

Defeasance: What is it and why is it so prevalent?



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Defeasance is the preferred form of call protection for fixed-rate conduit/commercial mortgage-backed securities (CMBS) loans.

Nearly every CMBS loan on all property types originated nationwide since 1998 requires the borrower to defease the loan before selling or refinancing. Put simply, defeasance is a substitution of collateral. It is not a simple prepayment but a 30-45 day financial and legal process. The borrower has more flexibility with defeasance because of the ability to defease loans at par or even at a discount. There is also a high level of standardization of defeasance provisions. Note that REMIC regulations prohibit defeasance during the first two years from the date the loan is securitized (not the date the loan was closed).

What is involved in the defeasance process?

Typically, the borrower uses proceeds from the sale or refinance to purchase a portfolio of U.S. government securities that is sufficient to make all of the remaining debt service payments. The securities are pledged to the lender, and the lender releases the real estate from the lien of the mortgage. The promissory note, which remains outstanding, and the portfolio of securities are assigned by the borrower to a successor borrower who makes the ongoing debt service payments. The defeasance process is complicated which is why a defeasance consultant should facilitate the process. An experienced consultant should be able to outline the process and provide a checklist of items with deadlines to be completed by each party to meet the borrowers closing deadline. There are a number of defeasance reports, agreements and opinions to be completed before closing. The third parties that may be involved include: borrower, borrower's counsel, REMIC counsel, primary servicer, master servicer, special servicer, servicer counsel, accountant, custodian/securities intermediary, special NY counsel, title company, rating agency, securities broker, successor borrower, successor borrower counsel and escrow agent. The defeasance concludes with a 2 or 3 day closing process which also including structuring the last securities portfolio which will determine the final cost of the defeasance.

Current defeasance market

According to a Moody's Investor Service March 2008 report, of the almost 3000 loans defeased in 2007, multifamily represents the largest share of defeasance at 30%, followed by retail and office at 25% and 20% respectively. They also note that approximately 50% of the loans defeased in 2007 were less than \$5 million in size and 9% were \$25 million or larger. Given the recent widening of CMBS spreads in 2008 and the general reaction to uncertainty about spreads in the CMBS lending community, there are not a significant number of loans of any kind closing. Since defeasances are typically coordinated with an associated sale or refinance, there may not be many defeasances closed in the first half of 2008. However, some in the industry are predicting that if the market settles down in the coming months, conduit loans, and by association, defeasances, will be back with a vengeance later in the year as pent up demand is released. For those that haven't been through a defeasance, the lull could be used to learn about the defeasance process. For those that have been through a defeasance, this time could be used to gather loan documentation and

submit it to a defeasance consultant for assistance in estimating defeasance costs. If a 2nd half rush comes to fruition, those that have used this market interruption wisely will be prepared to move quickly and secure the best chance of completing their transaction quickly.

How much does a defeasance cost?

Using an online defeasance calculator, like the one found at www.defeasewithease.com, is the first step. The defeasance cost is comprised of two components; the securities cost and the third party transaction fees. The securities cost is a function of the spread between the loan coupon and the yield on the securities on the date the securities are purchased. Generally, if the loan coupon is higher than the average yield on the securities, there is a defeasance premium; if the loan coupon is lower than the average yield on the securities, there is a defeasance discount. Several loans with interest rates around 5% were defeased last year. In other words, the cost of the government securities that served as the defeasance collateral was lower than the outstanding balance on the loan.

Engaging a defeasance consultant

Before engaging any defeasance consultant, ask how many "defeasances" they have closed, request references, obtain a written cost estimate, and always get a written engagement letter. If you have a unique transaction such as a partial, multi-loan or New York-Style defeasance a more experienced consultant should be able to anticipate and avoid any issues before they occur. Knowledge, responsiveness and pro-active transaction management will save valuable time and money, so the borrower, broker and borrower's counsel can focus on the sale or refinance with complete confidence that the defeasance will close on schedule. For those that have not been through a defeasance, it is important to learn about the process. The first step is to gather your loan documentation and submit it to a defeasance consultant for help in estimating defeasance costs well before your anticipated sale or refinance. ■

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Knowledge

Since facilitating one of the earliest CMBS defeasances in 2000, we have continuously remained the industry leader by creating new innovations and exceeding our clients' expectations.



Responsiveness

Defeasance is and always has been our main focus. Our proactive transaction management has streamlined the process to save you valuable time and money.



Experience

We have defeased thousands of commercial loans nationwide from small, single loan defeasances to large, complex multi-loan defeasances with every major CMBS servicer.



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