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CMBS Market Saw $6Bln of Defeasances Last Year
Commercial Real Estate Direct Special Report
Mortgage defeasance, a relatively new practice, could become far more commonplace, given the general increase in property values. Commercial Defeasance of Charlotte has so far dominated the market.

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February 17, 2005
***Commercial Real Estate Direct* Staff Report**

A total of $6 billion of the commercial mortgages that back CMBS transactions were defeased, or replaced by government securities last year.

That volume is expected to climb sharply going forward, largely because so much of the real estate securing those mortgages has increased in value.

The result is that just about every loan that was securitized more than two years ago "is in the money," according to Rob Finlay, who runs Commercial Defeasance LLC, a Charlotte, N.C., company that helps borrowers defease their loans.

Commercial Defeasance handled some $5.5 billion of the mortgage defeasance volume last year. Finlay estimates that currently some $450 billion of securitized loans could be retired before their stated maturity via defeasance.

"Conduit borrowers buy and sell properties," Finlay explained, "so there will always be demand" for a mechanism that allows for early mortgage repayments.

In simple terms, defeasance is the process of retiring a mortgage before its maturity by replacing its collateral.

The massive potential volume has resulted in competition to Commercial Defeasance, which was the sole player in the market when Finlay launched the firm nearly five years ago.

Since then, Wachovia Securities has started advising borrowers on defeasing their loans, as has GMAC Commercial Mortgage's Newman Associates.

Given the potential volume of loans that could be defeased, others are likely to jump into the market.

Defeasance is a very complex maneuver that allows for the early repayment of a mortgage while ensuring that the lender continues receiving the return expected from that mortgage. As a result, structuring a defeasance is no easy task. It involves negotiating with a host of professionals, from attorneys, to accountants, servicers, trustees and ratings agencies. More importantly, it involves finding and buying Treasury or comparable securities that would provide the same cash flow as the mortgage being replaced for the period through the loan's maturity.

Wachovia and Newman might have an advantage with the latter because the two both have active bond-trading desks. But Commercial Defeasance, which charges a flat fee for its services, isn't affiliated with any trading house, so it's able to work in the borrower's best interest, Finlay said. He added that his firm runs a trading desk that constantly seeks the best deals in the bond market.

Finlay has been crisscrossing the country holding educational seminars for mortgage brokers – who represent the front line in the mortgage world – on defeasance. Because they are familiar with their clients' borrowings and collateral values, they would be the ones best able to determine whether a defeasance ought to be pursued.

The prevailing wisdom has been that defeasance is best sought when interest rates have fallen substantially because a mortgage could be replaced with a lower-coupon loan. But defeasance might also be suitable in a rising-rate environment. That's because the Treasury securities needed for a defeasance could be purchased at a lower cost.

But the driver today is increasing property values. An example: A borrower had a $15 million securitized loan. Because interest rates are so low today, he had to purchase some $18 million of bonds to defease the loan. So it would appear that the defeasance process wouldn't be worthwhile. But because the collateral property's value had increased so much, the borrower was able to borrow $22.9 million against it – substantially more than the defeased loan. And the monthly debt service hadn't changed much because the new loan carried a rate of 5.5 percent.

Examples such as that recently prompted Watt Commercial Properties, a Santa Monica, Calif., real estate firm, to tap Commercial Defeasance on three of its loans, which totaled $13.3 million. In each case, the loans were refinanced with greater proceeds.