U.S. CMBS: Real Estate Value Declines and Reduced Liquidity Cause 2008 Defeasance Activity To Plummet

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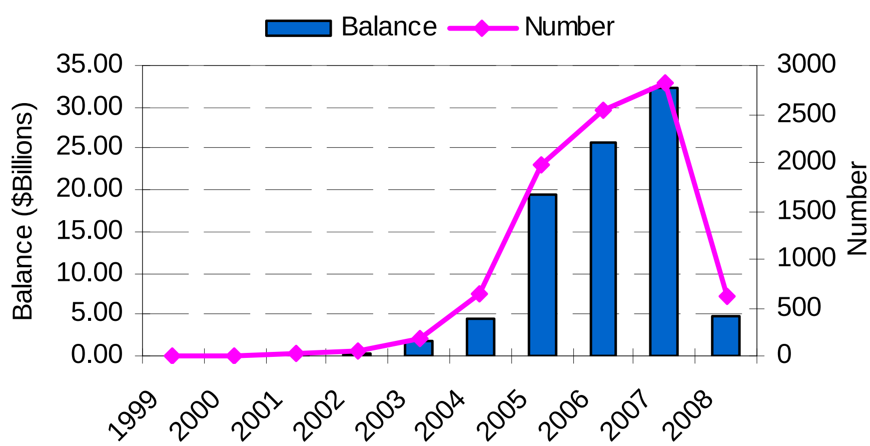
SUMMARY

The dramatic increase in defeasance of loans in commercial mortgage-backed securities (CMBS) transactions since 2005 came to an abrupt halt in 2008 due to declines in commercial real estate values and lack of liquidity in the financial markets. The tapering off of defeasance activity began in the second half of 2007 and accelerated in 2008. 2007 represented the highpoint in defeasance activity, with the defeasance of almost 3,000 loans with an outstanding balance of $32.4 billion. Defeasance volume in 2008 declined 85% to $4.9 billion (See *Figure 1*).

Figure 1
Balance and Number of Defeased Loans Per Year
(Based on Loan Balance at Defeasance)



Defeasance has had a positive credit impact on CMBS, contributing to upgrades of seasoned CMBS deals. However, we expect that defeasance activity will continue to decline in 2009. This, together with expected higher delinquencies caused by property cash flow declines due to the weaker overall economy and increased balloon risk due to the lack of liquidity in the financial markets, will lead to more downgrades than upgrades in 2009.

Generally, borrowers of securitized loans can't pay off their loans prior to loan maturity. Defeasance, however, allows a borrower to substitute the real estate collateral securing a mortgage loan with a portfolio of U.S. treasury or agency securities. The cash flows from the securities are structured to exactly match the loan's scheduled mortgage payments, including the balloon payment. The mortgage loan remains in the trust, the real estate that originally served as collateral for the loan is released, and the certificate holders receive an uninterrupted payment stream from the mortgage loan. The defeasance process is expensive, with aggregate costs generally totaling 15% or more of a loan's outstanding balance, and therefore borrowers generally do not undertake this process unless there is a significant increase in property value as well as favorable financing opportunities.

Moody's has published a number of special reports on defeasance activity[1]. Even though defeasance activity declined in 2008, it remains an important feature in CMBS because of its positive impact on credit quality. Especially in an environment of economic stress, as we are currently experiencing, the substitution of real estate collateral with Aaa-rated government securities eliminates both term and balloon risk for a portion of a CMBS pool, thus improving the pool's overall credit profile.

