

Defeasance by Design Update

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■ Summary

In May 1999, Fitch published a report that explained the major features of defeasance, a type of call protection that was becoming more prominent in commercial mortgage-backed securities (CMBS). The original report has been updated to address additional questions and changes in the defeasance process, which includes eligible securities and modifications to Fitch's review criteria.

What is Defeasance?

Bond defeasance has been common in public finance transactions, although defeasance of underlying loan obligations in asset-backed transactions has not been a regular occurrence. In the CMBS market, defeasance is the process of replacing a mortgage on real estate with U.S. government obligations or other eligible securities as substitute collateral for a loan, provided that the substitute collateral generates sufficient cash flow to match all debt service requirements. Defeasance is complex and costly but, nevertheless, appropriate for securities backed by static pools of large loans like those found in CMBS transactions.

Beginning in early 1995, only a small number of newly issued CMBS transactions featured loans locked from prepayment with defeasance options as a replacement for prepayment with yield maintenance. Today, loan defeasance has become widely accepted and is a structural characteristic in the majority of loans originated for purposes of securitization. This report answers many of the most frequently asked questions about defeasance.

How is Defeasance Accomplished?

Typically, the borrower pledges U.S. government obligations as substitute collateral for the loan to the trustee and then transfers the loan and assigns the substitute collateral to an unaffiliated special purpose entity (SPE) created for the sole purpose of receiving defeased loans.

Why is Defeasance in CMBS Transactions?

Defeasance satisfies different goals. While a borrower wants a prepayment option, a CMBS investor would prefer that the borrower has no option to prepay. A borrower seeks a prepayment option to refinance or sell the underlying real estate collateral at any time. A CMBS investor seeks the predictability of a yield, which is preserved through prepayment lockouts. Defeasance allows for the release of property to a borrower during a prepayment lockout period and provides a continued source of cash flow for the investor. Seeking to maximize proceeds by satisfying borrowers and investors, depositors establish vehicles and criteria for defeasance that will satisfy these divergent goals while preserving the integrity of the CMBS structure.

When is a Loan Defeased?

A loan is defeased only at the request of the borrower. Generally, the borrower must provide the lender with at least 30 days' written notice of intent to defease a loan. To protect the real estate mortgage investment conduit (REMIC) tax status of a CMBS transaction, defeasance is prohibited within two years of the securitization closing.

What Happens to the Loan?

The loan remains outstanding. If a loan is secured by several mortgages and the borrower seeks to defease a select mortgage, the borrower will transfer the defeased portion to the successor borrower and continue to be obligated on the remaining portion of the loan.

■ General Roles of the Parties

What is the Depositor's Main Role?

The depositor must create the proper documentation and vehicles for executing, holding, and administering defeased loans. The depositor should ensure that each borrower, trustee, servicer, and successor borrower is party to the appropriate documents and fully aware of all defeasance requirements.

What is the Borrower's Most Significant Obligation?

The borrower is responsible for pledging substitute collateral to the trustee and then transferring the loan and assigning the substitute collateral to the successor borrower.

What is the Role of the Successor Borrower?

The successor borrower replaces the borrower as the obligor under the defeased loan, is controlled by an independent trustee, and holds the funds from the U.S. government obligations in its name for the benefit of the trust. The successor borrower is not the holder of the defeased mortgage or the new owner of the property.

Generally, What is the Role of the Servicer?

The servicer is responsible for ensuring that all terms and conditions of defeasance in the pooling and servicing agreement (PSA) are satisfied. The servicer reviews the borrower's request and third-party requirements, submits a complete package to the rating agencies for review, and effectuates release of the mortgage.

What is the Role of the Rating Agency?

Fitch intends to review defeasance requests for any of the top 10 remaining loans in the pool or for any loans representing a top 10 borrower concentration. Fitch reviews the compliance letter from the servicer stating that each defeasance requirement has been satisfied and the required legal opinions. If the release of the original collateral will not adversely affect the transaction, Fitch sends a confirmation letter to the servicer stating that the defeasance will not result in a suspension, qualification, withdrawal, or downgrade on any of the current ratings assigned to the certificates. In the past, Fitch reviewed every defeasance transaction and affirmed the ratings on these deals. Therefore, Fitch has ascertained a level of comfort that the major servicers, along with servicer counsel, perform an adequate analysis to evaluate the defeasance proposal on behalf of the trust.

■ Purchase and Substitution of Collateral

What Costs are Incurred?

The borrower must have a sufficient amount of cash to purchase U.S. government obligations that will timely pay all scheduled interest and principal. In addition, the borrower must also pay all related costs and expenses. Related expenses include the cost of acquiring substitute collateral and fees for the legal opinions, comfort letter, and rating agency confirmation letter. No yield maintenance or prepayment premiums are due in connection with a defeasance. None of the costs should be an expense of the trust.

Who Buys the Substitute Collateral?

The borrower is responsible for purchasing the U.S. government obligations, but, as a practical matter, the borrower may hire an agent or bond trader to help the borrower identify what to acquire. The borrower must deliver instructions to its agent, specifying the amount and type of U.S. government obligations to purchase.

What Types of Collateral are Eligible for Substitution?

Eligible substitute collateral includes noncallable and nonprepayable obligations of the U.S. government or securities considered "government securities" as defined in the Investment Company Act of 1940. Permitted investments include U.S. Treasury obligations, direct obligations of Fannie Mae or Freddie Mac and interest-only strips issued by the Resolution Funding Corp. (RFC). Principal-only strips issued by the RFC are explicitly excluded. Cash flow

from the substitute collateral must be sufficient to timely meet all scheduled mortgage payments without reinvestment, including the balloon payment, and to pay all related expenses.

