



Methodology

*Rating U.S. Equipment Lease
and Loan Securitizations*

JANUARY 2010

*Operational Risk Review section updated in methodology entitled
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Insight beyond the rating.

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Related Research:

Legal Criteria for U.S. Structured Finance Transactions
Operational Risk Assessment for U.S. ABS Servicers

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Rating U.S. Equipment Lease and Loan Securitizations

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Executive Summary

Equipment-backed secured facilities have been prominent since its earliest days of development in the global structured finance market. Beginning in the mid-1980s with the securitization of computer leases and loans, equipment securitization has grown to become a vital method of financing for the lessors of commercial equipment. Once considered an esoteric asset class, a wide variety of equipment and related loans and leases have been included as collateral for secured transactions. Despite the contractions and dislocations that have plagued the structured finance markets during 2008 and 2009, the U.S. equipment finance industry has maintained certain fundamental strengths and continues to play an important role in the capital markets.

Structured facilities for equipment transactions have been supported by collateral ranging from “micro” commercial equipment (such as bank card processing machines), to small-ticket commercial equipment (such as computers and copiers), mid-ticket commercial equipment (such as printing, graphic and industrial equipment), and large-ticket assets (such as large computers systems and medical equipment). The sector also includes equipment employed for agriculture and construction, as well as operating assets in the transportation sectors – railcars, aircraft and shipping containers. Operating transportation assets include distinguishing characteristics, such as servicer-intensive operations and remarketing risk, and consequently are not covered under this methodology. Attributes of the issuers within the equipment leasing securitization market vary in size, with both smaller independent “specialty finance” companies and large leasing “captive” companies being active participants in the term securitization market.

This report details the DBRS methodology for rating equipment loan and lease backed transactions which may differ somewhat in application based on asset class and issuer, but generally includes a review and analysis of the following key analytical considerations:

- Legal and Structural Matters; Documentation
- Originations, Underwriting and Portfolio Management
- Evaluating Collateral and Credit Support
- Estimating Expected Pool Losses and Variability

Overview

The equipment leasing sector has utilized securitization to access the capital markets as a source of funds to finance business operations and expansion since it began representing an attractive cost of capital. Securitization issuance in the US for the equipment leasing and loan sector from 2005 through 2007 included approximately \$9.0 billion in 2005, \$8.4 billion in 2006 and \$6.0 in 2007¹. While the issuance volume has stabilized since the early 2000s, the number of participants has decreased due to consolidation within the industry and the bankruptcy or exit of weaker participants. Early in its development, the sector was populated with more micro, small and mid-ticket lessors sponsoring various types of equipment lease-backed issuance than are active issuing securitization debt today. As the securitization market has become more defined, captive and large specialty finance companies have become the dominate players in securitization and make up the vast majority of issuance since 2005.

1. Source: ABS Alert.



INDUSTRY PARTICIPANTS AND EQUIPMENT TYPES

Leasing of goods has existed for centuries, with companies active in leasing such goods perpetually seeking to efficiently finance the leases originated. The market of equipment lessors breaks down into captive leasing companies and independent leasing companies. Independent leasing companies can be further separated into large and small lessors and bank financiers.

Captive Leasing Companies

A captive leasing company is wholly-owned and supported both financially, and through a sharing of product expertise, by the sponsoring parent entity. Often, however, credit decisions remain under the direction of the captive, who specializes in underwriting credit extensions to potential customers. The sole purpose of these captive leasing companies is to facilitate the leasing of the parent's manufactured products. Due to their role of supporting the sponsoring parent's leasing operations, large captive lessors generally offer product options on a narrow but defined market sector, e.g. agricultural or construction equipment. Typical characteristics of these entities include investment grade or non-investment grade ratings, substantial operating history, brand loyalty, low losses and variability, ability to work through problems and a track record of successful securitizations. Some examples of large captive lessors include Caterpillar Financial Services Corporation, CNH Capital Corporation and John Deere Capital Corporation.

Independent "Specialty Finance" Lessors

Independent "specialty finance" lessors can be divided into three categories:

Large Independent Leasing Companies: Independent leasing companies depend on their own product expertise and capital. Independents are most often vendor-neutral, because they do not have a financing relationship or alliance with any one manufacturer. They compete by offering flexibility and a broad array of products to meet their customers' needs. These participants generally have over \$1 billion in lease receivables and have a national presence. Typically these entities are large and diversified portfolios with multiple product lines, a deep bench of managerial talent, substantial operating history, ability to work through problems and a track record of successful securitizations. Examples include GE Capital, Inc. and CIT Group, Inc.

Small to Medium Independent Leasing Companies: Independent leasing companies in this category usually have a receivables base of less than \$1 billion and generally finance fewer types of equipment than their larger competitors. Participants in this category often specialize in certain types of equipment, e.g. office equipment or medical devices. Typical characteristics of these entities include, public or private companies which may or may not be investment grade, not diversified in terms of product lines, may have track record of successful securitizations, often have significant equipment concentrations, limited number of key managers, multiple liquidity lines and rapid issuance growth. Examples include GreatAmerica Leasing Corporation, Marlin Leasing Corporation and LEAF Financial Corporation. This group also includes smaller niche lessors who may have limited equity and funding sources, may or may not have substantial historical data, a limited number of employees and may be reliant on small number of vendors/brokers.

Bank Financiers: This category encompasses the spectrum of banking institutions from money center and regional banks, to local and community banks, and specialized business. Many financial institutions view leasing as an extension of their finance products offered to customers. Banks had been active in financing large- and mid-ticket equipment, but to date have not been active in publicly securitizing their equipment-backed receivables.

Participants in the leasing industry may also be categorized by the dollar size of their primary lease transactions, which is often determined by the type of equipment being leased. While most small participants tend to focus on certain equipment types, the larger participants often have a broader focus that includes



multiple types of equipment. Categorizing the industry participants according to the cost of equipment would include the following breakdown:

- **Micro-Ticket Equipment** – These portfolios would include equipment with an original cost of less than \$25,000, and include bank card processing machines, street/business signs, alarm systems, computers and copiers. Micro ticket leasing companies generally specialize in credit underwriting to a diverse group of obligors covering various industries and geographic locations.
- **Small-Ticket Equipment** – These portfolios are comprised of equipment with an original cost of \$25,000 to \$100,000, and include larger office equipment, machine tools, small computers systems, and small printing equipment. Typically, the small-ticket leasing company leases its equipment to a diverse group of lessees in various industries and geographic locations, and may include various different types of equipment leased to a lessee. Incorporated in the market for equipment of this size are certain segments which have experienced steady growth over the past two decades, while being particularly active in the term securitization market creating the development of a niche sector. These include the agricultural and construction equipment sectors.
- **Mid-Ticket Equipment** – These portfolios generally include equipment with an original cost between \$100,000 and \$500,000. Typically, equipment types are graphics, printing, mainframe computers and certain types of specialized commercial and industrial equipment.
- **Large-Ticket Equipment** – These portfolios contain equipment that costs in excess of \$500,000. Large-ticket equipment pools include large computer systems, magnetic resonance imaging, and other medical equipment. The high cost and specialized nature of this equipment will often result in the anticipation of substantial residual values.

LEASE TYPES

An equipment lease is a contract between a lessor and a lessee that permits a transfer of the right of possession and use of property in return for defined set of scheduled payments. While there are various types, equipment leases can generally be separated into two broad categories, (1) operating leases, where the lessor retains ownership of the leased property, and thus, the risks related to ownership of the equipment, most specifically, the risk related to residual value of the equipment at the conclusion of the lease term and (2) financing leases, where the lessee makes lease payments covering the full value (or a significant portion) of the equipment or leases the equipment for the entire (or a significant portion) useful life of the equipment, and hence bears the risks related to ownership of the equipment.

Determination of whether a lease is a financing or an operating (or “true”) lease may be difficult as industry dynamics sometimes produce contracts that exhibit characteristics of both types of obligations. For the purposes of determining credit enhancement provided by a collateral pool, the primary difference is the inclusion of the equipment and any expected residual value following the lease term in the collateral supporting the transaction. In all cases where a transaction seeks to have credit assigned to residual amounts realized during the transaction’s life, the equipment must be transferred to a securitization trust under the appropriate terms with related filings made to protect the bondholder interests.

