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STRUCTURED FINANCE

MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

US CMBS: Defeasance Continues Upward Trend Due to Favorable Market Conditions

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In 2012, defeasance increased significantly over 2011, rising to its highest level since its peak in 2007. The increase was due to several factors, including a rise in liquidity, a low interest rate environment, and continued improvement in real estate fundamentals. New CMBS issuance and insurance company lending has also picked up steam, making more commercial real estate financing available. Still, defeasance activity in recent years is far below the levels of 2005-2007.

Among the defeasance highlights of 2012 are the following:

» Defeasance of CMBS loans increased 21% to $5.9 billion from $4.9 billion in 2011.

» The largest shares of defeased loans, by property type, were retail, 30%, office, 26%, and multifamily, 17%. By balance, over a third of the retail loans that defeased in 2012 were secured by five super regional malls.

» The 10 largest defeased loans amounted to $1.5 billion or 24% of defeasance volume. The largest loan defeased in 2012 was the AFR Portfolio loan. With a $232 million loan balance, the AFR Portfolio loan represented approximately 4% of total 2012 defeasance.

» Most of the loans that defeased were originated between 2003 and 2005.

» By aggregate loan balance, 58% of the loans that defeased had remaining terms of one year or less.

» Defeasance remains a positive credit factor in seasoned pools, but has had a limited impact on the performance of more recent deals, which have had low levels of defeasance.

2012 Defeasance

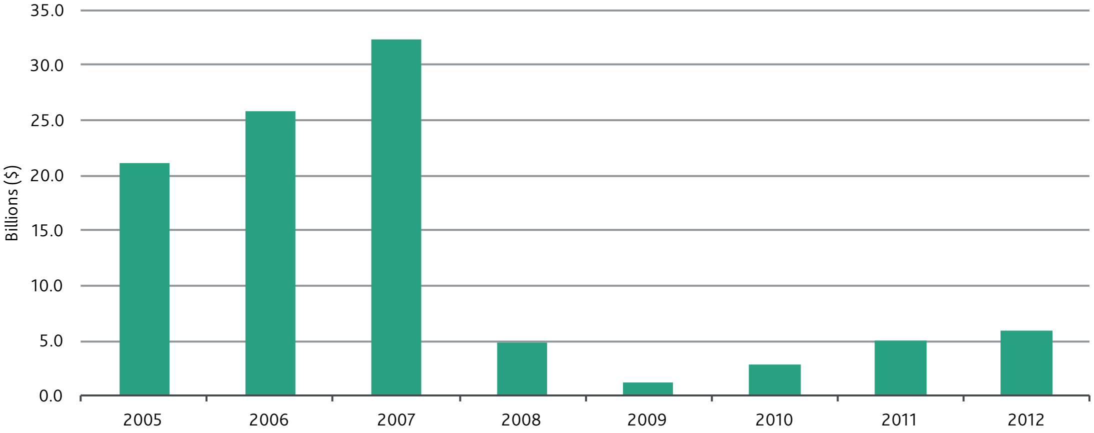
In 2012, defeasance increased 21% to $5.9 billion, from $4.9 billion in 2011. By loan count, defeasance increased 29% to 488 loans, from 379.[1]

Even with the increase in defeasance in recent years, activity is still far below the level seen from 2005-2007, as Exhibit 1 shows. The year-over-year increase in 2012 is due in part to a rise in liquidity, a low interest rate environment, and continued improvement in real estate fundamentals. Additionally, new CMBS issuance and insurance company lending has picked up steam, making more commercial real estate financing available.