Who Determines if the Substitute Collateral is Sufficient to Cover Payments and Expenses?

The borrower must obtain a comfort letter from an independent public accountant who is a member of the American Institute of Certified Public Accountants (CPA) and experienced in assessing securities. The letter should certify that the cash flow from the substitute collateral will be sufficient to timely meet all scheduled mortgage payments. The servicer will provide the CPA with a statement of remaining debt service obligations.

Then, the borrower must deliver trade confirmations or other appropriate evidence that the substitute collateral purchased and pledged to the trust exactly reflect the amount, interest rate, and maturity dates of those in the comfort letter.

How is the Collateral Substituted?

The borrower delivers a pledge agreement pledging a first lien security interest in the substitute collateral to the trustee. The borrower represents and warrants that: it is authorized and has the legal right to pledge the collateral; no consents are required; it shall not execute or authorize any other liens or financing statements pertaining to the substitute collateral; and the execution and delivery of the pledge agreement will not result in a breach of any other contract or violate any law. Upon an event of default under the loan, the trustee shall have the right to enforce and collect payments or proceeds from the pledged collateral.

The servicer will execute a form release upon acceptance of the substitute collateral for any fully defeased mortgage provided that all defeasance requirements have been met.

Can Loans be Partially Defeased?

Loans cross-collateralized by multiple properties can be partially defeased if permitted by the loan documents. Specifically, loan documents should stipulate that the defeased amount on cross-collateralized pools be equal to 125% of the allocated loan balance for the property being removed. Furthermore, all other requirements necessary to execute a defeasance shall be applicable to the partially defeased loan.

Execution

The defeasance process should be executed in the following order of priority:

- Borrower delivers a notice of intent to defease to the master servicer 30 days prior to the proposed defeasance date.
- On or before the defeasance date, the borrower delivers the following to the servicer: a cash collateral deposit; an instruction letter; a comfort letter; and a form release of the mortgage.
- The borrower buys U.S. government obligations or securities and delivers the securities to the trust.
- Borrower delivers the following to the servicer: trade confirmation; a fully executed pledge agreement pledging the securities to the trustee; a fully executed assignment and assumption agreement between the borrower and special purpose entity; signed opinions of counsel; and an officer certificate certifying compliance with all conditions to defeasance.
- The master servicer delivers a copy of all materials received from the borrower to the trustee and rating agencies, along with a compliance letter stating that all defeasance requirements have been satisfied.
- The rating agencies execute a confirmation letter.
- The servicer executes the release of the mortgage and delivers it to the borrower.

What Happens to the Borrower?

Once the collateral is substituted, the borrower is usually replaced. The borrower has effectively prepaid the loan, and the trust prefers to distance itself from the credit risk of the original borrower. Consequently, at the servicer's request, the borrower is required to irrevocably transfer the loan and assign the substitute collateral to a successor borrower.

■ Execution

Who and What are Involved in the Defeasance Process?

Given that there are many parties and documents required in a defeasance, the procedure is quite complex and must be handled in a specific order, as shown in the box above.

■ Legal Requirements

Where are Defeasance Requirements Documented?

The mortgage loan documents contain requirements that the borrower must fulfill to defease a loan. The PSA contains requirements that the servicer must fulfill to accomplish the defeasance. Organizational documents limit the actions of the entity holding the defeased loan.

Does the Borrower Have to be an SPE?

A borrower preferably should be an SPE, particularly if the loan is one of the 10 largest loans in the pool at the time of securitization.

Who Creates the Successor Borrower?

Under most defeasance provisions, the borrower would either sell the property and hold the collateral itself or create a new SPE to hold the collateral and assume the loan. In most circumstances, it is preferable to have the successor borrower as a bankruptcy-remote SPE unaffiliated with the original borrower. For simplicity, the depositor can elect to establish a transaction-specific SPE to assume all defeased loans in the pool. The benefits of establishing a single SPE for the transaction include: lower defeasance transaction costs; easier administration by the servicer; lower risk of the borrower neglecting state franchise fees, taxes, or other entity requirements; and avoiding possible substantive consolidation or other bankruptcy risk with the initial borrower or its principals.

Are Loans Eligible for Defeasance at any Time?

At the time of defeasance, the loan may not be in default. The loan must be paying in accordance with the terms and conditions of the note as of the cutoff

date. A mortgage may not be defeased unless the original loan documents provide for defeasance.

What Types of Legal Opinions are Required?

To mitigate the risk of bankruptcy of the successor borrower, the depositor must give the servicer a nonconsolidation opinion with respect to any transaction SPE as successor borrower.

The borrower delivers a security interest opinion to the servicer confirming that the trust has a legal and valid first-priority perfected security interest in the substitute collateral and all proceeds thereof under the appropriate applicable state law.

An attorney should prepare an enforceability opinion concluding that the subsequent assignment and assumption of the substitute collateral and obligations of the original borrower to the successor borrower do not affect the validity, enforceability, or priority of the first-priority perfected security interest granted to the trust.

The borrower's counsel must produce a REMIC opinion confirming that defeasance will not adversely affect the status of any REMIC in the transaction or impose a tax (there is typically a two-year lockout period for any defeasance).

■ Surveillance

How Does Defeasance Affect CMBS Ratings?

A defeased loan secured by U.S. obligations is less risky collateral than a loan secured by commercial real estate. Ultimately, if a sizable portion of a CMBS pool is defeased, an upgrade may occur due to the reduced risk of default and loss.

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