Financing leases are also known as “full-payout” leases because the scheduled payments are structured such that their net present value equals at least 90% of the original equipment costs or fair market value (as the case may be) and term of the lease covers at least 75% of the equipment’s useful life. A finance lease will also include a purchase option for the lessee at the conclusion of the lease term for the remaining value not yet paid under the scheduled payments (often manifested as either as a below fair market value or 10% of the original equipment cost purchase option, or a purchase option for some nominal amount, i.e. a \$1 buyout purchase option). Important to the analysis is that the lessee’s obligation to make such purchase is set forth under the terms of the lease and that the lease is non-cancelable. Technically, finance



leases that require such non-cancelable satisfaction are in essence sale installment agreements with the creation of security interest in favor of the lessor. For bankruptcy purposes, a finance lease is treated as a loan secured by the equipment and related cash flows, making perfection and priority of such security interest a paramount issue in rating transactions in the sector.

Operating leases are also known as “true” leases because, consistent with common understanding of the term “lease”, the lessor retains some interest in the property leased (a residual) and upon completion of the lease term, possession and use of the property revert to the lessor. Classification of a lease as a “true lease” is dependent on the expectation of the lessor in the value of the residual retained by the lessor for which the lessor has the responsibility of realizing. For tax purposes, the residual value anticipated for the equipment must have been reasonable at the time the equipment is first leased to a lessee.

Leases included in a securitization should be “triple-net” or “hell-or-high-water” meaning the underlying leases create an absolute and irrevocable obligation to pay on the part of the lessee with the lessee also obligated to pay the costs of maintaining, operating, and insuring the asset. The nature of the “hell-or-high-water, triple-net” lease is that there are no exceptions to the obligation to pay rent; even the destruction of the equipment itself will not exempt the lessee from its obligation (although insurance proceeds should cover due amounts). “Hell-or-high-water, triple-net” leases are also common in certain transportation leasing sectors including railcars, aircraft and shipping containers which are outside the scope of this report. Flexibility within a lease that permits the lessee may have to modify or cancel a lease may prevent the lease and the related equipment from serving as collateral for a rated securitization.

The leases should be standard amongst the lessees for each type of financing and there should be no allowable amendments to the documents. The lease must allow for the sale and assignment of the interests in the cash flows and ownership interest in the equipment, under appropriate circumstances and within legal requirements, to a third party.

Structural and Legal Matters

RISK ISOLATION AND SECURED INTERESTS

The primary goal of an asset-backed structured transaction is to reduce risk related to the subject assets through structural isolation, thus lowering financing costs of the sponsor. Individually, a sponsor may have specific goals for a securitization regarding reduction of risk exposure or recognition of gain through monetization of future payments. A sponsor may also have certain limitations or challenges to achieving these goals presented by the collateral. Consequently, depending on the goals of a sponsor, they will choose one of the general structural models which have been developed by the industry as a starting point for designing a securitization.

Model Transaction Structures

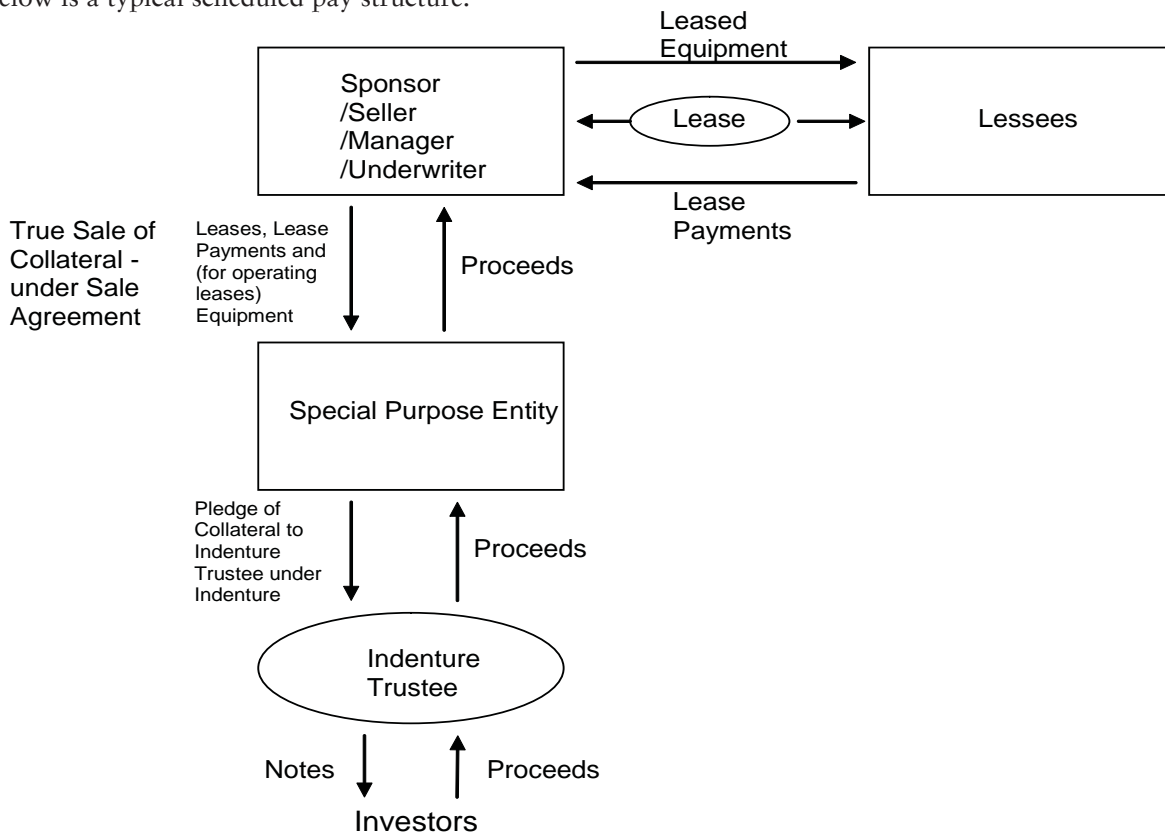
Often, the sponsor/manager of the transaction is also the originator of the leases. As described above, these leases must contain a number of characteristics that ensure certainty of payment in order to serve as collateral for a highly rated securitization. To initiate a transaction, leases and rights to related cash flows are sold via a “true sale” to a special purpose entity (SPE) under a sale agreement. For transactions involving operating leases, the sale of the collateral also includes the equipment and a pledge of rights to anticipated residual value of such equipment. Despite what should be a defined within the sale agreement as a sale, the agreement should also include the grant of a “back-up” security interest in the event that the sale was recharacterized as a loan.



The sponsor and SPE also simultaneously enter into a management agreement for the assets sold to the SPE. The SPE then (1) pledges the assets as collateral under an indenture to secure bond obligations issued by the SPE or (2) deposits them into a trust in exchange for certificates representing the interests in the trust which the SPE then sells to investors. The SPE uses the proceeds of the sale of the bond obligations issued to purchase the equipment under the sale agreement. Uniform Commercial Code (UCC) filings would be required perfecting the security interests granted to (1) the SPE as a back-up to the intended sale from the seller under sale agreement and (2) the (a) indenture trustee (for the benefit of bondholders) from the SPE under the indenture are required or (b) SPE as depositor to a securitization trust, in each case, with accompanying legal opinions regarding the actions necessary to perfect.