Fixed-rate loans originated for CMBS generally limit a borrower's ability to prepay a loan before maturity. Defeasance allows the borrower to refinance or to sell a property unencumbered by debt and provides the trust with the scheduled stream of interest and principal payments from the defeased loan.[2]

EXHIBIT 1

Annual Defeasance, 2005-2012



Source: Defeasance consultants

Defeasance by Property Type

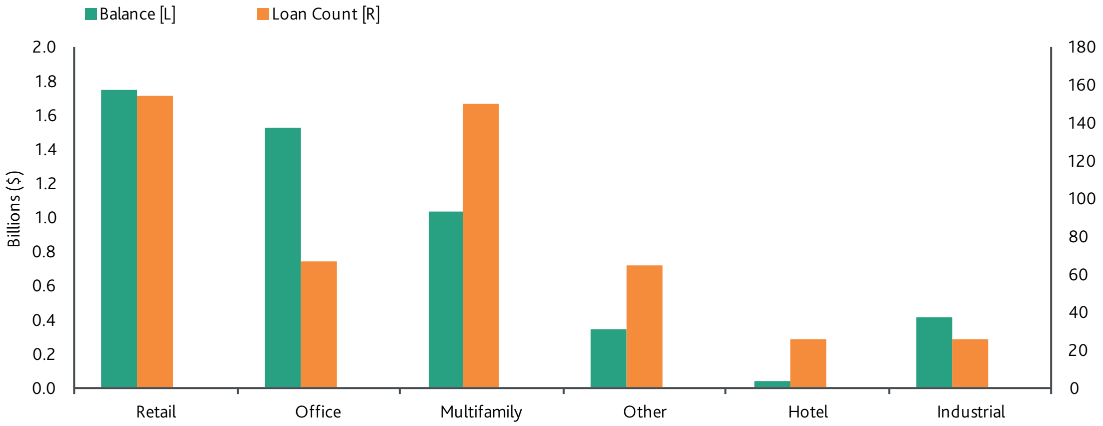
By balance, the largest share of defeased loans were backed by: retail, 30%, office, 26%, and multifamily properties, 17%, with other, 17%, hotel, 5%, and industrial properties, 5%, following. By number of loans, retail also constituted the largest share, 32%, with multifamily, 31%, and office properties, 14%, following. Other property types represented 13% of the total loan count, hotel, 5%, and industrial properties, 5%, as Exhibit 2 shows.

[1] Data for this study came from advisory firms involved in the defeasance process, including AST, Bank of America, Chatham Financial, Commercial Defeasance, Trimont Real Estate Advisors, Waterstone Capital Advisors and Wells Fargo.

[2] Defeasance allows a borrower to substitute the real estate collateral securing a mortgage loan with a portfolio of US Government securities sufficient to satisfy all debt service payments, including the balloon payment upon maturity. 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 Aaa payment stream from the defeased mortgage loan.

EXHIBIT 2

2012 Defeasance by Property Type



Source: Defeasance consultants

The distribution of defeasance by property type varies over time because of changes in investor appetite, borrower motivation, liquidity, and financing opportunities. In 2012, retail, office, and multifamily properties constituted the largest shares by balance, reflecting the improved fundamentals in these property markets. Over a third of the retail loans by balance that were defeased in 2012 were secured by five super regional malls: the Mall at Millenia, the Grove, Solomon Pond Mall, Eastview Mall, and Battlefield Mall. Most of the defeased office loans were located in major markets, including New York, Houston and Los Angeles, where fundamentals have improved. Multifamily continued to benefit from improved real estate fundamentals and additional financing options including the availability of government-sponsored enterprise (GSE) debt.

