U.S. CMBS: 2007 Defeasance Activity Set New Record Despite Midyear Slowdown

AUTHORS:

Sandra M. Ruffin
Senior Credit Officer
(212) 553-4074
Sandra.Ruffin@moodys.com

Gordon Sinclair
Assistant Vice President
(212) 553-7149
Gordon.Sinclair@moodys.com

CONTACTS:

Tad Philipp
Managing Director
(212) 553-1992
Tad.Philipp@moodys.com

Michael M. Gerdes
Senior Vice President
(212) 553-4776
Michael.Gerdes@moodys.com

Brett Hemmerling
Investor Liaison
(212) 553-4796
Brett.Hemmerling@moodys.com

WEBSITE:
www.moodys.com

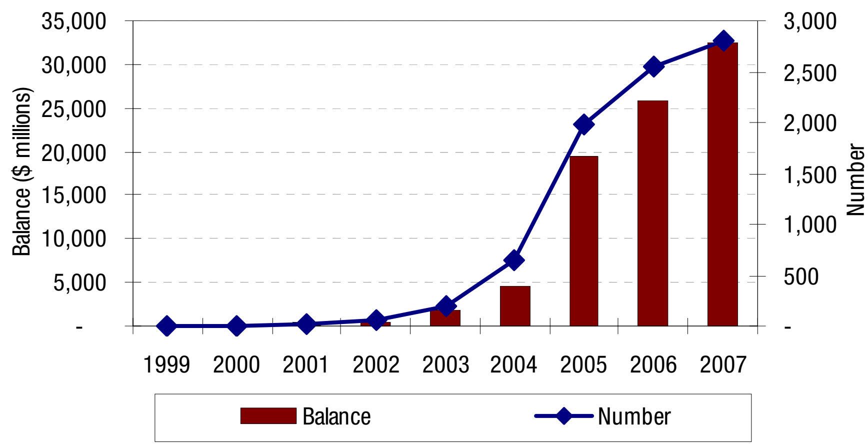
CONTENTS

- Overview
- Real Estate Appreciation Strong in 2007
- 2007 Defeasance up 25% over 2006 Levels
- Review of 2007 Defeasance Activity
- Defeasance may have Less Credit Impact on Seasoned Deals
- Appendix

OVERVIEW

Real estate appreciation continued to be strong in 2007, leading to a surge of defeasance in the first half of the year. However, defeasance tapered off significantly in the second half of 2007 due to a lack of liquidity and the resultant decline in CMBS loan originations. Even with this decline, defeasance in 2007 was 25% higher than in 2006. Almost 3,000 loans with an outstanding balance of $32.4 billion defeased in 2007, compared to $25.9 billion in 2006 (See *Figure 1*).

Figure 1
Balance and Number of Defeased Loans Per Year
(Based on Loan Balance at Defeasance)



Moody's has published a number of studies which have discussed the defeasance process and reviewed cumulative defeasance activity[1]. This report focuses only on defeasance activity in 2007, not the full universe of outstanding defeased loans, in order to highlight recent defeasance trends.

1 Moody's previous special reports include U.S. CMBS: Defeasance Benefits Borrowers and Investors, April 1, 2005; U.S. CMBS: Strong Real Estate Appreciation Drives Defeasance to Record Levels, March 27, 2006 and U.S. CMBS: Strong Commercial Property Appreciation Fuels Defeasance, March 19, 2007.

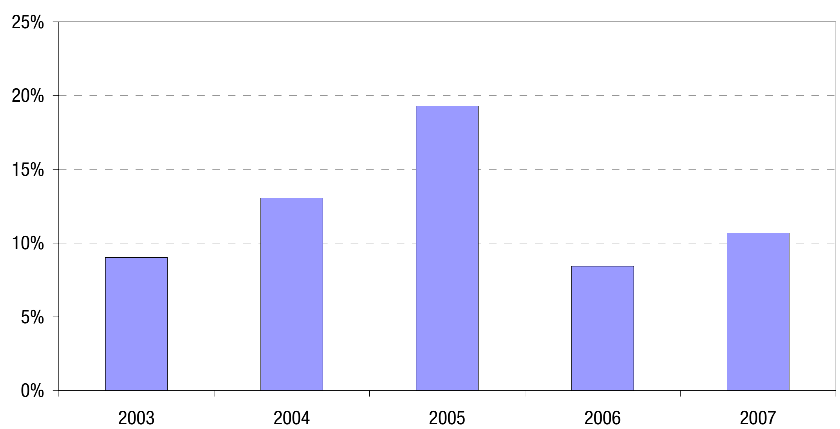
The key findings of this report are as follows:

