

DuPont Morgan & LEASE-BACKED SECURITIZATIONS

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The SEC's adoption of a principles-based definition for ABS not only allows broad flexibility to the asset types that fall under Regulation AB compliance, but also includes a critical provision for lease-backed securitizations. The definition put forth by the SEC is essentially the same basic definition that has existed since 1992, but with the addition of specific language that states "...provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cashed proceeds from the disposition of the physical property underlying such leases." (1)

The SEC's awareness of the continued use and growth of lease-backed securitizations within the ABS market, along with support from many professional bodies and their respective comments, prompted the modification of the original ABS definition. However, though the SEC is well aware of the growth in lease-backed securitizations, the issue of "residual value" is subject to additional factors that are not present in securitizations backed solely by financial assets that convert to cash. (2)

Furthermore, the SEC states that assumptions and various modeling activities are needed to determine the actual residual value, and that the higher the percentage amount of cash flows that come from residual values, the more important other factors, such as modeling, become, and the less the overall transaction resembles a traditional securitization.

The SEC also favors what they call a "defined limited exception" regarding the overall limits on residual values, basing this on the simple fact that the core principles of asset-backed securities should be primarily serviced by financial assets that convert into cash. Professional bodies commenting on this particular topic felt there should not be a limit at all regarding the percentage amounts of residual values. However, the SEC has adopted disclosures on how residual values are derived along with establishing limits on the percentage of the securitized pool attributable to residual values for asset-backed securities.

(1) Securities and Exchange Commission 17 CFR Parts 210, 228, et al. Asset Backed Securities: Final Rule

(2) Securities and Exchange Commission 17 CFR Parts 210, 228, et al. Asset Backed Securities: Final Rule

As a result, a principal concern regarding lease-backed securitization is "...how residual values are estimated and derived, statistical information on historical realization rates and disclosures about the entity that will convert the residual values into cash." (3)

Furthermore, the SEC has proposed limits regarding cash flows to repay the securities that originate from the residual values of the physical property underlying the leases. For automobiles and all other loans, residual values shall not exceed 65% or more, and 50% or more, respectively, of the original asset pool at the time of the issuance of the asset-backed securities.

It's important to note regarding lease-backed securitizations the SEC's flexibility in responding to comments from professional bodies claiming the proposed percentages are too stringent. With the case of motor vehicles, residual value limits were initially set at a maximum of 60%, but subsequently raised this to 65%. Equally important, however, is the SEC's disclosure, requiring in-depth detail regarding many attributes relating to residual values. The combination of flexibility coupled with a strict adherence to particular elements for lease-backed securitization should be considered fair and practical by all in the industry.

(3) Securities and Exchange Commission 17 CFR Parts 210, 228, et al. Asset Backed Securities: Final Rule



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Charles Denyer, DuPont & Morgan, LLP
cdenyer@dupontmorgan.com

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