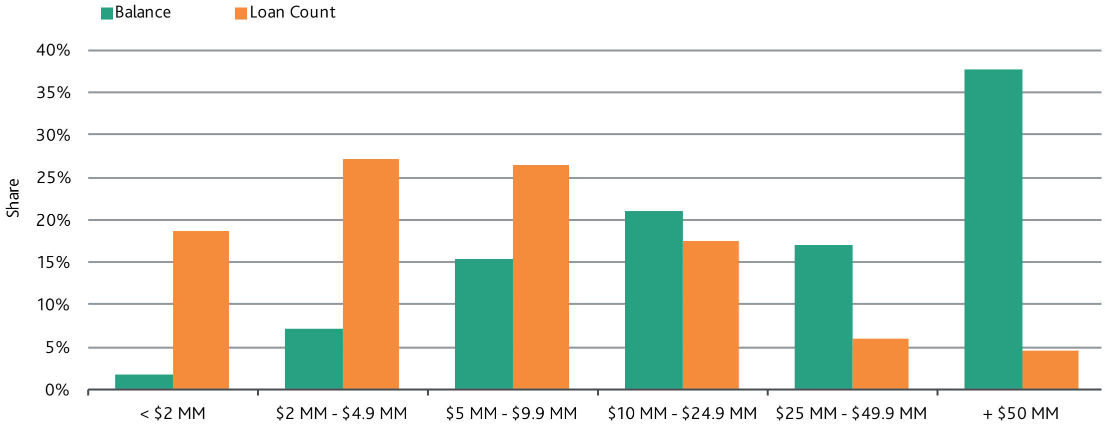
Defeasance by Loan Size

By count, approximately 46% of loans that defeased in 2012 had balances of less than $5 million, but by balance they constituted only 9% of aggregate defeasance. Loans of $50 million or greater constituted 38% of aggregate defeasance volume but just 5% by count. Exhibit 3 shows the dispersion of defeased loans by balance and loan count. Over half of the loans by balance that defeased in 2012 were greater than $25 million at the time of defeasance. As of December 2012, the average loan balance in the CMBS universe was roughly $12 million[3] which is in line with the average balance of defeased loans in 2012.

[3] Source: Trepp LLC

EXHIBIT 3

2012 Defeasance by Loan Size



Source: Defeasance consultants

Exhibit 4 shows that the 10 largest defeased loans constituted approximately 24% of overall volume. Borrowers defeased for a variety of reasons, for example, to facilitate refinancing on more favorable terms, to sell a property, or to reposition a portfolio.

EXHIBIT 4

Top 10 Defeased Loans in 2012

Property Name	Location	Property Type	Vintage	Years to Maturity	Balance at Defeasance
AFR Portfolio	Various	Mixed Use	2003 & 2004	<1	232,408,484
World Apparel Center	New York, NY	Office	2004	2	202,034,432
Mall at Millenia	Orlando, FL	Regional Mall	2003	<1	196,984,250
The Grove	Los Angeles, CA	Retail	2003	1	152,521,790
Republic Plaza	Denver, CO	Office	2004	1	152,173,222
Bay Plaza Community Center	Bronx, NY	Mixed Use	2004	1	122,847,654
200 Public Square	Cleveland, OH	Office	2005	<1	108,878,535
The Solomon Pond Mall	Marlborough, MA	Regional Mall	2003	<1	100,618,558
609 Fifth Avenue	New York, NY	Mixed Use	2003	<1	93,346,852
Eastview Mall	Rochester, NY	Regional Mall	2004	<1	90,469,814
Total					**1,452,283,590**

Source: Defeasance consultants

The largest defeasance was backed by the AFR portfolio, which consists of 114 offices, operations centers and retail bank branches located in various states. The loan has a $232 million balance and accounted for around 4% of 2012 defeasance activity.

The second-largest was World Apparel Center, an office building in Midtown Manhattan, with a $202 million balance. This defeasance accounted for around 3% of activity. Canadian real estate firm Ivanhoe Cambridge purchased a minority interest in the property, and along with Swig Co. recapitalized it with a new $375 million loan.

The third-largest was Mall at Millenia, a regional mall in Orlando, with a $197 million balance that accounted for around 3% of activity.