- Almost 3,000 loans totaling $32.4 billion defeased in 2007. This represented a 25% increase over 2006 defeasance volume. Defeasance fell off significantly in the second half of the year due to the liquidity crunch affecting the CMBS market. Defeasance in the fourth quarter, which reflected the full impact of the liquidity crunch, was approximately 53% lower than defeasance activity in the same period in 2006.
- In 2007, office, multifamily and retail represented the largest share of defeasance by aggregate loan balance, at approximately 34%, 20% and 19%, respectively. The largest share of defeasance by loan count was multifamily, at 30%, followed by retail and office, at 25% and 20%, respectively.
- As in previous years, small balance loans accounted for a significant share of the number of defeased loans. Approximately 50% of the loans that defeased in 2007 had balances that were less than $5 million. These loans, however, represented only 12% of the aggregate balance of defeased loans. Approximately 9% of defeased loans were larger than $25 million, but this subgroup represented approximately 49% of the aggregate loan balance.
- The largest share of defeasance occurred in transactions issued in 2004 and 2005, at 39%. Only 8% of aggregate defeasance occurred in transactions issued 1998 and earlier.
- Strong property appreciation and a robust lending environment during the first half of the year made it attractive for even relatively recently securitized loans to defease. Approximately 16% of the aggregate balance of defeased loans had only seasoned two years (i.e., were securitized in 2005), compared to 13% in 2006 (loans securitized in 2004) and 6% in 2005 (loans securitized in 2003).

REAL ESTATE APPRECIATION STRONG IN 2007

Based on Moody's Real/Commercial Property Price Indices (CCPI), real estate appreciation remained strong in 2007, at approximately 10%[2]. Real estate appreciation has increased in excess of 5% every year since 2003, peaking at 19% in 2005 (See *Figure 2*).

Figure 2
Real Estate Appreciation



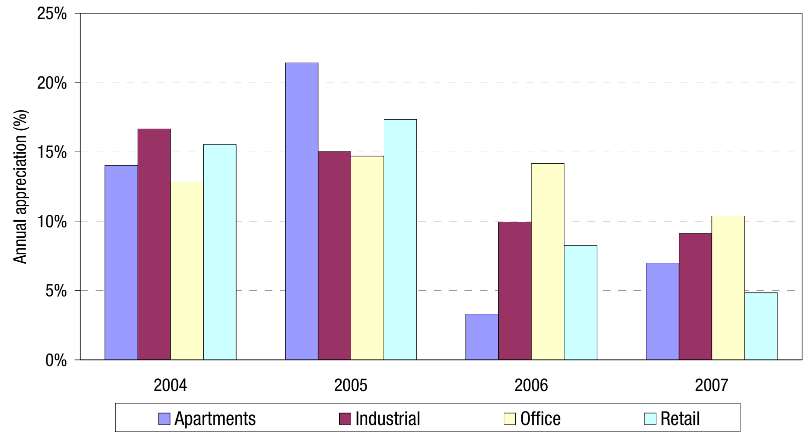
Source: Moody's REAL/CPPI

2 Moody's REAL/CCPI is a measure of the change in actual transaction prices for commercial real estate assets based on the repeat sales of the same assets at different points in time. A summary or short version of the repeat sales methodology is available in Moody's Special Report, Moody's Publishes the First Commercial Property Price Indices Based on Commercial Real Estate Repeat Sales Methodology, September 19, 2007.

Moody's CPPI also tracks appreciation by the four core commercial property types: office, retail, multifamily and industrial. All these property types have experienced value appreciation since 2004, although industrial, office and retail experienced less appreciation in 2007 than in 2006 (See *Figure 3*). Capital appreciation in 2007 ranged from approximately 5% to 10% for each of the major property types, with the highest levels for office, at 10%, followed by industrial, at 9%.