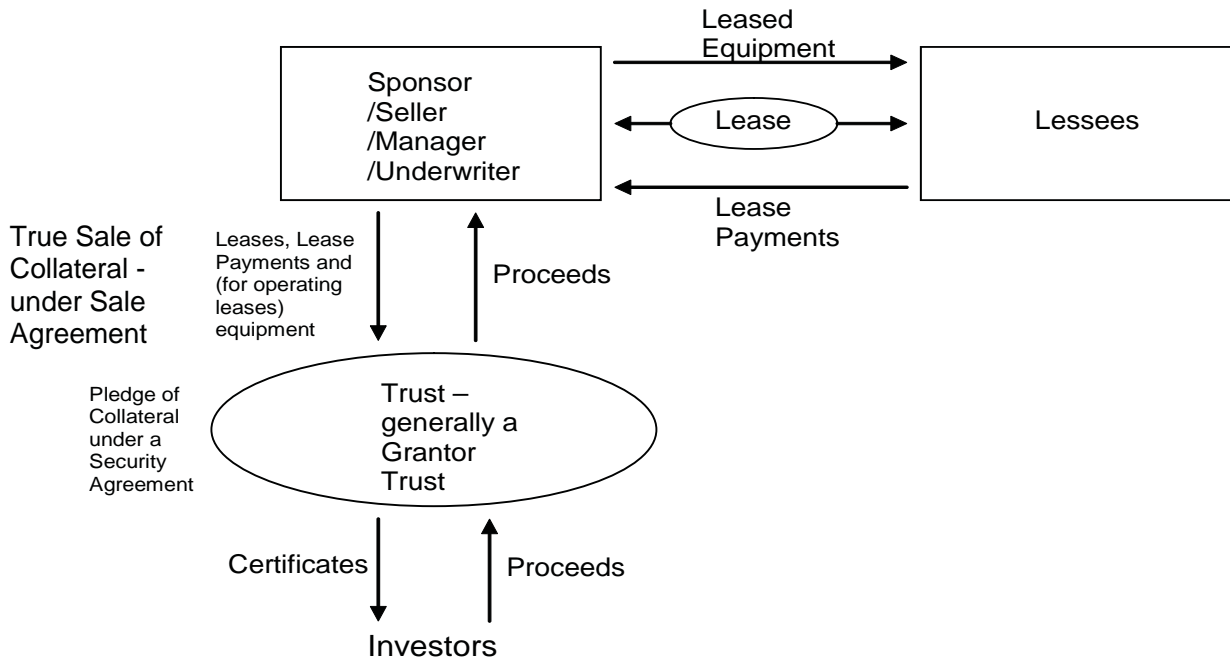
As illustrated on the following pages, the securitization may take the form of a scheduled payment debt structure or a pass-through structure. In a pass-through structure, the related cash flows are not reconfigured but simply passed through to the investor in proportion to the interest they hold. By passing through the revenue from the assets held in the trust, investors may be subject to greater variability with respect to principal repayment. For this reason, pass through structures have not been as prevalent in the capital markets as the scheduled payment debt structures. The obligations issued also differ from the scheduled pay structure. In a pass through structure, certificates are issued which represent a percentage ownership interest in the trust.

Below is a typical scheduled pay structure:





Below is a typical pass through structure:



Specific Legal Criteria

Lease securitization is conceptually reliant on the isolation of risk, particularly the isolation of the lease cash flows from the bankruptcy risk of the sponsor/originator. By legally separating the cash flows from the sponsor/originator for the purposes of a sponsor/originator bankruptcy analysis, the structure, at least in theory, is dependent on the performance of the lessees and no longer subject to the solvency of the originator. Legal isolation of the cash flows is essential to justify a credit analysis based on portfolio losses and/or obligor defaults.

Regardless of the type of lease, whether a “true lease” or a finance lease, the originator perfects its interest through possession of the original lease which is chattel paper under the UCC and is also required to make a precautionary filing of a security interest. These filings are important for informational or precautionary purposes and provide a second method of perfection for the security interest granted, in addition to possession of the chattel paper which would have priority under the UCC. In cases involving the transfer of ownership interests in the equipment, the intent is to accomplish a true sale of the equipment to the securitization trust; however, it is still appropriate to receive a grant of a back-up security interest in the equipment to protect against recharacterization by a trustee-in-bankruptcy reviewing a seller’s bankruptcy estate.

At the heart of the structuring is the fact that the collateral is held by a bankruptcy-remote SPE that is designed for the single purpose of holding the transaction collateral. The primary risk related to the sponsor/manager insolvency is a challenge of the true sale of the collateral from the sponsor/manager, as a seller, to the SPE. In this case, the petitioner would likely be a creditor of the sponsor/manager and seek to maximize the bankruptcy estate of the sponsor/manager by having the collateral sold to the SPE “clawed-back” into the bankruptcy estate of the sponsor/manager. In order to prevail, the creditor would need to assert that the collateral was not sold to the SPE on a non-recourse basis, or that the sale to the SPE represents a preferential transfer in contravention of the creditor’s interest. To address this concern, transactions are structured as true sales of the collateral to the SPE for fair market value in an arm’s length transaction.



While the collateral is sold to the issuing entity, the true sale analysis does permit a limited amount of repurchase or substitution of equipment and leases for delinquent and defaulted obligors at the seller's option. The structure may also permit the substitution for leases that are subject to upgrades of equipment permitted by the manager to provide flexibility to a lessee (which is typical in the leasing of technologically sensitive equipment). In order to limit this type of recourse to the seller, substitution is capped at some predetermined percentage of the collateral (it is typical to see this amount limited to no more than 10% of the collateral sold to the issuing entity over the life of the transaction). Substitutions can alter the pool performance metrics and may vary over time as the seller circumstances and policies change and; therefore, must be included in the credit analysis.

For all types of lease securitizations, if a bankruptcy court deems a transaction to be a financing, the automatic stay provisions of the Bankruptcy Code² would apply. This could potentially trap the lease payments that, by application of the transaction documents, should be directed to the issuer. Although investors may ultimately get their money as a secured creditor of the seller (assuming the proper backup procedures and UCC filings were made at the time of the "sale"), by institution of the automatic stay, there will be a delay in payment to investors. Amongst other characteristics, two elements should be incorporated into the legal review: (1) the transaction structure includes covenants for separateness and bankruptcy remoteness of the issuer to be maintained and (2) if properly structured and maintained, that any delays in receiving the cash flows are limited in time and can be addressed within the structure through overcollateralization and the reserve account(s).

The structure will incorporate the characteristics of bankruptcy remoteness and require these characteristics to be incorporated in any SPE—usually a new corporation, limited partnership or limited liability corporation—seeking treatment as bankruptcy remote. Bankruptcy remoteness generally is achieved by the SPE adopting the following characteristics: restriction on activities and powers, debt limitations, independent director, no merger or reorganization, and separateness covenants provided by the sponsor/manager. The transaction documents should include the aforementioned characteristics as covenants of the sponsor/manager and SPE, which if maintained evidence the independence of the SPE.

While the SPE may have adopted the requisite criteria of bankruptcy remoteness, there remains the possibility that the insolvency of the issuer's parent may result in the issuer being treated as part of the parent's bankruptcy estate, either through the Bankruptcy Code doctrine of "substantive consolidation" or through the common law doctrine of "piercing the veil." Each of these results stem from overreaching behavior by the parent in the affairs of its subsidiary—essentially, by refusing to abide by the "separateness" mechanisms referred to immediately above.

To address the risks related to recharacterization or consolidation of the assets of the issuer with those of its parent (which is usually the originator), legal opinions are requested for any rated transaction covering "true sale" and non-consolidation. The "true sale" opinion should state that, in the event of a bankruptcy of the originator, the transaction will not be recharacterized as a financing by the originator and in effect, there has been a "true sale" of the leases to the SPE that conducts the financing. The non-consolidation opinion should state that, in the event of a bankruptcy of the originator, the SPE and the originator will not be treated as the same entity, i.e. consolidated, for bankruptcy purposes (provided the structure of the transaction has been maintained).

The legal opinions should also cover the anticipated treatment of any back-up security interests granted and perfected under the terms of the transaction documents. Related opinions should opine that the intended transfer would not be rejected under review of a bankruptcy court and deemed a sale if effected. Transactions may be afforded limited flexibility in managing these protections if such flexibility is deemed not to compromise the credit profile of the collateral pool. For example, a transaction may only require

2. 11 U.S.C. §362.



asset specific filings to perfect security interests on equipment exceeding a certain value (\$25,000 has often been used as a threshold for requiring filings) to ease administrative burdens on the manager.

In addition to the matters described above, all equipment lease secured transactions are expected to comply with the DBRS Legal Criteria for U.S. Structured Finance Transactions methodology dated September 2009.

