remote entity, such transfer may take the form of a first priority perfected security interest. Furthermore, if the bankruptcy-remote issuer is issuing debt securities, those debt securities should be secured by the grant of a first priority perfected security interest from the bankruptcy-remote issuer to the indenture trustee for the benefit of the debtholders.

For an entity to be considered bankruptcy-remote, Fitch generally requires that it be an SPE. An SPE can take many forms (corporations, limited liability companies, and trusts, among others). However, no matter what type of organization the SPE is, it should be formed and operated in ways designed to mitigate the likelihood of both voluntary and involuntary bankruptcy. A properly structured SPE should have restrictions on its powers, ability to incur debt and pledge assets, and ability to merge or reorganize. In addition, the SPE should be bound by a series of covenants that are designed to maintain its "separateness" and thereby mitigate the potential that the SPE and its assets could be substantively consolidated into its parent's bankruptcy.

To ensure that a retail auto lease securitization is appropriately structured to isolate both the pool of auto leases and leased vehicles and the SUBI from the bankruptcy risk of other parties, Fitch reviews the transaction documentation and legal opinions. Legal opinions should address the nature of the various transfers in the transaction and provide assurance that neither an SPE, nor its assets and liabilities would be consolidated with the assets and liabilities of its parent or of the other sellers and/or originators of the auto leases in any such party's bankruptcy. With respect to transfers from the origination trust of the SUBI to an SPE (together with all the transfers in between), the legal opinions should state that the SUBI being transferred will not be property of the transferor's bankruptcy estate in the event of such party's bankruptcy or be subject to the automatic stay in such bankruptcy. In addition, the legal opinions should state that the pledge of the assets from an intermediate SPE to the issuer and from the issuer to the indenture trustee for the benefit of debtholders creates a first priority perfected security interest in the auto leases and their proceeds, as well as in the SUBI.

In addition, auto leases have certain distinctive features that require additional legal comfort beyond the traditional issues associated with the structure of ABS transactions. Fitch will address concerns as to the potential liability of the origination trust as the owner of the leased vehicles, as well as the trust's potential pension liability as a member of a corporate group.

Auto leases also are somewhat unique in that the sale or assignment of a security interest in an automobile is typically governed by certificate of title laws in the applicable states. As a result, the sale of and assignment of security interests in automobiles are noted on the title certificate for each automobile. As previously mentioned, the titling trust is designed as a means around the expenses and difficulty of retitling automobiles.

Finally, Fitch typically also requires that the legal opinions address the tax status of the issuer and the origination trust in the transaction. Such opinions should state that the issuer and the origination trust would not be subject to federal, state, or local taxes in all applicable jurisdictions.

Copyright © 2000 by Fitch IBCA, Inc., One State Street Plaza, NY, NY 10004
Telephone: New York, 1-800-753-4824, (212) 908-0500, Fax (212) 480-4435; Chicago, IL, 1-800-483-4824, (312) 214-3434, Fax (312) 214-3110;
London, 011 44 20 7417 4222, Fax 011 44 20 7417 4242; San Francisco, CA, 1-800-953-4824, (415) 732-5770, Fax (415) 732-5610
John Forde, Publisher; Madeline O'Connell, Director, Subscriber Services; Nicholas T. Tresniowski, Senior Managing Editor; Diane Lupi, Managing Editor; Paula M. Sirard, Production Manager; Theresa DeNicolo, Jennifer Hickey, Renee Won, Igor Zaslavsky, Editors; Martin E. Guzman, Senior Publishing Specialist; Harvey M. Aronson, Publishing Specialist; Colin Grubb, Robert Rivadeneira, Publishing Assistants. Printed by American Direct Mail Co., Inc. NY, NY 10014. Reproduction in whole or in part prohibited except by permission.
Fitch IBCA ratings are based on information obtained from issuers, other obligors, underwriters, their experts, and other sources Fitch IBCA believes to be reliable. Fitch IBCA does not audit or verify the truth or accuracy of such information. Ratings may be changed, suspended, or withdrawn as a result of changes in, or the unavailability of, information or for other reasons. 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 IBCA receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from \$1,000 to \$750,000 per issue. In certain cases, Fitch IBCA 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 \$10,000 to \$1,500,000. The assignment, publication, or dissemination of a rating by Fitch IBCA shall not constitute a consent by Fitch IBCA to use its name as an expert in connection with any registration statement filed under the federal securities laws. Due to the relative efficiency of electronic publishing and distribution, Fitch IBCA Research may be available to electronic subscribers up to three days earlier than print subscribers.