

Automobile Leases¹

1. Characteristics of Automobile Leases

Auto leases, which are leases of cars including passenger cars and commercial vehicles, are divided into maintenance leases², in which a leasing company provides maintenance services, and finance leases without such maintenance services. In a finance lease, expenses for purchase payment for vehicles, payment for registration fee, tax and insurance payments (whether or not the non-life insurance other than automobile liability insurance is included in the services is left up to the discretion of lessee in general) are included in the lease fee. Lease fee for the finance lease is calculated by “Purchase Price for Vehicle + Charges during the Lease Term (tax, insurance, etc.) – Expected Value of the Vehicle at the End of the Lease Term” basically.

Chart 1. Maintenance Lease and Finance Lease

Contents	Maintenance Lease	Finance Lease
Purchase Price for Vehicle	Yes	Yes
Registration Fee	Yes	Yes
Automobile Tax	Yes	Yes
Automobile Liability Insurance	Yes	Yes
Automobile Acquisition/Weight Taxes	Option	Option
Voluntary Insurance	Option	Option
Automobile Inspection	Yes	No
Periodic Automobile Inspection (12, 6, 3 months)	Yes	No
Repair & Maintenance Fee	Yes	No
Replacement of Oil, Tire & Battery	Yes	No
General Repair	Yes	No
Accident Repair	Yes	in-between
Accident Treatment (Cooperation treatment with non-life insurance company)	Yes	in-between

Content of services vary depending on lease companies.

There are many cases where lessees can choose only parts of the services of the maintenance services (shaded area in the Chart).

In the maintenance lease, maintenance services for vehicle such as automobile inspection, inspection/repair & maintenance, replacement of oil and parts are included additionally, and the leasing companies add these charges to the leasing fee as their maintenance fee to calculate the amount claimed against the lessee (However, breakdown for each of these items is not necessarily clearly specified in the lease contract). Although in many cases leasing firms delegate the maintenance services to their affiliated repair & maintenance companies scattered nationwide and pay them for their services, there are some

¹ Please refer to http://www.jcr.co.jp/rat_stru/pdf/k_01_02.pdf for rating methodology for general leases securitization products.

² To be more precise, maintenance lease is a product name for customers, and it is a finance lease with special agreement on maintenance services in accounting terminology. Although computer lease with special agreement on maintenance services is called maintenance lease as well, maintenance lease indicates solely automobile lease with special agreement on maintenance services in this report.

cases in which leasing firms do repair & maintenance work at their plants.

In the domestic automobile lease transactions, ratio between maintenance lease and finance lease is roughly 6 to 4 according to Japan Leasing Association.

2. Issues on Finance Lease

(1) Addition of Tax and Insurance Premium Payments to the Required Subordination Amount

In securitization of general leases, the required subordination amount is the total of the following three loss amounts estimated under the stress scenarios: (i) Credit loss involving insolvency of the lessees; (ii) Loss from cancellation involving lump sum money paid upon such cancellation after the servicer replacement coming short of the amount of remaining lease payment; and (iii) Commingling loss involving commingling of collection money with originator's other assets in the event that the originator as servicer goes bankrupt.

In securitization of automobile leases, total amount of automobile tax, automobile weight tax (if it is included in the lease), automobile liability insurance, and voluntary insurance (if it is included in the lease) needs to be added to the required subordination amount in the form of cash reserve or overcollateralization in order for the lessee to continue to use the vehicle in the event that the originator can no longer pay tax and insurance premium owing to its default.³

(2) Addition of Tax and Insurance Premium Payments to the Required Liquidity Support Amount

In securitization of general leases, funds to be required in a period till remittance of the collection money to the SPV or trust resumes after the backup servicer takes over servicing operation of the originator as servicer in the event that it cannot conduct servicing operation as usual due to bankruptcy or other similar reasons, are reserved in the cash reserve account from the beginning as a liquidity support.