This report provides an update to Moody's previous reports and summarizes 2008 defeasance activity.[2]

The key findings of this report are as follows:

- Defeasance activity declined significantly in 2008, to $4.9 billion from $32.4 billion in 2007. This represented an 85% decline over 2007 defeasance volume.
- By aggregate loan balance, multifamily at 36% and office at 34% had the largest shares of defeasance activity, followed by retail at 14%. The largest share of defeasance activity by loan count was multifamily at 42%, followed by retail and office, at 19% and 16%, respectively.
- As in previous years, loans with relatively small balances accounted for a significant share of the number of defeased loans. Over 50% of the loans that defeased in 2008 had a balance that was less than $5 million at the time of defeasance. These loans, however, represented only 18% of the aggregate balance of defeased loans.
- The largest share of defeasance occurred in transactions issued between 2003 and 2005, at 53% of the aggregate balance. Approximately 3% of defeasance occurred in 2006 transactions.
- Recent declines in real estate values have impacted the seasoning patterns of defeasance and resulted in a smaller share of defeasance among recent vintage loans. Approximately 3% of the aggregate balance of defeased loans in 2008 had only seasoned two years (i.e., were securitized in 2006) compared to 16% in 2007 (loans securitized in 2005) and 13% in 2006 (loans securitized in 2004).

RECENT REAL ESTATE VALUE DECLINES DAMPEN DEFEASANCE VOLUME

The volume of defeasance activity is strongly influenced by real estate value appreciation. After several years of strong appreciation, real estate has experienced a steady decline in value since late 2007. Based on Moody's Real/Commercial Property Price Indices (CCPI), real estate appreciation peaked in October 2007, when prices were over 90% higher than they were in December 2000, the inception of the index[3].

[1] Moody's previous special reports include *U.S. CMBS: Defeasance Benefits Borrowers and Investors*, April 1, 2005; *U.S. CMBS: Strong Real Estate Appreciation Drives Defeasance to Record Levels*, March 27, 2006, *U.S. CMBS: Strong Commercial Property Appreciation Fuels Defeasance*, March 19, 2007 and *U.S. CMBS: 2007 Defeasance Activity Sets New Record Despite Midyear Slowdown*, March 3, 2008.

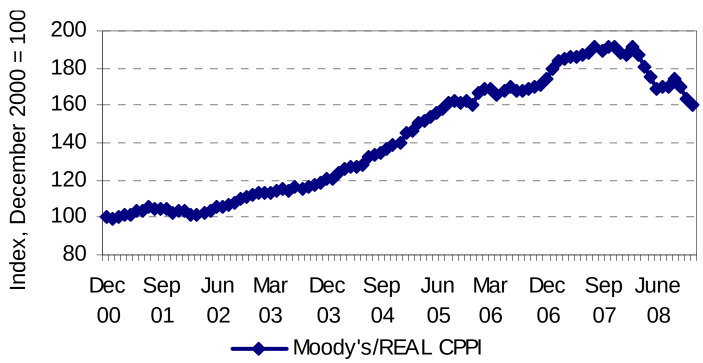
[2] Data for this study was provided by the advisory firms involved in the defeasance process, including AST, Bank of America, Capmark Securities Inc., Chatham Financial, Commercial Defeasance, Defeasit, TriMont Real Estate Advisors and Waterstone Capital Advisors.

[3] Moody's/REAL CCPI index is a measure of the change in actual transaction prices for commercial real estate assets based on the repeat sales of the same assets at different points in time. A summary or short version of the repeat sales methodology is available in a Moody's Special Report, *US CMBS: Moody's Publishes the First Commercial Property Price Indices Based on Commercial Real Estate Repeat Sales Methodology*, September 19, 2007. The most recent REAL/CCPI Indices are included in *Moody's REAL/Commercial Property Price Indices, February 2009*, February 18, 2009.

Since the peak, prices have declined in 11 of the last 14 months. As of December 2008, the index for all property types and all markets in the aggregate was 15% below December 2007 and over 16% below the peak measured in October 2007 (See *Figure 2*). Moody's expects that the peak-to-trough decline in commercial property values will reach 30% or more over the next 12 to 24 months as a result of the declines in property cash flows resulting from the economic slowdown as well as increased cap rates.

