Association of Consumer Vehicle Lessors

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Federal Trade Commission
Office of the Secretary
Room H-113 (Annex V)
600 Pennsylvania Avenue, NW
Washington, DC 20580

Re: Motor Vehicle Roundtables, Project No. 104811

Dear Commissioners:

The Association of Consumer Vehicle Lessors ("ACVL") appreciates the opportunity to comment on certain topics set forth in the Federal Trade Commission ("FTC") notice announcing Public Roundtables on Protecting Consumers in the Sale and Leasing of Motor Vehicles and discussed at the November 17, 2011 Roundtable. ACVL is the national trade association for the largest manufacturer and import distributor captive finance companies, banks and independent leasing companies whose primary goals include increasing consumer understanding of lease benefits and responsibilities through improved disclosure.

ACVL submits this letter to offer background information on two vehicle leasing issues discussed at the November 17, 2011 Roundtable:

- Advantages to consumers of vehicle leasing compared to purchase financing; and
- Costs of leasing compared to purchase financing.

I. Advantages of Leasing

Virtually all consumer vehicle leases are "closed-end" in nature.[1] Under a closed-end lease, the lessee is not responsible for the difference if the actual value of the vehicle at the scheduled end of the lease is less than its residual value determined at the beginning of the lease (the "residual value").[2] Closed-end leasing can have a number of advantages compared to purchase financing. This letter summarizes some of the most significant consumer benefits.

[1] Unless otherwise stated, all subsequent references to leasing mean "closed-end" vehicle lease agreements written with consumers.

[2] However, the lessee may be responsible at scheduled termination for excess wear and excess mileage charges and for other lease requirements, which may include payment of a disposition fee.

A. Protection at scheduled termination from unexpected declines in used car prices.

A lessee has the right to return the vehicle at scheduled termination without any residual value obligation even if the market value at turn in is less than the residual value determined at the beginning of the lease.[3] Conversely, a purchaser who trades-in a vehicle must absorb the full amount of the depreciation.

Historical experience proves that closed-end leases provide valuable protection against a volatile wholesale used vehicle market. In some periods lasting several years, actual wholesale vehicle values of leased vehicles at lease end have averaged more than $4,000 less than their residual values.[4] For individual vehicles with depressed used car prices due to any number of factors (*e.g.*, high gas prices, reduced market prices and/or better technology and features on similar new vehicles, unpopular color, bad equipment combinations or an oversupply of that model in the used car market), consumers can avoid losses of as much as $8,000 to $10,000 or more in depreciation by leasing rather than purchasing.[5]

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[3] In a motor vehicle lease, the consumer pays the adjusted capitalized cost down to the residual value. If the vehicle has depreciated to a value at lease end that is less than the residual value, the consumer is not responsible for the difference. This "walk-away" feature is the distinguishing characteristic of a "closed-end" lease. It is subject to a contingent obligation to pay for any excess miles or excess wear. This is the case because the residual value established at the beginning of a lease is based on the assumption that the leased vehicle will be returned with no more than the allowed mileage and with only normal wear and tear.

[4] This was the case for vehicle leases terminating during 2000 through 2002 because they were written with high residual values during the strong economy from 1995 through 1998 and terminated during the 2000–02 recession. A similar phenomenon occurred for leases of low fuel efficiency vehicles written during the 2003–06 period that terminated during the 2008-09 period of high gas prices and the severe recession. In December 2008, vehicle average wholesale values (adjusted for age, mileage and equipment) fell to a 13-year low according to the Manheim Used Vehicle Value Index. Moreover, even when the average vehicle value at lease end is equal to the predicted residual value, there can be huge variations in actual vehicle values for different vehicle makes, models, equipment combinations and colors. For vehicle leases terminating in 2005, lessors lost an average of $2,328 on end-of-lease-term vehicles that were returned and sold for a loss. See "Table 33: 2005 full-term leases in which vehicles were returned to the lessor." 2006 ACVL Lease Survey.

