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## Question of the Month

# What type of commercial loan typically prohibits a cash prepayment?

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Commercial  
Defeasance,  
LLC

Did you know that the majority of fixed-rate loans securitized in the commercial mortgage-backed securities (CMBS) market originated after 1998 prohibit a cash prepayment and require that the loan be defeased in order for the borrower to sell or refinance. Most CMBS lenders have incorporated defeasance as the standard call protection in their form documents, because bond buyers are willing to pay more for bonds backed by mortgages containing defeasance instead of cash prepayment options like yield maintenance.

#### What is defeasance?

Put simply, defeasance is just a substitution of collateral. Typically, the borrower uses proceeds from a refinance or sale to purchase a portfolio of U.S. government securities that is sufficient to make all of the remaining debt service pay-

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ments. The securities are pledged to the lender, and the lender releases the real estate from the lien of the mortgage. The note remains outstanding but is assigned to a successor borrower.

Defeasance is a process with its own unique requirements. Typically a defeasance runs on a parallel track with a sale or refinance. Defeasance involves finding and buying qualified Treasuries or comparable securities that mature prior to, but as close as possible to, each remaining payment date in amounts sufficient to make all remaining payments as they become due. For a loan with 5 years remaining in its term, the defeasance collateral could consist of as many as 40 individual securities. The process also involves coordinating a host of professionals, including a loan

servicer, attorneys, an accountant, rating agencies, a securities intermediary, the title company, the refinance lender or the buyer's lender. The typical defeasance will take 30 days to complete, but with an influx of demand industry wide in the 4<sup>th</sup> quarter it may take upwards of 45-60 days.

In a sampling of 930 loans defeased across the country so far this year, 90, or 10% were secured by New York commercial real estate. Of those, 55 were defeased to facilitate refinances and of the 55 refinances 45 were structured as "New York style" defeasances as an accommodation to the borrower. By structuring those defeasances with an assignment of the existing loan to the new lender, the borrowers were able to limit the portion of

the new loan subject to mortgage recording taxes to the amount by which the new loan exceeds the principal balance on the existing loan at the time of defeasance.

Interestingly, three of the 930 loans were actually defeased at a discount. In other words, the interest rate on the loan being defeased was lower than the yield on the portfolio of securities serving as the substitute collateral such that the cost of the securities portfolio actually was lower than the outstanding principal balance on the loan. The CMBS bond investors don't mind borrowers defeasing at a discount because the securities are still sufficient to make all future debt service payments. And the borrowers certainly didn't mind defeasing at a discount particularly considering that had the documents contained a typical yield maintenance prepayment provision instead of defeasance, the borrower would have had to pay a minimum 1% prepayment penalty.

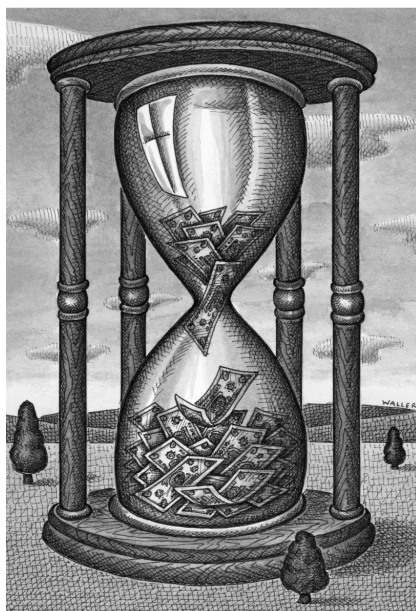
#### Is now the time to defease?

If the loan requires defeasance, the borrower should use a free online defeasance calculator like the one found at [www.defeasewithease.com](http://www.defeasewithease.com) or contact an experi-

enced defeasance consultant to obtain a written defeasance cost estimate. Updated cost estimates should be obtained periodically, as increase in securities yields reduces the cost to defease, and decreases in securities yields increase the cost to defease. Therefore, if it doesn't make economic sense to defease now, keep getting cost updates periodically, because it may make sense at a later date. Most calculators will also provide a sensitivity analysis which describes an approximate dollar movement in the securities cost for each basis point movement in securities yields. Another useful feature at [www.defeasewithease.com](http://www.defeasewithease.com) is the ability to register, enter loan information one time and then return for updated cost estimates without having to re-enter loan information. If it's been a while since an estimate was run on a property or if an estimate has never been run, now is a good time to call or get online and obtain fresh numbers, especially if there is any thought of selling or refinancing in the fourth quarter.

**Janell Otis is vice president of marketing at Commercial Defeasance, LLC, Charlotte, N.C.**

## Time is running out...



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## Planning to sell or refinance before year end?

### Does your conduit/CMBS loan require defeasance?

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- Exceptional customer service
- Active deal management for timely closings
- Reasonable fixed fees
- Fully optimized, unbiased securities portfolios
- Deep industry relationships and broad experience
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