ESTABLISHING CASH FLOW CERTAINTY

These structural specifications discussed above are required to ensure legal isolation of cash flows to be allocated according a defined priority of payments. The priority of payments provides the trustee with specific instructions for the allocation of cash once it is deposited by the manager into a collection account. To be an eligible account, the collection account must be “controlled” by the trustee for the purposes of Article 9 of the UCC. Control as defined by Section 9-205 of the UCC is required to ensure that the trustee-in-bankruptcy in an insolvency proceeding of the sponsor/manager would respect the trustee’s claim to the funds in the account. Eligibility is required for any account that is included as credit enhancement for the transaction. The priority of payments should limit distributions senior to interest and principal on the bonds to transactions related costs, including but not limited to, trustee, administrative and management fees.

When financial insurance was prevalent in this industry, insurance premiums to an insurance company (insuring timely interest and ultimate principal) were permitted to be senior to bondholder interest and principal payments. In all cases however, items paid senior to interest must be well defined and quantifiable, and DBRS includes any downside or increased cost risk in its cash flow analysis. Uncapped payments and liabilities like swap termination payments and legal indemnities to transaction participants are not to be senior to bondholder interest, principal and senior payments required for the management and administration of the SPE.

The obligor payment obligations must also be analyzed for certain features that increase credit risk or modify timing of the anticipated cash flows in order to ensure accurate quantification. Some financing instruments for equipment may require a large or balloon payment due from the lessee at the end of the lease. Balloon payments are larger than the periodic payments and may be as high as 30% of the original equipment cost or fair market value, and hence pose a greater risk of non-payment by the obligor. Where balloon payments are incorporated in the lease terms, an analysis is performed to determine whether such payments can be included in the anticipated cash flows and if additional cash reserves are necessary to address the related risks. Some industries, e.g. construction and agriculture, are seasonal and may include seasonally adjusted payment obligations incorporated in the lease terms to match the anticipated cash flows. Other industries, e.g. medical equipment, often have scheduled payments increasing over time. In these cases the timing of the payments must be included in the cash flow analysis which may result in the need for additional cash reserves to address increased volatility risk.

ELIGIBILITY CRITERIA

The structural benefits of securitization also provide the ability to design and maintain a portfolio profile for the transaction. This is accomplished by establishing eligibility criteria for the permitted assets either on a lease by lease basis through the sale agreement or by monitoring exposure across the collateral pool through the financing documents. Common examples of criteria for an eligible lease includes that the lease (1) is not delinquent or defaulted or with a restricted person (as defined by the Office of Foreign Assets Control), (2) is triple-net, non-cancelable and (3) has a certain minimum yield and final maturities within 12 months. If the lease does not satisfy the eligibility criteria, it is not eligible for sale to the SPE. The seller should be mandated under the sale agreement to repurchase any leases sold to the SPE which are later found not to have been eligible at the time of sale. If a lease is eligible at the time of sale and later becomes ineligible, such lease would not be subject to mandatory repurchase by the seller but would be removed from any determination of collateral support for the outstanding obligations.



REPRESENTATIONS AND WARRANTIES

Repurchases of collateral by the seller are often triggered by a breach of the representations and warranties made under the sale agreement. In each case, if nonconforming collateral is sold to an SPE, the related representation would be breached and the collateral would be subject to a repurchase obligation on the part of the seller. A common representation made by the seller at the time of sale is that the collateral sold conforms to the eligibility criteria set forth in the transaction documents. Repurchases resulting from collateral nonconformity to the eligibility criteria are mandatory and uncapped, making them clearly distinguishable from repurchases of nonperforming collateral that are capped for true sale purposes. Other typical representations and warranties include the seller's authority to enter into the transaction and its good title to the equipment sold.

ADDITIONAL STRUCTURAL ISSUES

Careful determination of these risk levels is particularly important for structures that permit a portion of the collateral to be prefunded or for structures that are constructed as master trusts. These structures are dynamic and include the addition of new collateral to support the prefunding, or future funding to the sponsor through a revolving warehouse series or the issuance of additional term series of debt.

Prefunding permits the issuance of debt for collateral not yet originated by the sponsor/originator. Prefunded amounts are available for a defined period of time and should be maintained in an eligible account and disbursed as collateral which is then sold to the issuing entity. If prefunded amounts are not used to purchase additional collateral by the conclusion of a defined prefunding period, they would be expected to be used to pay down the outstanding debt principal.

Master trust structures use a master indenture and series supplements. Often, the collateral pledged to the trustee under a master trust structure secures obligations for all series of notes issued under the related master indenture. These master trust structures create cross-collateralization across multiple series' issuance which benefits credit enhancement through diversification. While diversity through cross collateralization will decrease credit risk, it can add an element of uncertainty if risk exposure limits are not incorporated and maintained. This would include revolving warehouse note facilities which are anticipated to increase over time as the sponsor originates new business. Since the intention of a warehouse structure is to act as an aggregation facility before critical mass is reached for a term series, such series "revolve" requiring only timely interest on drawn amounts and no payment of the principal outstanding under such series. Revolving series often include step-up payments and amortization triggers, the impact of which must be clearly defined and incorporated into the cash flow analysis. If the transaction structure includes revolving warehouse notes to be held by a conduit, as is the case in many ABS transactions, the conduit is expected to meet the criteria set forth in DBRS' Asset-Backed Commercial Paper Criteria Report: U.S. ABCP Conduits, dated August 2009.

The transaction documents should also contain certain levels to be maintained on a pool-wide basis for collateral to remain eligible. These levels would measure certain risk exposures that may exist with respect to the excess concentrations to individual or groups of lessees, certain types of equipment or geographic regions. If these established levels are exceeded the related collateral is excluded from the calculation of the collateral base supporting the outstanding debt. Maintenance of these levels over time ensures that the collateral pool maintains its desired characteristics and creditworthiness as exposures in the pool may migrate over time due to the addition and subtraction of assets.

The transaction structure is often designed to increase certainty of payment to bondholders by requiring rapid amortization of principal or trapping of cash within the structure upon the occurrence of certain events. These early amortization or cash trapping events help address risks related to deterioration of the seller/manager or the collateral. Typical amortization or cash trapping events related to the seller/manager include failure of the manager to maintain certain operational and/or financial ratios, defaults under the management agreement and breaches of certain material representations and warranties. Early amortiza-



tion or cash trapping events related to collateral should include performance triggers and maintenance of credit enhancement to avoid a deficiency in the amount of collateral supporting the outstanding debt.

One key risk element that is often found in equipment-backed transactions is a mismatch between the funding basis of the underlying assets and that of the notes issued by the funding trust. To the extent that a fixed versus floating rate mismatch exists, hedging arrangements need to be entered into to remove this exposure from the trust and ensure that the note holders have access to the appropriate type of interest cash flows. A similar issue exists if there is a currency mismatch between the underlying finance obligations and the currency of the notes that fund the assets. In both instances, the trust could be unable to absorb the related risk position and appropriate hedging is needed at the inception of the transaction. Please see DBRS U.S. Legal Criteria for Structured Finance Transactions dated September 2009.

VALUATION OF SECURED EQUIPMENT CONTRACTS

The collateral supporting the repayment obligations under the transaction must be valued at the time it is sold to the issuing entity. This requires an understanding of the method used for the collateral valuation, which is generally determined by discounting the scheduled payments under the lease at par or at premium. It is important to understand the discounting method, as the differing methods will change the risk profile of the transaction. A 'valuation at par' would apply the weighted average yield on the leases as the discount rate, while the 'at premium' method would use the weighted average interest rate of the financing obligations (plus the cost of senior items in the priority of payments) as the discount rate. The 'at par' method results in a lower valuation of the collateral since a higher discount rate will be applied to the future payments, creating excess spread during the life of the transaction as actual returns at premium are realized. The excess spread acts as an additional form of credit enhancement and provides a more conservative profile for a transaction. The 'at premium' method uses a lower discount rate based on the weighted average interest rate of cost (plus the cost of senior items in the priority of payments) for financing the collateral, and results in a higher valuation of collateral. In both cases, since the methods involve averaging future rates to achieve the discount rate, the potential exists for variability if obligations are prepaid.