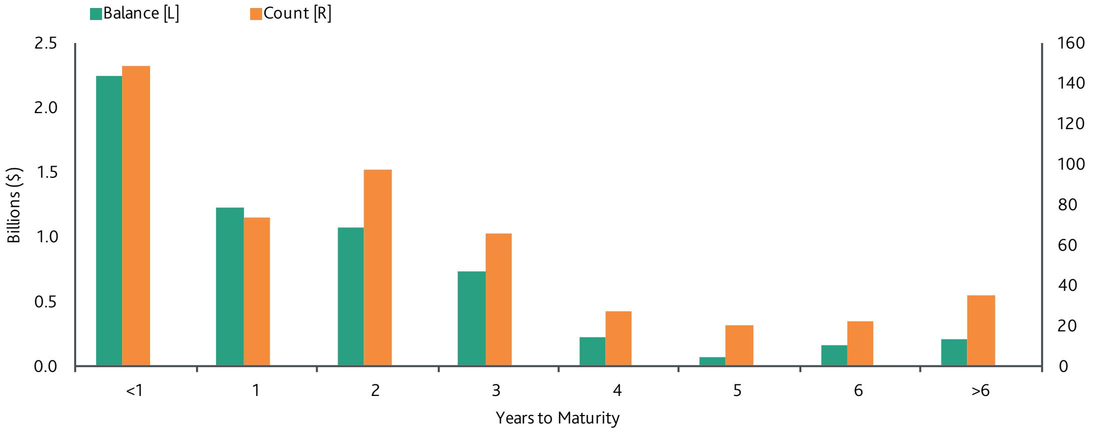
Defeasance by Years to Maturity

By aggregate balance, 58% of the loans that defeased in 2012 had remaining terms of one year or less; only 7% had remaining terms of five years or more, as Exhibit 5 shows. By loan count, 45% had remaining terms of one year or less, while 16% had remaining terms of five years or more.

Given the high cost of defeasance, borrowers who had to only purchase replacement government securities for a relatively short period of time were responsible for the largest share of defeasance. Several loans defeased even though they would have matured within a few months because the borrower wanted the assurance of locking in a favorable refinancing rate or to accommodate a property sale. Due to the short remaining loan terms of seasoned loans, new owners wanted the ability to refinance with a five- or 10-year term rather than assume the existing short-term debt.

EXHIBIT 5

2012 Defeased Loans by Years to Maturity



Source: Defeasance consultants

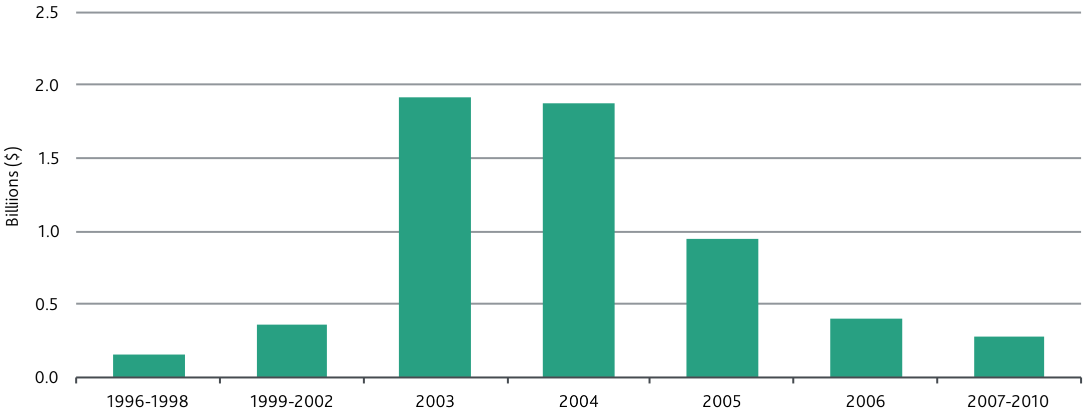
Defeasance by Vintage

Because of REMIC regulations, defeasance cannot take place until after the second anniversary of the closing date of a CMBS transaction. Thus, no defeasance took place in any of the deals from 2011 and 2012. Exhibit 6 shows that most of the loans that defeased in 2012 were originated between 2003 and 2005, accounting for approximately 80% of total defeasance in 2012. Most likely, these loans benefited from more collateral appreciation and amortization than more recent vintages. Furthermore, these loans had shorter periods to maturity, and in many cases lower market interest rates than in-place contract rates.

Loans originated between 1996 and 2002 constituted only 9% of all 2012 defeasance by balance; those originated between 2006 and 2010 represented 11% despite including several high origination volume years.