Figure 3

Appreciation by Property Type



Source: Moody's REAL/CPPI

2007 DEFEASANCE UP 25% OVER 2006 LEVELS

The tremendous growth of defeasance that CMBS has experienced since 2004 continued into 2007. Defeasance activity in 2007 was 25% higher than 2006 volume, which itself was 33% higher than 2005 volume. The 2007 increase was due to the torrid pace of defeasance in the first half of the year, which was 42% higher than for the same period in 2006. In fact, defeasance activity for the first half of 2007 equaled full year 2005 defeasance volume and represented almost 75% of volume for 2006. However, activity dropped off significantly in the second half the year. The fourth quarter experienced the full brunt of the liquidity crunch and defeasance activity was 53% less than during the same period in 2006.

Looking forward, we expect that defeasance volume will be negatively affected by the tapering off of real estate appreciation and reduced liquidity - the same forces affecting the CMBS market generally.

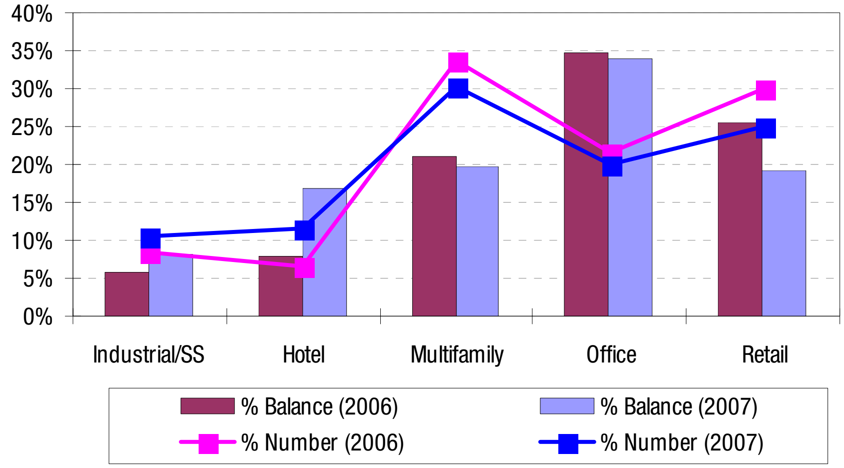
REVIEW OF 2007 DEFEASANCE ACTIVITY

Defeasance by Property Type

Loans originally secured by office properties represented the largest share of the aggregate defeasance balance, at 34%, followed by multifamily and retail, at 20% and 19%, respectively. This is a modest shift from 2006, in which office represented 35% of the aggregate balance, followed by retail and multifamily, at 26% and 21% (See *Figure 4*). The large share of defeasance of office properties over the past two years is not surprising given the appreciation gains of this property type during this period. Office values grew 39% during the past three years, while multifamily and retail values increased by 32% and 30% over this same period.

In 2007 we saw a continued increase in the share of defeasance of loans secured by hotels. Approximately 17% of the aggregate defeasance balance was represented by hotels, compared to 8% in 2006. Although this property type is not covered in Moody's CPPI, NCREIF data indicates that hotel properties have realized a cumulative increase in value of almost 33% since 2005.

Figure 4
Defeasance by Property Type - 2006 versus 2007

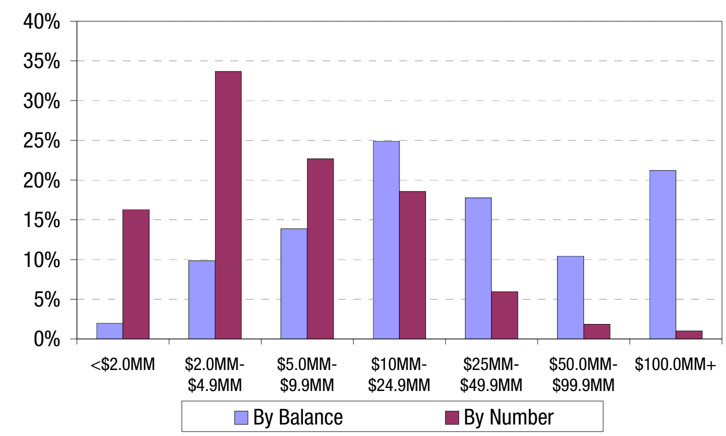


If one looks at property type distribution by loan count rather than aggregate balance, multifamily represents the largest share of defeasance, at 30%, followed by retail and office, at 25% and 20%, respectively.

Defeasance by Loan Size

The majority of defeased loans had relatively small balances at the time of defeasance. Approximately 50% of the loans that defeased in 2007 were less than $5 million in size. These loans, however, only represented 12% of the aggregate defeasance balance. On the other hand, while only 9% of defeased loans were $25 million or larger, these loans represented 49% of the aggregate defeasance balance (See *Figure 5*).