The impact of the discounting method on a transaction can be magnified in a senior/subordinate structure. This occurs because of the higher interest rates required for the subordinate classes, versus those of the senior classes of securities, and the timing of principal payments to the senior and subordinate securities. Senior/subordinate structures pay either pro rata or sequentially. In a pro rata senior/subordinated structure, both the senior and the subordinate classes of securities receive principal payments concurrently during the life of the transaction. Regardless of the discounting method used, pro rata structures typically create more risk for a senior class, since the subordinate class is receiving principal payments together with the senior class, and the assets and related cash flows supporting all series are limited. When an 'at premium' method has been employed to discount the collateral, pro rata payment of the securities could result in cash flow shortfalls, since excess spread, which may be necessary to compensate for cash flow fluctuations, has been reduced or eliminated through the discounting method. These concerns are increased in a sequential pay structure. In a sequential pay structure, the marginal rate of interest of a transaction increases over time as the senior classes, with lower interest rates, are paid off. This can have a negative affect on the ability of cash flows to meet required payments in the latter part of the transaction since the weighted average rate for discounting the collateral would be the weighted average interest rate for all classes, and thus below the interest rate of the subordinate securities. This could result an inability to pay the subordinate class, once the senior class obligations have been paid. While this concern is present in all sequential pay structures where the collateral has been discounted using the at par method, the excess spread created through the discounting method may provide the ability to absorb the higher interest rates carried by the subordinate class still outstanding after the senior class obligations have been satisfied.



DBRS examines the valuation method and the creation of excess spread and potential variability, and integrate them into its risk analysis. DBRS also considers the transaction structure in determining to potential impact of the discounting method to assess the potential need for additional credit enhancement.

Origination, Underwriting and Portfolio Management

REVIEW OF THE SPONSOR/ORIGINATOR/MANAGER

Equipment lease securitizations are initiated by holders of equipment and related leases who seek to finance these assets through use of the capital markets. The sponsor is also often the originator of the leases, and as previously described, serves as the manager of the collateral securing the transaction. Given the significant and varied roles the sponsor may play in the transaction, DBRS conducts an operational risk review of the sponsor and its market position, as well as its role as (1) an originator and underwriter of the lessee obligations and (2) as a manager of the securitization portfolio (as outlined in Operational Risk Assessment for ABS servicers dated June 2011).

General Review of Sponsor

The sponsor's role of originating the leases through its credit underwriting operations and new role as manager of the collateral for the securitization, most often necessitates a sponsor review in order to ensure quality and capacity. For these reasons, the DBRS asset-backed structured finance team typically coordinates with the financial institutions and corporate finance teams to complete a review of the sponsor with continued collaboration throughout the life of the transaction. The scope of the review of the sponsor is not intended to determine an individual credit rating for the sponsor, but designed to assess the sponsor's ability to perform the duties and responsibilities related to the securitization.

The process begins with a review of the sponsor, market segments within which it participates, the equipment types and lease products it offers, company history, management experience, future business plans and financial condition. For each of these areas, the review focuses on the position of the sponsor as a going concern, and how that position relates to the broader industry and its competitors.

Sponsor Operational Capacity

The sponsor analysis focuses on the origination of leases, underwriting process for credit and portfolio management of the equipment and the leases.

A lessor's method of origination may vary greatly based on the type of originator, whether it is a captive or independent, and equipment being leased. The originator should be able to demonstrate the procedures it uses to solicit and track new and existing accounts. The originator should also be able to demonstrate an ability to perform segregation of the portfolio by vendor/broker, lessee, equipment type (and cost), lease type and geographic region analysis. For those lessors who use vendor programs and third party brokers, which is most common method of origination for independent lessors, the review includes an evaluation of the vendors or brokers, and the program or arrangement supporting the lessor's pipeline for origination. These programs and arrangements add a layer of complexity to the origination process and may create additional credit risk which must be analyzed. Originators are expected to understand and articulate the underwriting process of each vendor or broker, and provide data on delinquency and charge-offs and warranty performance for each. Documentation and terms for each of these programs and arrangement is reviewed by DBRS to evaluate recourse and determine if such program and arrangement create any additional credit risk. One final area of review includes the originator's systems architecture which allows for an understanding of the various sources of information technology, linkages of reports and nature of reporting utilized in the management of the portfolio. It allows DBRS to review the sources of information technology and an overview of the firm's information storage and disaster recovery programs.



Underwriting policies and procedures are crucial to creating consistency in the performance of a lease portfolio. The sponsor's experience and the experience of its personnel are important factors in the assessment of underwriting process. DBRS expects an experienced underwriter to have a well defined written set of underwriting criteria. Review of the underwriting procedures is expected to differ somewhat based on the type of equipment and lessee. For example, smaller ticket and mid-ticket items often provides the availability of bank or credit bureau reports which should be considered by an underwriter of credit. Many construction and farm equipment leases also have personal guarantees from individuals which would make FICO³ scores an appropriate item to review when underwriting. In all cases, underwriting should focus on the creditworthiness of the lessee, including the payment of past obligations for repeat customers and a review of all available financial information. For lessors that have developed internal scoring models for obligors, DBRS endeavors to understand these credit approval processes to assess risk levels.

Evaluating Credit Support

TYPES OF CREDIT SUPPORT

The rating process centers on an analysis of the credit supporting the obligations issued in connection with a securitization. Credit support may be "hard", which are enhancements directly available to support the securitization obligations, or "soft", which are enhancements that will support the securitization obligations if and when they are available. Typical forms of credit support in an equipment lease securitization include overcollateralization, subordination, reserve accounts, excess spread.

Overcollateralization

Overcollateralization is a form of hard credit enhancement which acts as a first loss piece, absorbing losses before any shortfalls to securitization investors. Overcollateralization is achieved by the issuance of obligations in a lesser amount than the value of the collateral securing those obligations. Proposed levels of overcollateralization are evaluated by DBRS after its review of the sponsor and application of its rating criteria to the proposed collateral pool.

Among the most difficult forms of overcollateralization to evaluate and quantify is the residual value of the equipment which is available to support the transaction. The uncertainty related to residual value amounts and timing of realization of those amounts has resulted in these values often only serving as additional credit enhancement. Consequently, such amounts are not incorporated into the collateral balance for purposes of issuing the securitization obligations. To the extent that credit is requested for residual values pledged to a transaction, the manager's role in realization is more heavily analyzed and discounted as described herein.

Subordination

Subordination is a form of hard credit support that creates a cushion for losses on the related leases. It is the creation of a junior class of notes that is subordinate in right to senior class with respect to amounts available for payment. These junior classes are available to absorb losses, and therefore act as additional overcollateralization for the senior classes. DBRS is careful to analyze any mechanisms within a transaction that modify the availability of these junior classes to act as credit enhancement for senior classes.

Reserve Accounts

Another form of hard credit support are cash reserve accounts that are available to pay interest, and sometimes principal, on the securitization obligations. Reserve accounts are included in most equipment lease transactions as set dollar amounts or a percentage of the debt outstanding, and are funded

3. Fair Isaac Company.



either at the outset of a transaction or over time through the transaction cash flows. Reserved amounts provide additional liquidity to the transaction and may be included to allow the transaction to successfully perform under stressful scenarios. In equipment leasing transactions, which amortize principal over time and hence reduce related outstanding risk, reserve accounts may be permitted to decline over time, as the transaction pays down the outstanding principal and the collateral gains seasoning.

Excess Spread

Excess spread is created in a transaction when the discounting method of the transaction uses a discount rate that is less than the yield on the underlying leases. As previously described, the sponsor/manager applies a discount rate to future payments expected under the leases to determine the value of the collateral. In determining the discount rate, the sponsor/manager typically uses the average yield expected on the collateral pool or the interest rate of the notes to be issued. Where the interest rate of the notes is used, the calculation must include expenses senior in the priority of payments (i.e. trustee fees, management fees) for determination of the discount rate. If the discount rate is higher than the weighted average interest rate of the notes plus the costs of items senior to interest in the priority of payments, excess spread is created. Excess spread is a soft form of credit enhancement since it is based on anticipated, but yet uncertain performance of the collateral. Further, it is subject to delinquency and default of underlying obligors, making it subject to timing variability. Consequently, DBRS takes a conservative approach in assessing the value of excess spread for rated transactions.

