

## **Defeasance 101**



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Jun 27, 2008

### **What is defeasance?**

In the United States and Canada, many fixed-rate loans that encumber self-storage and other property types strictly prohibit prepayment during the term of the loan, if the lender securitized the loan (transferred it and other loans to a trust that issued bonds backed by the mortgages). However, most loan documents do allow the borrower to “defease” the loan in order to obtain an early release of the real estate collateral for a sale or refinancing. In many cases, a property owner may not know whether or not the lender securitized the loan, so it’s best to check the note, mortgage and loan agreement (if there is one) for a defeasance provision. If the documents do contain a defeasance provision, an experienced defeasance facilitator can help you determine whether the loan is still in its initial two year defeasance lock-out period (required by REMIC regulations) or is eligible for defeasance at that time. Note that the two-year period during which defeasance is prohibited commences when the loan is securitized by the lender (not on the closing date of the loan). Put simply, defeasance is a substitution of collateral. It is not a simple prepayment but a 30-45 day financial and legal process.

### **What is involved in the defeasance process in the United States?**

In the United States, a borrower typically uses proceeds from a simultaneous 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. As part of the defeasance, the promissory note, which remains outstanding, and the portfolio of securities are assigned by the borrower to a successor borrower who is responsible for making the ongoing debt service payments after the defeasance. The borrower is released from most future liability under the loan, and any remaining liability is contingent or remote enough that many borrowers fully deduct the defeasance premium and costs in the year in which the defeasance closes (the same as if the loan had been paid off).

### **How is the defeasance process different in Canada?**

Similar to U.S. defeasances, the borrower in a Canadian defeasance pledges to the lender a portfolio of government bonds which are sufficient to make all remaining debt service payments in replacement of the real estate security. However, there are slight differences. Once the bonds are pledged to the servicer and delivered to a third party custodian who holds them for the servicer, the servicer will instruct the lender to discharge the mortgage or “charge” of record. However, the borrower is not released from any of its obligations, other than those related specifically to the land. For example, the obligations of the borrower under the Commitment Letter survive, but after defeasance, payment and performance are secured by the government bonds.

### **How much does a defeasance cost?**

Using an online defeasance calculator, like the one found at [www.defeasewithease.com](http://www.defeasewithease.com), is the first step in determining the cost of a defeasance. There are two cost components to a defeasance; 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. Unless a borrower pays to hedge the cost of the securities, the securities cost fluctuates constantly with the market until the securities are purchased at the defeasance closing. The other cost component, third party transaction fees, is pre-populated on most website calculators based upon the past experience of the calculator sponsor with various defeasance participants. Of course, anyone that does not want to try to generate their own cost estimate on-line can always contact an experienced defeasance facilitator who will do it for them. Depending upon the facilitator's projections and policies regarding any residual value that could be returned to the successor borrower when the loan is paid in full, there may also be an opportunity for the borrower to receive a present value payment of a portion of the estimated residual at the defeasance closing to help reduce the overall cost of the defeasance.

### **Current defeasance market**

According to a Moody's Investor Service March 2008 report, of the almost 3,000 loans defeased in 2007, Industrial/Self Storage represents slightly over 10%. Moody's also notes that approximately 50% of the loans defeased in 2007 were less than \$5 million in size and only 9% were \$25 million or larger.

Given the continued 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 CMBS loans being originated. Because capital is not readily available at prices borrowers deem reasonable and most sales and refinances are dependent on third party capital, there has been and will continue to be a reduction in the number of sales and refinancings, and therefore defeasances, in 2008. However, given the efficiency of the capital markets, most market commentators expect the CMBS market to right itself and begin to recover in late 2008 and early 2009. In the mean time other sources of capital, like regional banks, insurance companies and government agencies, will help to fill some of the void.

Such a market lull could be used to review loan documents to determine if they include a defeasance provision, to organize loan information in a spreadsheet or database, or to learn more about the defeasance process. Most defeasance facilitators are happy to provide cost estimates even if the potential defeasance date is a year or more away. Once the initial data is input, it's easy to update the defeasance cost as securities prices fluctuate over time.

### **Engaging a defeasance facilitator**

In both the United States and Canada, a defeasance has a lot of moving parts that need to be coordinated if the borrower is to be in a position to close the defeasance when the related sale or refinancing is ready to close. With the myriad of parties to be coordinated and the number of deliveries to be completed before closing, nearly every borrower elects to engage a defeasance facilitator for every defeasance regardless of loan size. An experienced facilitator can explain the process, structure an efficient securities portfolio, and proactively manage the completion of the various checklist items to meet the borrower's closing schedule. For more specialized types of defeasance transactions, like partial, multi-loan or New York-Style defeasances, it is even more important to engage an experienced facilitator whose familiarity with lender requirements for such transactions will keep the defeasance on track. Knowledge, responsiveness and pro-active transaction management save valuable time and money, so the borrower, broker and borrower's counsel can focus on the sale or refinancing 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 now. The first step is to locate the promissory note and mortgage and submit it to an experienced defeasance facilitator for assistance in estimating defeasance costs well in advance of a sale or refinancing.



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