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What is defeasance and why is it so prevalent? An overview of the defeasance process

jo Janell Otis



Commercial
Defeasance

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. Defeasance has become so prevalent in securitized loans that life insurance companies, HUD and others seeking to preserve the ability to securitize their loans have incorporated defeasance into their form loan documents, as well. Put simply, defeasance is a substitution of collateral. It is not a simple prepayment but a 30-45 day process that usually is coordinated with a sale or refinance. 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. 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

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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.

Given the recent widening of CMBS spreads 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 temporary lull could be used to learn about the defeasance process. For those that have been through a defeasance, the lull 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 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. That's not always going to be the case, but defeasance premiums have come down over the last few years as yields on government securities have crept up.

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. Knowledge, experience, 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—ahead of any rate lock expiration or sales contract deadlines.

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 assistance in estimating defeasance costs well before your anticipated sale or refinance.

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