Rating Approach to Equipment Lease Securitization

POOL CHARACTERISTICS

The collateral supporting a securitization often includes thousands of equipment leases with differing terms and obligations to several hundred, or even thousands, of lessees. While characteristics may differ somewhat from transaction to transaction, the pools generally include certain definable characteristics which aid in the performance risk analysis.

Collateral Evaluation

The characteristics of the collateral that comprise the securitization pool must be definable to allow for the segregation, quantification and minimization of risk. The collateral pool is typically segregated into sub-pools with common characteristics to allow for stratifications which permit the analysis of common risks. The stratifications are analyzed by DBRS to ensure they accurately capture the common characteristics necessary to assist in the risk analysis. Characteristics which are isolated for analysis may vary based on the type of asset and overall composition of the pool, but usually include seasoning, obligor concentrations, geographic concentrations, and equipment type and manufacturer.

When a lease has some measurable period of performance by the lessee it is deemed to be “seasoned.” History has shown that newly originated leases are statistically more prone to default than those which have experienced some period of performance by a lessee. Seasoning of leases in a collateral pool not only affects the aggregate anticipated loss analysis but the expected timing of those losses. Consequently, the pool’s seasoning is reviewed to ensure that it is comparable to previously originated pools, thus permitting the appropriate application of a loss curve.

Lessee Concentrations

Among the benefits of stratifying the collateral pool is that it permits review and stress analysis for lease obligations concentrated to individual obligors. A higher degree of credit risk exists in pools where lease obligations are concentrated with an individual obligor. For industries with relatively few players, e.g. shipping containers, it is common to see an individual lessee represent more than 5% of the lease obligations in a collateral pool. This can be particularly acute when the lessee is non-investment grade. For this



reason, DBRS examines lease concentrations for collateral pools and address risks through increases in cash flows stresses, additional reserves of cash and/or the imposition of limits on such concentrations at the transaction outset and over time.

Geographic Concentrations

Concentration by geographic region is another risk that must be examined to ensure an accurate assessment of portfolio risk. Geography poses a risk to a transaction when events like weather and regional economic downturn can affect portfolio performance. Concentrations for geography are common in states with high populations but are normally limited to 10-15% of the collateral pool. Limitations on geographic concentration is established at the outset of a transaction and maintained over its life. In addition, the stress scenarios incorporate risk related to unusually high concentrations in the determination of anticipated losses for the transaction.

Equipment Types and Manufacturers

The type of equipment and its manufacturer may add risk to a transaction if concentrations exist. Certain types of equipment, e.g. computers, are regularly upgraded and may be subject to obsolescence from a performance perspective, hence entire pools of such equipment may compare poorly to a pool of agricultural equipment as collateral for a transaction which issues term debt. Additional risk exists if the lessee does not require the equipment to perform its business, since such a discretionary expenditure, which may be abandoned by a lessee during a downturn. Portfolios of obligations related to equipment from a specific manufacturer also introduces risk to a transaction if the manufacturer is required to honor warranties on the equipment it manufactures, which is most often the case with mid and large-ticket equipment. DBRS analyzes concentrations of equipment types and manufacturers, and incorporates this analysis in its determination of loss proxies.

PORTFOLIO PERFORMANCE

A portfolio of equipment lease receivables provides various metrics that allow industry participants to track and analyze performance and evaluate risk. With respect to evaluating credit risk of equipment lease receivables pool the key metrics are delinquencies, defaults, recoveries and prepayments. Each item is reviewed by DBRS in determining the credit risk related to a particular portfolio.

Delinquencies

The ability of lessees to make timely payments is an integral part of the cash flow analysis. The manager needs to demonstrate that they are capable of tracking these payments, and that they employ procedures to ensure lessee performance. The information provided by the manager is used to approximate anticipated performance variability. Typically, the manager is expected to provide a history of receivable aging for lessee obligations that are past due by 30-60 days, 61-90 days and over 91 days. This information is also often used by issuers to structure the transaction performance triggers which assist in guarding the portfolio against deterioration.

Defaults and Charge-offs

A payment default occurs when the lessee, after any applicable grace period, is either unable or unwilling to make its payment obligation under a lease. Payment default data is one of the most important sets of information used in the quantification of expected losses for a portfolio. DBRS uses the default information to develop its base case expectation for the portfolio's performance, as well as the starting point for application of stress scenarios of static and annual pool losses. The analysis begins with a review of the lessor's default history and charge-off policies to provide clarity as to how and when defaulted obligations have occurred, and when defaulted obligations are deemed uncollectable. The review is needed to determine the reliability of the data and to allow DBRS to ascertain the suitability of using the data as a basis for predicting future pool performance.

While the standard for charge-off of losses in the equipment leasing industry vary somewhat, generally policies should charge-off amounts deemed to be uncollectable. The uncollectable amounts should be



based on the full net book value of the related collateral and the unearned income expected under the related lease, less any amounts expected to be recovered. Application of the policies should be uniform and exhibit consistency. In addition, since future performance is to be governed by the charge-off policy set forth under the transaction documents, the typical policies instituted by the manager are compared with the transaction policies to ensure conformity. To the extent that historical charge-off policies vary materially from those required under the transaction, special consideration must be given to how the new policies will effect the manager's operations and pool performance. For purposes of the securitization, the charge-off of a defaulted obligation is typically based on the passage of time related to a delinquency, usually 120 to 180 days past due. In any event, the transaction documents must be clear and specific with respect to defining defaulted amounts and the timing of loss recognition, and the manager must agree to manage charge-offs as contemplated therein.

Recoveries (Value and Timeframe)

Following an event of default under a lease, the manager's obligations do not cease, but become those of recovery. Since managers are often successful in recovering amounts owed by lessees under defaulted leases, DBRS analyzes the historical recovery data to determine if credit can be given for anticipated recoveries of obligations. If sufficient recovery data exists, the process for recovery is analyzed to place the historical information in context and highlight consistency with the transaction documents. Review of consistency with the transaction documents includes ensuring that the manager has the rights under the underlying documents to effectuate recovery and the transaction has clear rights to amounts recovered. The review also takes into account the timing of recoveries and allow for some anticipated lag time when granting credit to recoveries. To the extent a transaction may include repossession and resale of the equipment as a remedy under a lease, the history and experience of the manager to perform these duties is evaluated. For this reason, history of non-investment grade managers may be discounted to incorporate the increased risk of a disruption in managing the portfolio.

Prepayments

The leases for equipment require scheduled payments to be made in exchange for the use of the equipment (for operating lease) or as installments for the sale of the equipment (finance lease). Usually the ability of a lessee to prepay is limited, and when permitted, may include some step-up charge. Consequently, prepayments do not necessarily impair the ultimate performance of the collateral. However, the timing of payments and the specific leases which are prepaid can change the anticipated cash flows and pool composition in a manner that can change risk related to the securitization obligations.

For example, lessee, asset type and geographic concentrations may increase as lease obligations are prepaid. Of greater importance would be prepayment of leases with yields that are higher than the rate used to discount the future payments for determining the collateral value, which could result in cash flow compression or even a shortfall. In this case, while the prepaid amount would reduce the amount outstanding under the securitization, the remaining portfolio cash flows could be proportionally less than that which was anticipated for the base case for the transaction. The DBRS review includes the underlying lease documentation, concentrations that may exist and any flexibility the lessee may have to prepay, and the prepayment history of the manager by asset type and lessee. Based on that review, prepayment assumptions are applied to securitization cash flows to simulate potential risks.

ESTIMATING EXPECTED LOSSES AND VARIABILITY

Analysis of historical data can present one of the most valuable tools in evaluating the anticipated performance of a collateral pool and for determining the necessary credit enhancement for rated securitizations. Historical data is most reliable when there are a large number of lessees tracked over multiple years of origination and a significant amount of diversity related to the individual lessees. Such diversity exists in data sets where the default of the large lessees could occur and it would not result in a default of the related securitization.