In securitization of automobile leases, even if the costs for the tax and insurance premium payments are reserved in the form of overcollateralization, of which total amount of automobile tax, automobile weight tax (if it is included in the lease), automobile liability insurance, and voluntary insurance (if it is included in the lease) to become due within 4 months after the originator as servicer goes bankrupt, needs to be reserved in the cash reserve account as an additional liquidity facility from the beginning in order not to delay the tax and insurance premium payments.

(3) Legal Issues

(i) Bilateral Executory Contract

It is stipulated under Article 53 of Bankruptcy Act that if both the bankrupt and its counterparty under a bilateral contract (a reciprocal arrangement between two parties where each has a duty to

³ In the case of overcollateralization, amount of addition should be determined after giving consideration to credit losses and impairment of receivables as a result of cancellation and commingling.

perform an act in exchange for the other party's act) have not yet completely performed their obligations by the time of commencement of bankruptcy proceedings, a bankruptcy receiver may cancel the contract. Article 49 of Civil Rehabilitation Act and Article 61 of Corporate Reorganization Act (hereinafter referred to as "Article 53 of Bankruptcy Act, etc.") are the same as this Article.

There used to be a prevailing legal interpretation that in the event that bankruptcy or similar proceedings against an originator was commenced and that bankruptcy receiver applied Article 53 of Bankruptcy Act, etc. to the securitized lease contracts, for the reason that they constitute bilateral contracts which are executory on both sides, the trust property might be reduced. However, since the Supreme Court decided on April 14, 1995 to deny the application of Article 103(1) of the former Corporate Reorganization Act, which is the same as Article 61 of the current Corporate Reorganization Act, to a full payout (a lessee enjoys an entire economic benefit of lease property substantially and bears its whole costs in effect) finance lease on the ground that use of the lease property in each month is not linked to lease payment for the same month, a full payout finance lease has been considered the one, to which Article 53 of Bankruptcy Act, etc. may not be applied.

(ii) Automobile Leases with residual value exceeding 10% of Purchase Price

Differences between a purchase price of lease property and a present value of the total lease payments during the lease term (residual value) tend to be large in the case of automobile leases due partly to the active used car market. Therefore, there are many automobile leases which do not fall under the full payout lease. As for the automobile leases with their residual value being above 10% of the purchase price, if the sum of the total lease payments during the lease term and the estimated amount of the lease property at the end of the lease term as a price of used property is designed to be able to recover the full amount of the expenses for the purchase of the lease property and other charges, such case is understood as follows: Use of the lease property in each month is not linked to lease payment for the same month, and such automobile leases have similar characteristics to full payout finance leases; therefore, Article 53 of Bankruptcy Act, etc. does not apply to this case.

Given that the new lease accounting standards began to apply to the leases in April 2008, JCR considers it necessary to watch whether or not the new standards can have any impact on the above interpretation and other issues on the lease securitization.

3. Issues on Maintenance Lease

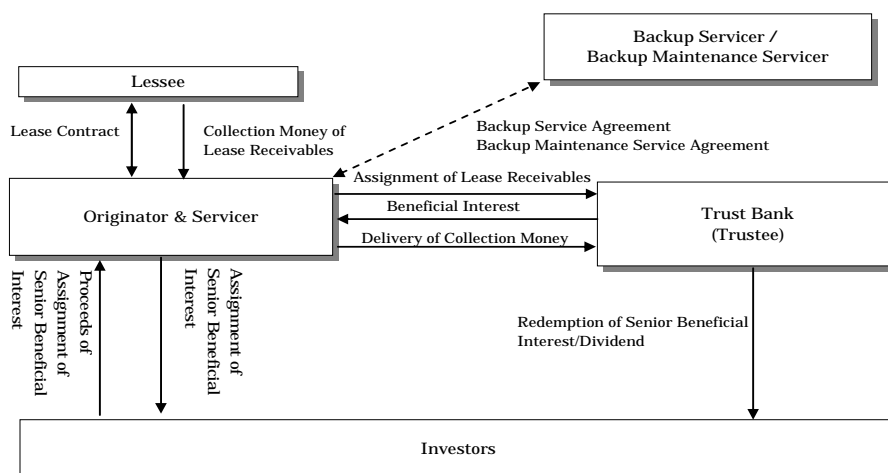
(1) Backup Maintenance Servicer

In lease securitization, a scheme is established to ensure that the trustee, etc. may cancel the servicing agreement and the backup servicer can take over the servicing operations in case that bankruptcy, civil rehabilitation, or corporate reorganization proceedings are commenced against the originator as servicer, resulting in disruption of its servicing operations.