[5] "By November 2008, total monthly residual losses on Fitch's portfolio of rated auto lease ABS had surpassed 20% of the securitized residual value." Fitch: Rebound in Used Vehicle Values Benefits U.S. Auto Lease ABS, October 14, 2009 (available at http://www.allbusiness.com/automotive/automotive-sector-performance/13218148-1.html.). Thus, a leased vehicle with a $40,000 residual value could have had a residual loss of over $8,000 in 2008.

Instead of vehicle leasing consumers bearing such unexpected losses in market value, the vehicle leasing companies do. In one period, vehicle lessors experienced residual value losses exceeding $10 billion.[6]

B. Ability to purchase at scheduled termination for a fixed purchase option price.

Although it is not required, virtually all vehicle leases that we have seen include an option to purchase the leased vehicle at scheduled lease end for a fixed purchase option price. Consumers thus have the opportunity to purchase the vehicle at lease end even if its wholesale value is greater than the purchase option price. The consumer with a fixed price purchase option has the opportunity to capture the excess value if the vehicle is worth more than the fixed purchase price. This "heads I win, tails you lose" feature is not part of purchase financing.

C. Reduced monthly payment.

Leasing typically results in a reduced monthly payment. Instead of paying for the entire purchase price of the vehicle, the lease customer pays for only the expected depreciation over the lease term (*i.e.*, the expected decline in vehicle value), plus a rent charge, taxes and fees such as a lease administration fee. Furthermore, the shorter the lease term, the higher the residual value, the smaller the expected depreciation and the bigger the difference in the monthly payment.

D. Protection from gap losses.

Unlike purchase financing, most leases we have seen include protection from responsibility for the "gap" between the vehicle insurance proceeds and the adjusted lease balance when the vehicle is stolen or is a total insurance loss. The "gap" may be smaller in purchase financing than in leasing due to higher down payments and larger monthly payments, but this means that the consumer has paid those higher amounts in connection with purchase financing.

E. Greater flexibility at lease end.

Leasing provides a lessee with more flexibility at lease end than that enjoyed by a purchaser at the end of the finance term. As a practical matter, most consumers only retain a new vehicle for 60 months.[7] Even if the consumer decides to purchase the

[6] "'As we saw in the final days of the last lease bulge [2000 – 2003] when the industry had a $10 billion shortfall between contract residuals and actual used values for those leased cars and trucks. . . . It drove many lessors out of the business.'" CNW Marketing "CNW Predicts Residual Value Loss Per Vehicle Growing Steeper," Auto Remarketing, January 21, 2010 (available at http://www.autoremarketing.com/content/trends/cnw-predicts-residual-value-loss-vehicle-growing-steeper).

[7] "Average Length of Ownership 2001 thru 2Q 2010," R.L. Polk, 2011.

vehicle at the end of the lease term, he or she has still had the benefit of the flexibility offered by leasing rather than having committed to purchase the vehicle up-front.

F. Reduced sales tax in most states.

Whereas a purchaser must pay sales tax on the entire vehicle value purchase price in virtually all states, most states tax leases only on the capitalized cost reduction (if any) and the monthly payments. Generally, sales tax rates are the same for leases and purchases.

G. Eliminates the need to negotiate the trade-in value.

When the vehicle is returned at scheduled termination, the consumer does not need to negotiate a trade-in value.

H. Protection from diminished value of repaired vehicles.

Leasing also provides protection from the diminished value loss that occurs when vehicles are damaged, even if they are repaired. When a damaged vehicle is repaired, it nevertheless is less valuable because a subsequent purchaser would not be willing to pay as much for it. When a leased vehicle is damaged, however, the consumer is only responsible for making the repairs (or paying for the repairs), not for the diminution in value. In contrast, if the consumer owns the vehicle, the consumer bears this loss because the trade-in value of the vehicle will be reduced by the diminution in value.

II. Costs of Vehicle Leasing Compared to Costs of Vehicle Financing

Vehicle leasing involves different contractual rights and obligations than purchase financing. A lessee contracts for the right to possess and use the leased vehicle during the lease term, at the end of which the lessee must return the leased vehicle unless he or she decides to exercise his or her option to purchase it. A purchaser who buys a vehicle on credit contracts to finance the purchase over the term of the contract, at the end of which the secured obligation is satisfied and the purchaser owns the vehicle. The different contractual rights and obligations associated vehicle lease and financed purchase transactions produce different payment obligations.