Figure 5
Distribution of 2007 Defeasance by Loan Size

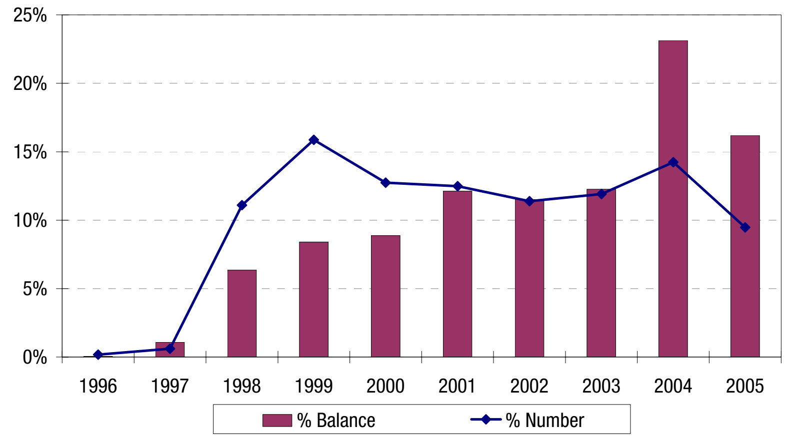


Approximately 1% of loans that defeased in 2007 had a balance of $100 million or greater at the time of defeasance. Although small in number, these loans represented 21% of the aggregate defeased balance. It is interesting to note that 50% of this group is represented by loans originally secured by office, with 44% of the properties located in New York City. The next largest shares within this group are hotel (27%), followed by industrial (12%) and retail (11%).

Defeasance by Vintage

A relatively small share of defeased loans, 8% by aggregate balance, is from transactions issued in 1998 and earlier. This is not surprising since defeasance was available only to a limited extent prior to 1998 and a significant amount of defeasance from these vintages has already occurred in previous years. The largest single concentration of defeased loans, by aggregate balance, is from 2004, at 23%, followed by 2005, at 16% and 2003 and 2001, each at 12% (See *Figure 6*).

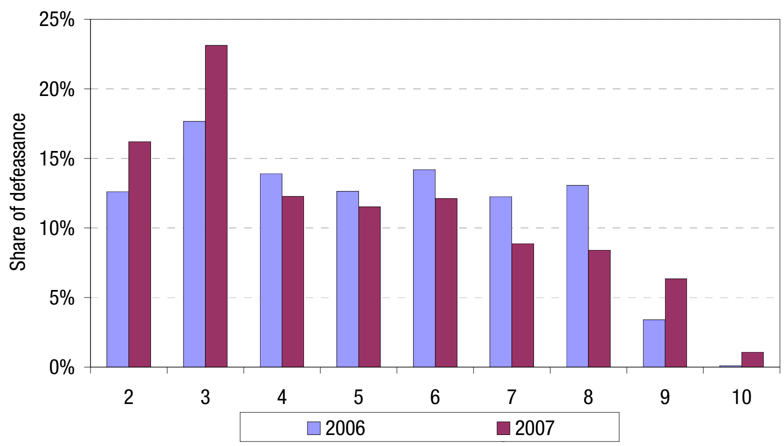
Figure 6
Distribution of 2007 Defeasance by Vintage



Defeasance by Seasoning

A review of the seasoning patterns of defeased loans highlights the impact recent appreciation gains have had in significantly increasing borrowers' equity in their real estate holdings in relatively short periods of time. In particular, given the cost of defeasance, the increase in the defeasance of relatively "young" loans demonstrates a favorable cost/benefit tradeoff even if a loan has only seasoned two or three years. Approximately 16% of the aggregate defeasance balance had only seasoned two years (i.e., were securitized in 2005), compared to 13% in 2006 (loans securitized in 2004) and 6% in 2005 (loans securitized in 2003). The comparison of seasoning for loans defeased in 2007 compared to 2006 is presented in *Figure 7*.