In maintenance lease securitization, under the lease contract, the originator is obliged to provide the

maintenance services even after implementation of the securitization. Thus, in case that bankruptcy, civil rehabilitation, or corporate reorganization proceedings are commenced against the originator as servicer, resulting in disruption of its maintenance services, a backup maintenance servicer is appointed and it is ensured that it can take over the maintenance services in the event of the originator's bankruptcy.⁴

Chart 2. Maintenance Lease: Example of Securitization Scheme



(2) Legal Issues – Cancellation of Bilateral & Executory Contract

In a maintenance lease, in which the originator bears obligations to provide the maintenance services, even if such obligations remain on the originator's side as an executory obligation in the event of commencement of bankruptcy proceedings against the originator, it can be interpreted as follows: There is a risk that a bankruptcy receiver will exercise Article 53 of Bankruptcy Act, etc. and cancel the part of the special agreement on maintenance services in the lease contract. However, if the following points are met, it is taken that the possibility of cancellation of the whole lease contract, including the leasing in itself, is low.

- An automobile lease contract can be held to be a mixing contract which can be divided into the leasing and maintenance services due to the following natures:
 - Maintenance services fee is calculated in accordance with maintenance services separately from lease fee.
 - Lessee can choose with or without maintenance services at the time of making a lease contract.
 - During the securitization period, the maintenance fee receivable is managed separately from the main lease fee receivable.
- Even if special agreement on maintenance services exists, the automobile lease contract as a whole maintains the natures of a financial transaction.
 - Maintenance fee is not disproportionately larger than lease fee.

⁴ Concerning this point, refer to “Complete Collection of Finance Laws, Update” compiled by Nishimura & Partners (current Nishimura & Asahi) for the details.

- The maintenance services provided by leasing companies are typical as shown in Chart 1, and expenses for repair and replacement of parts exceeding the services clearly specified in the contractual document in terms of range and type of services are borne by lessee.
- As for the part of the leasing of the whole contract, use of the lease property in each month is not linked to lease payment for the same month.

(3) Practical Issues

In case where a lessee cannot receive maintenance services, there is a risk that the lessee will refuse to pay lease fee as a practical matter, even if its obligation to pay lease fee is legally clear regardless of whether the maintenance services are rendered or not. In dealing with this risk, a backup maintenance servicer is appointed in preparation for a situation where the originator cannot provide its maintenance services. Then, a question of possibility of the provision of the maintenance services by the backup maintenance servicer arises, and the following would be the points to determine the possibility.

(i) Content of Maintenance

Items of maintenance services provided by the originator are general ones such as legal inspection, replacement of parts including oil, tire and battery, repair at time of breakdown, and a maintenance service provider can be replaced with other maintenance service provider without difficulty. The securitized maintenance leases do not include a large vehicle (for example, more than or equal to 10 tons).

(ii) Creditworthiness of Backup Maintenance Servicer and Preparedness of Its Maintenance Service Provision

An automobile lease or general lease company with high creditworthiness should be selected for a backup maintenance servicer. It must have many leasing vehicles, satisfactory records of actual performance and capacity, and there should be no material differences in operating area with the originator.

(iii) Content of Backup Maintenance Services

A backup maintenance servicer should be appointed from the beginning of the securitization transaction by entering into the backup maintenance agreement, and legal framework of provision of services by the backup maintenance servicer after commencement of backup maintenance services is effectively designed.

(iv) Manufacturing Companies of Vehicles

If manufacturing companies of vehicles, which make up lease property, are not diversified, and in particular, when there is a concentration into the manufacturing companies with low creditworthiness, JCR considers it necessary to examine impact of a risk from a situation where it becomes difficult to get replacement parts and then the maintenance services cannot be provided continually, on the rating for the securitization.