Historical data may be analyzed on an annual basis or as static pools by origination vintage. Analysis of annual information involves reviewing the manager's owned and managed pool performance year over year without regard to when the underlying collateral was originated. Static pool analysis provides a quantitative method for estimating cumulative expected losses for pools of collateral. There are limitations as to the effectiveness of quantitative analysis using static pool. Distortions can be related to several factors (e.g. changes in origination/underwriting standards, changes in technology, economic downturn and geographic concentrations), including concentrations which may exist in the obligor pool which could result in an understatement of credit risk. For this reason, DBRS evaluates obligor concentrations and incorporates this risk in its analysis when appropriate. In some cases, it may be prudent to adopt multiple quantitative approaches by analyzing sub-pools of the overall pool to address credit risks in a transaction. For each transaction, pool information is received which provides a thorough picture on the proposed pool of assets to be sold. This includes scheduled monthly cash flows from the loan and lease payments, term of underlying obligations, timing of any seasonal, balloon or residual payments due from the obligor, types of assets financed, new versus used equipment, largest 10 obligor exposures by name, geographic breakdown, industry breakdown as well as the interest generated on the outstanding loans and leases.

Static Pool Data and Estimation of Expected Loss

The analysis of static pool data to determine the cumulative expected loss for a pool begins with the historical information available from the sponsor/manager. The data should include detail regarding any substitutions of equipment (by year of equipment vintage) permitted under the transaction documents. For this analysis to be sufficiently comprehensive to support a related rating, the sponsor/manager should provide data for a period covering the anticipated life of the related equipment, and in any event for a period covering a full business cycle. Experienced sponsors and frequent issuers are often best suited to provide the detailed information required due to the history available to them and their familiarity with collecting and segregating the data.

Once the historical loss data is provided, DBRS uses the data to determine the base case estimate for cumulative expected losses (used to formulate the base case loss curve) on the securitized pool of collateral. The sponsor presents the information by segregating the historical data into vintages by year of origination. The vintages are then tracked year over year to determine losses for each vintage for each year following origination. For example if the sponsor/manager provides seven years of data for years 2002-2008, the analysis would determine losses for all vintages for year 1 and 2, losses for vintages 2002-2007 for year 3, losses for vintages 2002-2006 for year 4, losses for vintages 2002-2005 for year 5, losses for vintages 2002-2004 for year 6, losses for vintages 2002-2003 for year 7, and losses for vintage 2001 for year 8. The loss data will be reviewed to determine if performance is indicative of prudent origination, underwriting and servicing standards, and consistent with industry norms. Year over year changes for each vintage are aggregated to determine the loss history and project anticipated increases in losses across the pool. The year over year loss data is then added to determine the expected cumulative net loss figure which serves as one loss proxy for the securitization. The year over year changes can also be used to develop loss curves for the later vintages which are still active to project performance over the remaining life of those vintages. Thus, the application of the loss curve also provides a useful tool in anticipating the timing for losses on the securitization pool. The table on the next page sets forth an example of static pool data and the year over year loss analysis is generally performed.



Incremental Static Pool Data Analysis

Year	2002	2003	2004	2005	2006	2007	2008	Loss Curve
1	1.07%	1.01%	0.98%	0.92%	0.89%	0.87%	0.86%	24%
2	2.12%	1.99%	1.86%	1.76%	1.74%	1.72%	1.66%	47%
3	2.80%	2.69%	2.58%	2.47%	2.43%	2.41%		65%
4	3.42%	3.33%	3.12%	3.01%	2.88%			80%
5	3.98%	3.74%	3.54%	3.41%				91%
6	4.10%	3.98%	3.73%					96%
7	4.21%	4.14%						99%
8	4.23%							100%

Expected

Losses	4.23%	4.16%	3.89%	3.74%	3.61%	3.69%	3.51%
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Year	Year over Year Losses							Average Loss	Cumulative Loss
	2002	2003	2004	2005	2006	2007	2008		
1	1.07%	1.01%	0.98%	0.92%	0.89%	0.87%	0.86%	0.94%	0.94%
2	1.05%	0.98%	0.88%	0.84%	0.85%	0.85%	0.80%	0.89%	1.84%
3	0.68%	0.70%	0.72%	0.71%	0.69%	0.69%		0.70%	2.53%
4	0.62%	0.64%	0.54%	0.54%	0.45%			0.56%	3.09%
5	0.56%	0.41%	0.42%	0.40%				0.45%	3.54%
6	0.12%	0.24%	0.19%					0.18%	3.72%
7	0.11%	0.16%						0.14%	3.86%
8	0.02%							0.02%	3.88%

The historical loss data is also reviewed on an annual basis. Review of annual loss data is often helpful in identifying and understanding more global changes to a sponsor/manager's operations. Annualized reviews highlight the changes that affect all pools and would be evidenced across the underwriter's/manager's business in the year (or years) following implementation. Changes in underwriting or lessee credit quality are examples of changes which are usually more visible in the review of the data on an annualized basis.

Stress Multiples for Cumulative Net Losses

The cumulative net losses derived by analyzing the static pool data provide the loss proxy for the base case performance of the securitization pool. To arrive at an appropriate level of credit enhancement to support a designated rating the loss proxy is then stressed by applying multiples to the base case losses. To achieve a given credit rating, a transaction would have to maintain credit enhancement sufficient enough to withstand the stressed multiple of losses over the life of the transaction (as well as other stimulated stresses as appropriate). The table below sets forth the typical multiples for the corresponding rating category:

Stress Multiples by Rating Category	
Rating Category	Stress Multiples (x)
AAA	4.50 - 6.00
AA	4.00 - 5.00
A	3.00 - 4.00
BBB	2.00 - 3.00
BB	1.50 - 2.50
B	1.10 - 1.75



Limitations and Variability

While the static loss analysis and annualized review of data does yield some important insights into performance of a securitization pool its application is limited. Principally, the performance history of the sponsor/manager, or of one or many pools, does not dictate the performance of a newly rated pool.

Variability of performance is increased in circumstances where the volume or quality of data is compromised. With only 5 to 10 years of data typically available, the period of time for analysis does not provide an indication of how various business cycles would affect performance of the pool. In times of serious economic stress, the sponsor/manager may be required to employ greater flexibility with lessees that could impact pool performance. Furthermore, severe downturns in the economy may jeopardize the financial stability of the sponsor/manager or cause it to withdraw financing programs for lessees. Each business cycle is different and some will impact industries more significantly than others. This was seen in the construction industry following the financial crisis in 2007 and 2008 and the aircraft industry in the 2001 recession following the events of September 11, 2001.

The manager is competing in an ever changing business and economic environment which requires some evolution on the part of the manager to stay in existence. Uncertainty is introduced into every analysis since the pools themselves differ with respect to lessee mix and equipment type. Even in the most consistent business, there are always differences from pool to pool, and in the general environment. Consequently, DBRS performs a comparative analysis across managed pools and reviews all transactions for qualitative factors that could affect the quantitative analysis.

INCORPORATING CONCENTRATION RISK

One of the biggest limitations of cumulative loss analysis occurs when a concentration of leases exist to individual lessees. In these cases, the true credit risk of a transaction would not be captured by a cumulative loss approach since default of one or a small group of lessees could jeopardize the assigned ratings. For captive and large independent lessors, the top lessees in well diversified portfolios typically represent less than 1% of the related lease payment obligations. However, in some small-ticket and specialty lease markets portfolios with higher concentrations are not unusual. Typically, DBRS considers using the approach for pools with obligors representing obligations of more than 2% of the overall pool.

Lessee Concentration Risk Analysis

Lessee concentrations existing in the portfolio are reviewed by DBRS to determine if the potential for individual lessee payment defaults pose increased credit risk to the transaction. When such concentrations are identified, the creditworthiness of such lessees becomes a focal point of review. Often the lessees are not rated entities and require analysis to determine the level of default risk that they may present. The payment history, information available to sponsor/manager (credit profiles and summaries) and underwriting procedures are included in the review of the manager for its top lessees. If lessee concentrations present an increased risk to the transaction, it is appropriate to ensure that credit enhancement levels are sufficient to support the assigned rating. One method DBRS may employ is simulating the default of a number of top lessees in the cash flow analysis to determine the impact and assess the sufficiency of proposed credit enhancement levels. To the extent that this analysis indicates higher losses may result from these concentrations, credit enhancement will be increased to address the identified risks. The table below sets forth indicative ranges for the number of simulated defaulted lessees for each rating category.