Figure 7
Distribution of Defeased Loans for 2006 and 2007 by Years of Seasoning



DEFEASANCE MAY HAVE LESS CREDIT IMPACT ON SEASONED DEALS

The dramatic growth of defeasance over the past several years had a significant positive impact on the credit quality of seasoned CMBS pools. Many pools from seasoned vintages contain defeased loans in excess of 25% of the pool's outstanding balance. Although defeasance in and of itself is a positive credit feature, it may not always contribute to an upgrade of Moody's ratings. As a pool's share of defeasance increases, in particular when it reaches 30% or more of the outstanding balance, significant defeasance levels may contribute to increased loan concentration among the remaining pool. Defeased loans are not included in Moody's calculation of pool's diversity, as measured by the Herfindahl score (or "Herf")[3]. As the non-defeased portion of the pool becomes significantly less diverse, Moody's requires additional subordination for that portion of the pool in order to protect from potential volatility posed by high loan concentration.[4] Delinquency rates have the potential to ramp up much more quickly in low Herf deals. Therefore, if increased defeasance negatively impacts pool diversity, Moody's may require higher subordination levels for the remainder of the pool which may serve to offset the positive credit impact of defeasance. Since defeased loans are secured by Aaa government securities, Moody's does not require credit support for the share of the pool that has defeased.

3 The Herfindahl score is the inverse of the Herfindahl-Hirschman Index or HHI. The HHI is used to measure the size of firms in relation to their industry (or market share concentration) and is used by the US Department of Justice in antitrust cases.

4 See U.S. CMBS: Conduit Loan Diversity - Why the Herfindahl Score Matters, November 9, 2007.

APPENDIX 1: SUPPORTING STUDY DATA[5]

Table 1

Defeasance By Balance and Loan Count Per Year

Year of Defeasance	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
2000	50,051,145	0.1	8	0.1
2001	425,640,766	0.5	25	0.3
2002	376,354,719	0.4	61	0.7
2003	1,795,351,385	2.1	192	2.3
2004	4,618,106,267	5.4	647	7.8
2005	19,450,867,908	22.9	1,980	23.9
2006	25,865,842,182	30.4	2,549	30.8
2007	32,415,267,103	38.1	2,810	34.0
TOTAL	**84,997,481,475**	**100.0**	**8,272**	**100%**

Table 2

2007 Defeasance by Property Type

Property Type	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
Office	11,021,230,983	34.0	561	20.0
Multifamily	6,388,903,906	19.7	849	30.2
Retail	6,250,894,575	19.3	699	24.9
Industrial/Self Storage	2,641,109,015	8.1	292	10.4
Lodging	5,434,347,598	16.8	328	11.7
Mixed Use	445,618,268	1.4	45	1.6
Healthcare	202,102,244	0.6	30	1.1
Other	31,060,515	0.1	6	0.2
TOTAL	**32,415,267,104**	**100.0**	**2,810**	**100%**

Table 3

2007 Defeasance By Loan Size

Loan Size ($MM)	$ Balance at Defeasance	%Balance	No. of Loans	% Loans
< $2.0	642,155,716	2.0	458	16.3
$2.0-4.9	3,190,348,963	9.8	946	33.7
$5.0-9.9	4,498,648,471	13.9	637	22.7
$10.0-14.9	3,327,450,151	10.3	273	9.7
$15.0-19.9	2,740,199,936	8.5	159	5.7
$20.0-24.9	2,005,080,936	6.2	90	3.2
$25.0-49.9	5,757,393,019	17.8	167	5.9
$50.0-99.9	3,381,872,080	10.4	52	1.9
> $100.0	6,872,117,831	21.2	28	1.0
TOTAL	**32,415,267,104**	**100.0**	**2,810**	**100%**

Table 4

2007 Defeasance By Vintage

Vintage	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
1996	14,692,895	0.0	5	0.2
1997	348,998,045	1.1	17	0.6
1998	2,059,207,723	6.4	312	11.1
1999	2,725,401,383	8.4	446	15.9
2000	2,877,468,019	8.9	358	12.7
2001	3,929,651,332	12.1	351	12.5
2002	3,734,668,503	11.5	320	11.4
2003	3,975,800,392	12.3	335	11.9
2004	7,496,749,912	23.1	400	14.2
2005	5,252,628,898	16.2	266	9.5
TOTAL	**32,415,267,103**	**100.0**	**2,810**	**100%**

5 Data for this study was provided by Commercial Defeasance, Wachovia Securities, Capmark Securities Inc., Chatham Financial, Bank of America, TriMont Real Estate Advisors, Waterstone Capital Advisors, Defeasance Group, Capital Defeasance Group, Defeasit and AST.

Doc ID# SF125196