

A Primer on Defeasance

Knowledge of defeasance presents opportunity to add value and earn business

By John Hosmer, chief operating officer, Commercial Defeasance LLC

With commercial real estate loan production at historically high levels — up nearly 20 percent in the past year, according to the Mortgage Bankers Association — borrowers are savvier and more motivated than ever. As a broker, your ability to earn business in this highly competitive environment depends, in part, on your ability to add value to the process. A thorough knowledge of defeasance, a mandatory process in many loan documents for borrowers seeking to refinance or sell, can help you reach these goals.

The ABCs of defeasance

It is essential for brokers to understand the meaning of defeasance and its importance. 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 the remaining debt-service payments. The lender then releases the real estate from the lien of the mortgage, the note remains in place and debt-service payments are made as scheduled. The process generally takes about 30 days and involves several parties, including attorneys, accountants, a loan servicer, rating agencies (depending on the size of the loan) and, usually, a defeasance consultant.

Since 1998, nearly every fixed-rate Commercial Mortgage Backed Securities

(CMBS) loan has included defeasance as the standard form of call protection. Even funding sources that do not regularly securitize their loans have incorporated defeasance provisions into their loan documents. This preserves the option to securitize should they need to do so. With defeasance becoming more prevalent, you will often be unable to place a borrower in a new loan unless the existing loan is defeased.

A borrower analyzing a sale or refinance opportunity needs to know what the defeasance will cost. The total cost is made up of two components: the securities cost and transaction fees. The cost to purchase the securities is a function of the spread between the coupon on the existing loan and the yield on the securities portfolio on the date the securities are purchased. Transaction costs include the fees of the parties involved in the process.

Defeasance requirements

The requirements that necessitate the involvement of these various parties are typically set forth in the promissory note, security instrument or loan agreement. Fortunately, defeasance provisions are fairly standard across the industry, so the general process and logistics are always more or less the same.

However, if you're trying to place a borrower in a new loan, it is a good idea to review the language in the borrower's existing loan documents. There are still a

number of CMBS loans — often pre-1998 vintage — that require a yield-maintenance payoff instead of defeasance. Further, even if the existing loan documents do require defeasance, it will be prohibited during a stated lockout period of at least two years from the date the loan was securitized.

“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 the remaining debt-service payments.”

Although it is helpful to review the defeasance requirements, you can't always take them too literally. Over time, certain common industry practices and customs have arisen that are not readily apparent from the loan documents. For example, most defeasance provisions require that the loan be defeased on a regularly scheduled, monthly payment date, but that requirement is routinely waived. In fact, it's easier for everyone involved if the defeasance does not close on a payment date.

Additionally, many defeasance provisions require a “no downgrade” letter be obtained from the rating agencies rating the pool of loans in which the loan is



John Hosmer is the chief operating officer of Commercial Defeasance LLC, a company that actively manages the defeasance process. Commercial Defeasance pioneered the defeasance-consulting business in 2000 and has remained the industry leader with such innovations as the first defeasance cost estimator and the first return on equity calculator. Both calculators are available online, free of charge at www.defeasewithease.com. Contact Hosmer at jhosmer@cdfllc.com or call (800) 624-4779.

Continued ...

REPRINTED FROM SCOTSMAN GUIDE COMMERCIAL EDITION, AUGUST 2005

All rights reserved. Third-party reproduction for redistribution is prohibited without contractual consent from Scotsman Publishing Inc.

A Primer on Defeasance

... Continued

securitized. However, a rating-agency review is rarely required for loans less than \$20 million, unless the loan is one of the top 10 largest in its securitization. Moreover, some defeasance provisions require that borrowers give at least 60 days' written notice of their intent to defease. Most loan servicers require only 30 days' notice, and some will expedite the process for an additional fee — worth considering if a borrower has a 1031-exchange deadline approaching in three weeks or less.

■ ■ ■

The foregoing are just a few examples of how understanding defeasance can add value to your discussions with prospective clients about how to get out of their existing loans.

Questions about defeasance in their existing loans will naturally lead to questions about defeasance in the new loan in which you want to place them. Your knowledge of defeasance will create another opportunity to add value for clients. For example, when some borrowers learn they will have to pay a sizable defeasance premium to get out of their existing loan, they may not want defeasance in their new loan — even if it means paying a premium to avoid it.

Such a reaction is natural. However, after you explain the benefits of defeasance, borrowers may realize that the decision to avoid it may not be the best one. The same current interest-rate factors that contribute to a high defeasance premium on the existing loan (a high loan coupon relative to the current market yields on government securities) also mean that the new, lower-interest-rate loan in which you are placing them will have a possibility of being defeased at a discount in the future (whenever yields on government treasuries rise above the new loan coupon). With a minimum 1 percent to 2 percent penalty, yield maintenance will never offer that opportunity. Additionally, the borrower generally will have to pay a higher interest rate during the life of the new loan in order to get yield maintenance, if it's even offered. //

REPRINTED FROM SCOTSMAN GUIDE COMMERCIAL EDITION, AUGUST 2005

All rights reserved. Third-party reproduction for redistribution is prohibited without contractual consent from Scotsman Publishing Inc.