Figure 2

Moody's/REAL Commerical Property Price Index (CPPI)
National–All property Type Aggregate



Based on data through end of December 2008

Moody's CPPI also tracks appreciation by the four core commercial property types - office, retail, multifamily and industrial. All these property types experienced double digit declines in value since the peak in 2007. Value declines from the peak ranged from 12% for retail, 14% for office and industrial and 19% for multifamily.

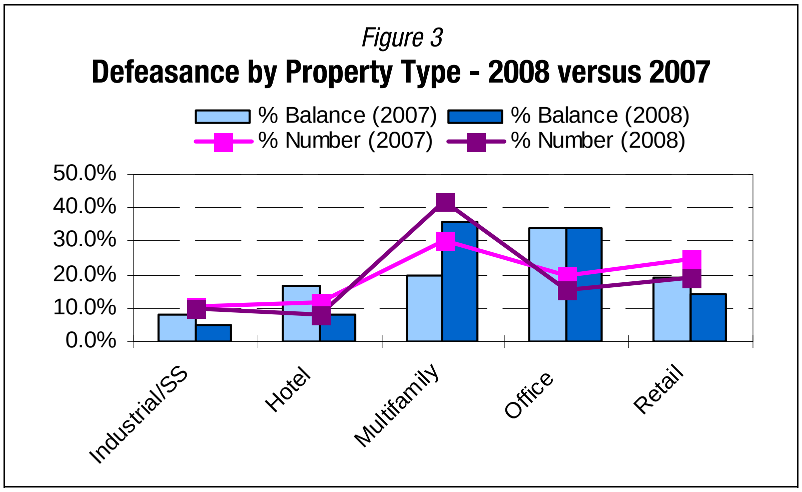
REVIEW OF 2008 DEFEASANCE ACTIVITY

Defeasance by Property Type

Loans originally secured by multifamily properties represent the largest share of defeasance by aggregate balance, at 36%, followed closely by office at 34% and retail at 14%.

If one looks at property type distribution by loan count rather than aggregate balance, multifamily represents the largest share of defeasance, at 42%, followed by retail and office, at 19% and 16%, respectively. Approximately 8% of the aggregate defeasance balance was represented by hotels, which was a sharp decline from 17% in 2007 (See *Figure 3*).

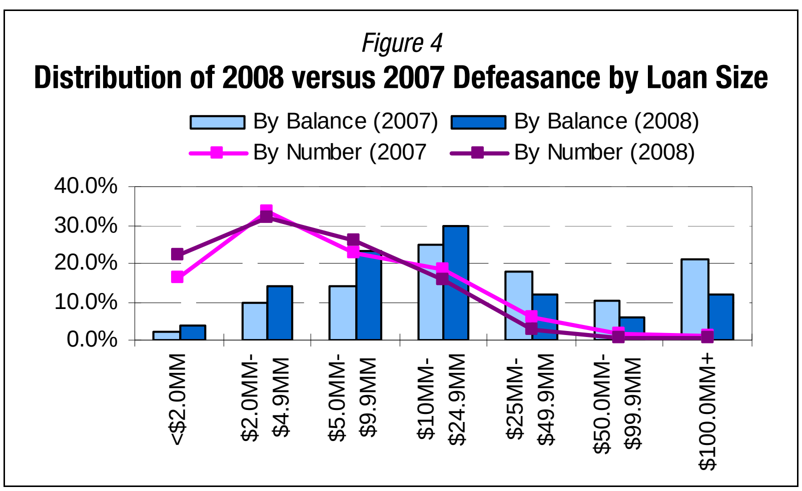
Although multifamily experienced the greatest decline in value since October 2007, this asset type had benefited from the highest overall increase in appreciation among the core property types from 2003 through 2005. Approximately 84% of the multifamily loans that defeased in 2008 were securitized prior to 2005. Borrowers of these loans still had equity in their properties despite recent value declines. Another factor contributing to the defeasance of a large number of multifamily loans was the availability of more financing alternatives for this property type, including Fannie Mae and Freddie Mac as well as commercial banks, than for other property types.



