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CMBS witnesses defeasance become penalty alternative

Since 1996, the \$300 billion commercial mortgage-backed security (CMBS) or conduit market witnessed defeasance become a preferred alternative to yield maintenance and other prepayment penalties. As real estate values soar and the availability of cheap capital remains, real estate professionals must understand the opportunities, as well as the pitfalls, of loans with the defeasance provision.

In the CMBS market, defeasance is the process of replacing a mortgage secured by real estate with a basket of U.S. Government Securities. The securities purchased pay interest and redeem the principal in an amount equal to the loan's monthly debt service and balloon payment. In essence, the note remains, but the mortgage is released allowing the borrower to sell or refinance his property. As a general rule, the smaller the spread between the loan coupon and the yield on the comparable maturity treasury, the less expensive the defeasance will be.

Technically, a loan with the defeasance provision is prohibited from prepayment for the entire loan term (unless, of course, the loan is defeased). Secondary financing is also prohibited, so borrowers who want to refinance or sell their properties are faced with the complex task of defeasance.

Defeasance provisions in loan documents began showing up as early as 1995, but became more widespread with the boom in the conduit market (1997-1998.) Defeasance came about to help sell the conduit loans in the secondary market because the buyers of CMBS bonds prefer defeasance to yield maintenance for various reasons.

Moreover, because the provision helped sell bonds, it also helped reduce the interest rate the borrower pays. In addition to the reduced financing costs, defeasance can be cheaper than yield maintenance. While it is typical in standard yield maintenance for the borrower to pay at least a 1% prepayment penalty, defeasance has no such requirement. Should interest rates increase to a point above the interest rate on the loan, theoretically, the loan could be paid off at a discount. Defeasance also acts as a hedge. If rates go up, the cost of the defeasance is less, but refinance costs are higher. Conversely, when rates go down, the defeasance cost is greater, but the refinance costs are less. A lower refinance cost is advantageous because hopefully, the borrower is refinancing for more money and for a longer term.

Borrowers currently have an excellent opportunity to refinance loans originated between 1996 and 1998. Most likely those loans represent substantial appreciation, and the currently low refinance rates make them prime candidates for pulling out equity. If you think your property is a candidate for refinancing, you can get an estimated defeasance cost online at www.defeasewithease.com.

Commercial Defeasance, LLC makes available, without charge, online defeasance calculators for those interested in including a calculator on their web site. The online calculator will give security costs as well as transaction costs. In addition, if the loan is not still locked out, the borrower can make future projections on interest rates so a sensitivity analysis can be performed.

Once a borrower has decided to proceed with the transaction, he and

his counsel must be very aware that the defeasance is a complicated process and, in fact, usually involves more parties than the refinance or sales transaction. Because of the complexity, a borrower typically engages a defeasance consultant. Even the largest investment banks and REITs use defeasance consultants to assist in the process.

The role of the defeasance consultant is to take the lead on the transaction and work with borrower's counsel for the benefit of the borrower. The consultant must be knowledgeable about the securities as well as the legal and structural issues. For example, most defeasance transactions fall under New York jurisdiction and require New York perfection and enforceability opinions. A good consultant knows this and will have developed relationships with several New York law firms to provide the opinions at a reduced rate. The importance of a defeasance consultant who completely understands the process and the legal documents will mean the difference between saving on transaction fees and a delayed closing with unnecessary additional cost.

In addition to transaction management, the defeasance consultant provides significant savings to the borrower in the optimization and bidding of the Government Securities. The greatest cost in a defeasance is the purchase of the securities used as the defeasance collateral. Unfortunately, without a consultant, borrowers typically pay too much for the securities. Because a defeasance portfolio consists of multiple securities, the borrower will pay the cost, plus some mark-up, although the mark-up is nearly impossible to calculate

without knowing where each security was purchased.

Our firm has seen a \$35,000 mark-up on a \$2 million purchase of securities. We accomplished the same purchase through another broker dealer for \$3,500. On this transaction, the borrower paid us \$10,000 to act as a consultant, but we saved him over \$30,000 on the securities alone. Because most borrowers do not normally purchase Government Securities on a daily basis, they will never get the cost savings (reduced mark-up) that a consultant can provide.

Our company takes the position that the consultant's fees should be a set fee and not a mark-up of the securities. In this way, the borrower knows exactly what he has paid for the securities.

In today's market, defeasance has become an attractive alternative for borrowers wishing to refinance or sell their assets. Borrowers must be aware, however, that defeasance is a highly technical and complicated process involving the coordination of twenty-plus different parties including rating agencies, trustees, servicers and securities intermediaries in addition to specialty legal and accounting professionals. For a small fee, a prudent borrower will engage a defeasance consultant to manage the transaction. A professional defeasance consultant can save the borrower potentially tens, of thousands of dollars - not to mention many hours and the inevitable stress of the complex, time-sensitive defeasance process.

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