Lease payments are calculated to amortize the initial adjusted lease balance (also known as the adjusted capitalized cost) down to the preset residual value. Under a closed-end lease agreement, the lessee is not responsible for any portion of the preset residual value.[8] Conversely, the payments due under a retail installment sale contract

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[8] Lease payments are based upon the contractual expectation that the lessee will return the vehicle with no more than the allowed mileage and only normal wear and tear. Lessees who accumulate excess mileage

("RISC") or other purchase-money obligation typically are calculated to fully amortize the amount financed down to zero. Accordingly, because a vehicle lease is a partially-amortizing transaction and a purchase financing typically is a fully-amortizing transaction, the total contractual obligation under a vehicle lease agreement typically is substantially less than under a contract to finance the purchase of a vehicle, assuming the same rates and other terms.[9]

To account for the different contractual rights and obligations, and the different behavioral choices consumers may make at the end of a lease, a holistic and personalized comparison of economic costs would compare equivalent lease and financed purchase scenarios. For example, a lease scenario in which the lessee returns the vehicle at lease end would be compared with a purchase scenario in which the purchaser sells his or her vehicle at the same point in time, whether by means of a trade-in to a dealership or otherwise. Conversely, a lease scenario in which the lessee exercised his or her option to purchase the leased vehicle would be compared with a financed purchase scenario in which the purchaser retained ownership of his or her vehicle. Additionally, a holistic and personalized comparison of the economic costs associated with equivalent lease and financed purchase scenarios would take into consideration the timing differences of the various payments and credits under the various scenarios. The Division of Consumer and Community Affairs of the Federal Reserve Board ("FRB") has published a sophisticated comparative methodology of this nature.

The FRB Comprehensive Consumer Guide ("FRB Guide") contains detailed guidance on a methodology for consumers to compare costs of leasing and financed purchases and the features of these options from a personalized, economic perspective.[10] The basic methodology compares the costs incurred during the three relevant time frames in relation to the various scenarios and options available to the consumer:

- Up Front: Determine the up-front payments for the various lease and financing options;
- During Term: Determine the lease or finance monthly payments for the specified term;

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and those whose leased vehicles have excess wear therefore are also subject to an obligation to pay for any excess mileage and excess wear at scheduled lease end.

[9] There are also differences in sales tax (depending on the state) and certain fees (*e.g.*, disposition fees paid in connection with lease transactions) but these differences are of a smaller order of magnitude than the difference between the depreciation and any amortized amounts in a lease transaction and the amount financed in connection with a credit sale or a purchase-money loan transaction.

[10] The comprehensive version of the FRB Guide is available at http://www.federalreserve.gov/pubs/leasing/resource/default.cfm, which is part of the FRB Webpage entitled "Keys to Vehicle Leasing."

- End of Term: Calculate the amounts paid by or returned to the consumer depending on whether the vehicle is returned or retained at the end of the term.[11]

For the During Term and End of Term time frames, in order to make a symmetrical economic comparison of payments and credits that are made or issued at different times, the Net Present Value ("NPV") of the payment/credit must be calculated to reflect the time value of money.[12] The FRB Guide gives consumers the step-by-step guidance needed to make a complete and accurate comparison between the costs of leasing and purchase financing and the features of these options from a personalized, economic perspective.

CONCLUSION

ACVL thanks the FTC for the opportunity to comment on these issues and commends the FTC for its work in protecting consumers. Please feel free to contact me with any questions at 615-383-1930 or rmccathren@blcassociates.com.

Sincerely,

Randall McCathren
Managing Director

[11] The segregated Regulation M disclosures follow this same categorization scheme of Amounts Due at Lease Signing or Delivery (up front costs), Monthly Payments (costs during the term) and Other Charges.

[12] See FRB Guide, Using Lease–vs.–Buy Models, available at http://www.federalreserve.gov/pubs/leasing/resource/different/models.htm. The FRB Guide shows how a consumer, without resort to a financial calculator or spreadsheet, can incorporate the time value of money into the comparison by constructing a chart reflecting the "interest earnings/savings" on the payment differences.