THE DEFEASANCE SOLUTION

Rising property values drive the need to defease.

John Hosmer

As interest rates continue to hover at historically low levels and commercial property values in some regions hit historic highs, more and more borrowers are looking for opportunities to extract the equity from their properties. For borrowers with loans securitized in the commercial mortgage-backed securities (CMBS) or conduit market — many of which prohibit mezzanine financing — the two primary vehicles to extract equity are selling or refinancing. However, since 1998, most originators have incorporated defeasance in their form documents, because bond buyers are willing to pay more for bonds backed by mortgages containing defeasance instead of yield maintenance. Today, nearly all fixed-rate CMBS loans prohibit a simple cash prepayment and require that the loan be defeased in order for the borrower to sell or refinance.

What is defeasance?

Put simply, defeasance is a substitution of collateral. Typically, the borrower uses proceeds from a refinance or sale to purchase a portfolio of U.S. government securities. The redemption of principal and interest from the securities is sufficient to make all of the remaining debt service payments, the lender releases the real estate from the lien of the mortgage, the note remains outstanding, and debt service payments are made as scheduled. As one might imagine, structuring a defeasance is no easy task. It involves negotiating with a host of professionals and companies, including attorneys, accountants, servicers, trustees and rating agencies. More importantly, it involves finding and buying qualified Treasury or comparable securities that mature prior to, but as close as possible to, each remaining payment date. For a loan with 5 years remaining in its term, the defeasance collateral could consist of as many as 40 individual securities.

The Whole Picture

One of the biggest stumbling blocks to selling or refinancing a conduit loan is the perceived cost of defeasance in a low interest rate environment. However, increased property values often outweigh the costs of defeasance. For example, let’s consider a multifamily property with net operating income of $1.85 million. In the current low interest rate environment, if a borrower has a $15 million principal balance on a conduit loan with a 7 percent interest rate, he may have to purchase some $18 million in bonds yielding only 4 percent in order to defease the loan. So at first glance, it would appear that completing the defeasance process would not be prudent. However, if the property’s value has increased and new loan rates are low relative to where they were when the loan was originated (5.5 percent vs. 7 percent), the borrower is able to borrow $22.9 million against the property — substantially more than the cost to defease the loan. Conversely, in a rising interest rate environment, the cost to defease the existing loan will decrease as yields on the bonds approach the interest rate on the existing debt, but the amount of proceeds available on a new loan also will decline.

This example makes defeasing in a low interest rate environment sound a little more feasible, but a borrower cannot make an informed decision without comparing the cost of defeasance with the cost of other alternatives: doing nothing now or obtaining mezzanine financing now (if the conduit loan documents permit it).

Is now the time to defease?

The decisions whether to defease a loan and when to defease depend upon several factors. The first and most obvious is whether or not the loan requires defeasance. If the loan is a fixed-rate conduit loan originated after 1998, it probably requires defeasance, but it’s good practice to check the original loan documents. If the loan documents require defeasance, read the defeasance provision and determine if the loan is beyond the lock-out period. Real Estate Mortgage Investment Conduit (REMIC) regulations mandate a 2-year period from the date the loan is secured during which the loan cannot be defeased. However, older defeasance provisions frequently state a longer lock-out period of 3 or 4 years from the date the loan is closed. If the loan requires defeasance, and it is beyond the lockout period, the borrower should use an online defeasance calculator or contact an experienced defeasance consultant to obtain a defeasance cost estimate. With a good idea of the cost, a borrower is then in a position to evaluate alternatives. This analysis can be accomplished rather quickly by using an online calculator to determine return on equity. Alternatively, a good broker, mortgage banker or defeasance consultant can help a borrower compare the costs of (a) defeasing now and obtaining a new loan at current interest rates, (b) obtaining mezzanine financing now and refinancing at maturity at prevailing rates, and (c) doing nothing now and refinancing at maturity at prevailing rates.

Keep in mind that calculators are just tools to aid in the decision-making process. They don’t include every factor imaginable and cannot incorporate intangibles such as the urgency of a specific borrower’s need to extract the equity from a property or the investment opportunities available to a specific borrower for reallocating equity to earn a higher return. A borrower interested in refinancing also needs to know how long he intends to hold the property in order to compare the sale horizon to the amount of time it would take to recoup the defeasance premium in the form of lower monthly payments and earnings on reallocation of equity.

When evaluating alternatives for extracting the equity from a property subject to a loan that requires defeasance, the most important thing is to complete the whole analysis. Don’t be deterred by high defeasance premiums. The results of a thorough comparison of the alternatives may make defeasance a more compelling alternative, because the same interest rate factors that make defeasance more expensive also make interest rates lower and increase proceeds on new loans.

John Hosmer is chief operating officer of Charlotte, North Carolina-based Commercial Defeasance LLC.