Defeasance by Loan Size

The majority of defeased loans had relatively small balances at the time of defeasance. Approximately 54% of the loans that defeased in 2008 were less than $5 million in size. These loans, however, only represented 18% of the aggregate defeasance balance. On the other hand, while only 4% of defeased loans were $25 million or larger, these loans represented 30% of the aggregate defeasance balance.

In 2008, large loans represented a smaller share of defeasance than in 2007. In 2008, loans over $25 million represented 4% by loan count and 30% by balance. In 2007, loans over $25 million represented 8% by count and 49% by balance. The decline in the share of large loans is partially due to the fact that there were more financing options for smaller properties in 2008, while the liquidity crunch made it more difficult for larger properties to refinance. *Figure 4* shows distribution of defeasance by loan size for 2008 and 2007.



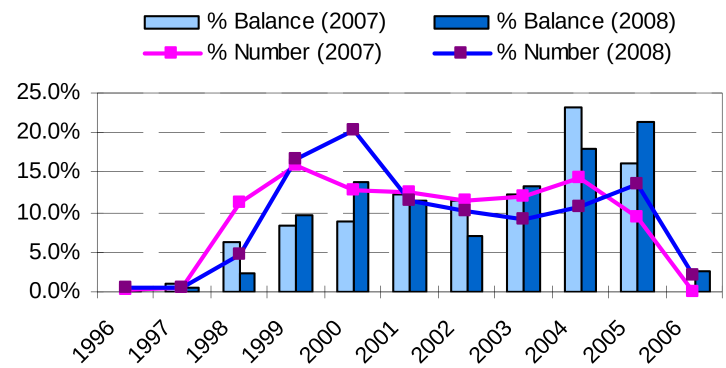
In 2008, only three loans greater than $100 million defeased, compared to 28 in 2007. These loans were secured by a New York City office building, a Washington DC office portfolio and a portfolio of retail bank facilities.

Defeasance by Vintage

A relatively small share of defeased loans, 3% by aggregate balance, is from transactions issued in 1998 and earlier. This is not surprising since a significant amount of defeasance from these vintages had already occurred in previous years. The largest single concentration of defeased loans, by aggregate balance, is from 2005, at 21%, followed by 2004, at 18% and 2000, at 14%. Only 3% of defeasance activity, by balance, was from the 2006 vintage (See *Figure 5*). Due to the REMIC prohibition against defeasance within the first two years after securitization, 2006 represents the most recent vintage from which borrowers were allowed to defease in 2008.

Figure 5

Distribution of 2008 versus 2007 Defeasance by Vintage



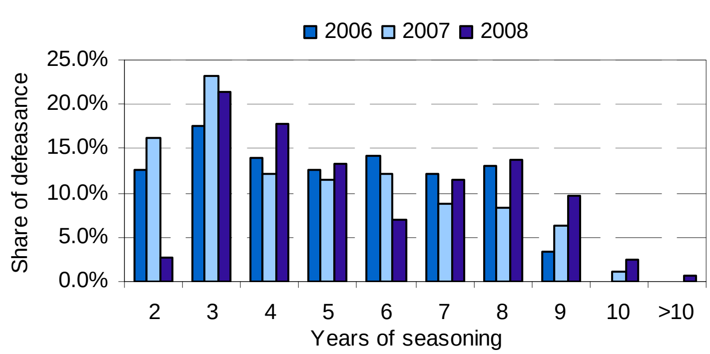
Defeasance by Seasoning

The seasoning, or maturity, of loans that defeased in 2008 varied significantly from 2007. In 2008 a smaller share of defeasance was represented by loans with little seasoning. Approximately 3% of the aggregate balance of defeased loans had only seasoned two years (i.e., were securitized in 2006) compared to 16% in 2007 (loans securitized in 2005) and 13% in 2006 (loans securitized in 2004). In 2006 and 2007, strong property appreciation and a robust lending environment made it attractive for even relatively recently securitized loans to defease. In 2008, however, borrowers of recent vintage loans did not experience increased equity in their properties due to value declines.