Obligor Default Simulation	
Rating Category	No. of Obligators
AAA	5.00 - 6.00
AA	4.00 - 5.00
A	3.00 - 4.00
BBB	2.00 - 3.00
BB	1.50 - 2.00
B	1.00 - 1.50



To ensure the risk profile does not change over time, DBRS reviews the transaction documents to ensure the appropriate concentration limits are included. Furthermore, maintenance of these levels should be in the transaction documents and confirmed in each period's manager report.

ADDITIONAL ITEMS FOR CASH FLOW ANALYSIS

In addition to defaults and losses that are captured in the analysis for cumulative losses discussed above, there are other items that can materially impact the transaction cash flows which must be considered. These include tangible items that can be defined such as the transactional mechanics and operational costs, as well as the soft items that are variable including delinquency rates, timing of defaults, prepayment speeds, timing of recoveries, residual realization and availability of excess spread. Each of these items are reviewed by DBRS and incorporated into the base case and stressed cash flow analysis.

Cash Flow Modeling

The transaction structure should provide for the manager to deposit payments received from lessees into transaction controlled collection account(s). Once deposited into a transaction collection account, the funds should be distributed according to a priority of payments. The documents typically also provide for some modification of cash flow allocation when performance triggers are not maintained or an amortization event occurs. Any modifications that change the sequential payment of obligations, or trigger payment of revolving or warehouse series' obligations are reviewed. Impact of these modifications are considered and included in the cash flow modeling exercises. Cash flow modeling should also demonstrate the ability of the cash flows to fund reserve accounts, if applicable.

Operational Costs

Items which are senior to interest and principal in the priority of payments must be reviewed for variability and impact on cash flows required for payment of rated obligations. These items are generally limited to the operational costs of the transaction and include trustee fees, administrative fees and costs, and manager fees. Any variability related to these amounts must also be considered. Trustee fees often permit some senior payment of indemnities by the SPE which should be capped with the capped amount included in the review of the cash flows. The cash flows should also demonstrate an ability to make back-up manager payments (or to make the funds available which would be required to attract a qualified back-up manager) in the event that a manager replacement is required under a stress scenario.

Collection and Delinquency Rates

The assessment of the manager includes its process for managing collections and delinquencies which impact anticipated cash flow performance. Delinquency rates will be reviewed for volumes and timing to determine an anticipated range of performance for the rated pool. The base case includes a rate of delinquency which is consistent with the review as a reduction to available cash flows or an extension to the collection time required for lessee payments. The anticipated impact is then increased to simulate stressful economic environment.

Default Timing

The assessment of the manager also includes a review of the default history of lessees. This is particularly useful in developing anticipated timing of losses, generally, there is no consistent loss curve that exists across the varying types of equipment. Consequently, since pools differ in composition, the identifiable characteristics need to be reviewed to determine the anticipation of loss timing. For example, newly originated leases have historically had a much higher likelihood of default making higher losses in the earlier part of the transaction more likely. DBRS considers these aspects in developing the timing of losses applied to cash flow modeling and the impact of various timing scenarios on the cash flows and apply the appropriate loss curves, including front-end and back-ended scenarios, as applicable.

Prepayments

The anticipated cash flow of a transaction is accelerated by prepayments, which changes the transac-



tion maturity and could change the credit risk profile of the related portfolio. The manager’s history provides the basis for determining the anticipated performance of the securitization pool. The analysis also includes a review of the underlying lease documentation to evaluate any flexibility the lessees may have regarding prepayment. Based on this review, the cash flow analysis considers the impact of potential prepayment situations.

Recovery Rates

Following a lessee default, the manager seeks remedies under the lease to satisfy the related lease obligations. The manager typically has significant detail on the recovery process which becomes the basis for the recovery analysis. Credit for recoveries is limited if the quality or experience of the manager prevents provision of sufficient information. DBRS evaluates the potential for providing credit for anticipated recoveries. In cases where credit is given to recoveries, the analysis of the cash flow also includes reductions to anticipated recoveries and extension of the time required for recovery realization (to simulate negative economic conditions), with a reduction to the anticipated recoveries as follows:

Credit for Recoveries	
Rating Category	Recovery Credit
AAA	50%
AA	66%
A	75%
BBB	85%
BB	90%
B	90%-100%

Residuals

The residual value of equipment can provide support to transaction, but may be limited due to the variable availability. For this reason, the experience of the manager in realizing residual values is reviewed and incorporated into the cash flow analysis. The manager typically has significant detail on the residual realization which is incorporated into the review. The accounting and depreciation policies are also reviewed and compared to actual realization.

The credit assigned for residual value is assessed for each transaction and includes an analysis of the manager’s methods for determining residuals, its managerial experience in realizing residuals and historical data relating to residual value realization. The residual analysis examines the methods of realization utilized by the manager and the typical turnaround time required for such realization. The manager’s individual experience is also compared to the broader industry. The manager should provide information on any proactive programs that it may maintain to assist in realizing the residual. The historical data for residuals should also provide a year by year breakdown by lessee, equipment and vendor. The residual analysis also examines the methods used by the originator in determining the residual value of equipment when the equipment is initially put on-lease to a lessee. The originator should consider the useful life of the equipment and the term of the initial lease in determining residual value. This value should be included in the originator’s books as the residual value at all points in the useful life of the equipment and the anticipated disposition value at the conclusion of the useful life. The equipment pool is evaluated to determine if any aging concentrations exist which could impact the manager’s ability to realize on the expected residual value. In order to be afforded any credit, the SPE must be the owner of the equipment and demonstrate that it maintains legal access to the equipment, and that the interest of the related bondholder is perfected under the UCC. To the extent that a portfolio includes both “true” leases and finance leases, residual credit is only considered for the equipment transferred and owned by the SPE (which is often the case with equipment subject to a “true” lease). In addition to these items, the analysis also considers the sensitivity of the transaction to a manager disruption event, any significant exposure to individual manufacturers or technology risk, and the required maintenance obligations for the related equipment.



For credit to be given to residuals, the manager would need to supply several years of data to support the cash flow assumptions. DBRS analyzes the data provided and applies an appropriate reduction to the anticipated residual value and extends the time required for realization and incorporate those items into the cash flow analysis to simulated economic stresses. This action may cause actual performance to differ from the manager's historical experience or the industry as a whole. The appropriate reduction shall be dependent on the manager's experience, the amount of historical data and the rating level sought for the securitization. Generally, for experienced managers with available information on residual value realization at the end of lease terms spanning a full economic cycle (usually 5-10 years), the credit for residuals for a particular rating level are as follows:

Credit for Residuals	
Rating Category	Residual Credit
AAA	30%-50%
AA	40%-60%
A	50%-70%
BBB	60%-80%
BB	70%-90%
B	80%-90%

Excess Spread

The anticipated cash flows are often structured to support the securitization obligations with some additional amount, or excess spread, built-in to absorb losses and variability. Excess spread is impacted by each of the aforementioned items which could reduce its availability at a given point in a transaction. Since even the most detailed analysis cannot resolve all variability, the rating process contemplates stressful events and default circumstances beyond those experienced by the sponsor/manager.

Scheduled and Legal Maturity

Each transaction is evaluated to determine if the structure permits the cash flows to pay timely interest and principal in accordance with the scheduled maturity date of the securities set forth in the transaction documents when anticipated losses and prepayments are consistent with base case expectations. The transaction is also evaluated to ensure, under the applicable stress scenarios, that the collateral and related cash flows can satisfy the transaction obligations within a reasonable time following the scheduled maturity - the legal final maturity date. The legal final maturity date for a transaction can vary based upon the asset type and transaction structure, but is typically no later than 12 to 24 months following the expiration of the underlying leases in the collateral pool.

Conclusion

Equipment lease securitization has become an important tool for financing the equipment industry. While some areas, such as micro- and small-ticket equipment, have been less active, new areas continue to develop. This report sets forth the DBRS methodology for rating equipment lease (and loan) securitizations. The analysis focuses on the sponsor/manager and the collateral pool, and uses the past performance of similar pools as an indicator of future performance.

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