On the other hand, a far larger share of loans that defeased in 2008 had seasoned longer than in 2007 or 2006. Approximately 38% of loans that defeased in 2008 had seasoned seven years or more, compared to 25% in 2007 and 29% in 2006. This means that a greater share of defeased loans in 2008 represented loans that were originated and securitized prior to 2005. The borrowers of these loans still retained significant equity despite value declines of 2007 and 2008 (See *Figure 6*).

Figure 6

Distribution of Defeased Loans for 2006 versus 2007 versus 2008 by Years of Seasoning



CREDIT IMPACT OF DEFEASANCE

The dramatic growth of defeasance over the past several years had a significant positive impact on the credit quality of seasoned CMBS pools. Many pools from seasoned vintages contain defeased loans in excess of 25% of the pool's outstanding balance. Although defeasance will continue to have a positive impact in CMBS, we do not expect to see significant defeasance in recent vintage transactions until the real estate markets strengthen and the capital markets become more liquid. In 2008, only 13 loans from nine 2006 vintage deals defeased, representing less than 1% of the aggregate balance for these transactions. This amount of defeasance has a negligible impact on improving a pool's credit quality.

APPENDIX: SUPPORTING STUDY DATA

Table 1

DEFEASANCE BY BALANCE AND LOAN COUNT PER YEAR

Year of Defeasance	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
2000	50,051,145	0.1	8	0.1
2001	425,640,766	0.5	25	0.3
2002	376,354,719	0.4	61	0.7
2003	1,795,351,385	2.0	192	2.2
2004	4,618,106,267	5.1	647	7.3
2005	19,450,867,908	21.6	1,980	22.3
2006	25,865,842,182	28.8	2,549	28.7
2007	32,415,267,103	36.1	2,810	31.6
2008	4,857,492,990	5.4	622	7.0
TOTAL	**89,854,974,465**	**100%**	**8,894**	**100%**

Table 2

2008 DEFEASANCE BY PROPERTY TYPE

Property Type	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
Office	1,654,474,872	34.1	97	15.6
Multifamily	1,729,993,282	35.6	262	42.1
Retail	684,178,638	14.1	119	19.1
Industrial/Self Storage	245,095,885	5.0	63	10.1
Lodging	381,228,652	7.8	51	8.2
Healthcare	67,198,387	1.4	9	1.4
Other (includes MU)	95,323,275	2.0	21	3.4
TOTAL	**4,857,492,990**	**100%**	**622**	**100%**

Table 3

2008 DEFEASANCE BY LOAN SIZE

Loan Size ($MM)	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
< $2.0	172,256,530	3.5	137	22.0
$2.0-4.9	689,548,764	14.2	200	32.2
$5.0-9.9	1,124,029,261	23.1	162	26.0
$10.0-24.9	1,434,697,530	29.5	98	15.8
$25.0-49.9	576,686,851	11.9	17	2.7
$50.0-99.9	286,424,411	5.9	5	0.8
> $100.0	573,849,643	11.8	3	0.5
TOTAL	**4,857,492,990**	**100%**	**622**	**100%**

Table 4

2008 DEFEASANCE BY VINTAGE

Vintage	$ Balance at Defeasance	% Balance	No. of Loans	% Loans
1996	11,151,968	0.2	3	0.5
1997	25,267,291	0.5	4	0.6
1998	114,308,915	2.4	29	4.7
1999	466,113,077	9.6	104	16.7
2000	668,409,859	13.8	126	20.3
2001	556,118,998	11.4	72	11.6
2002	336,578,331	6.9	63	10.1
2003	651,079,522	13.4	56	9.0
2004	869,322,755	17.9	67	10.8
2005	1,033,861,626	21.3	85	13.7
2006	125,280,649	2.6	13	2.1
TOTAL	**4,857,492,990**	**100%**	**622**	**100%**

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