EXHIBIT 6

2012 Defeasance by Vintage



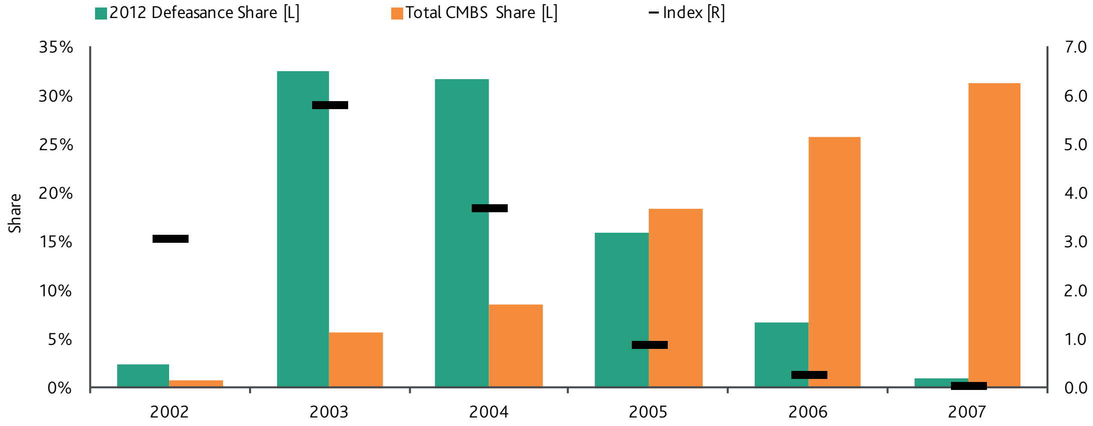
Source: Defeasance consultants

Exhibit 7 indexes 2012 defeasance by vintage to the share of each vintage in the CMBS universe. For example, loans originated in 2003 constituted the largest share of 2012 defeasance, 32%, even though the 2003 vintage constituted only 6% of the CMBS universe. Defeasance of 2003 vintage loans in 2012 was 5.8 times greater than its share of the CMBS universe. The 2002, 2004 and 2009 vintages had index values well above one; the 2005, 2006, 2007 and 2008 vintages had index values of less than one.

EXHIBIT 7

2012 Defeasance Indexed to CMBS Universe, by Vintage

Outstanding CMBS Balance as of December 2012



Source: Defeasance consultants and Trepp LLC

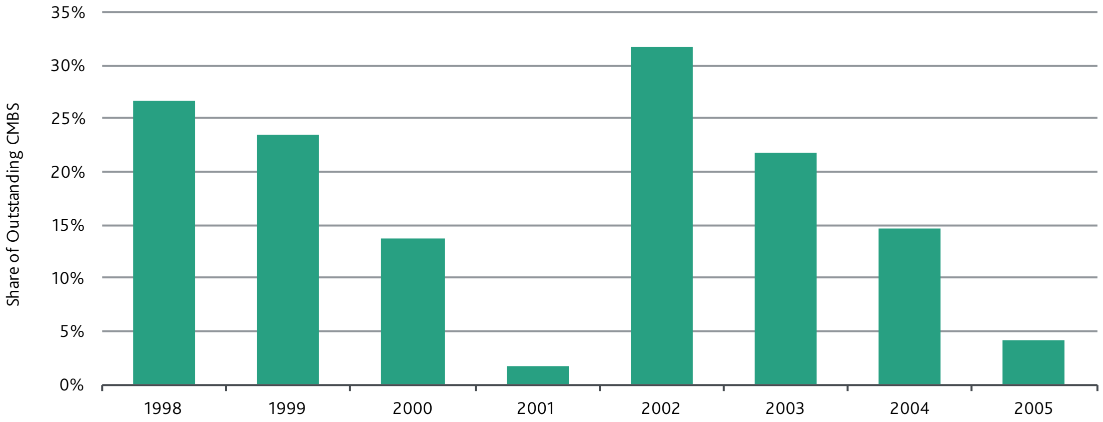
Impact of Defeasance on CMBS Credit

Defeasance remains an important factor in CMBS credit because it dramatically reduces the risk of the loss of principal with real estate assets, by substituting Aaa-rated US government securities for real estate collateral of lower credit quality. However, the amount of defeasance, and hence the benefit to CMBS credit, varies significantly by vintage and deal. For example, a large amount of the 2002 vintage has defeased to date, which can have a significant impact on the credit of 2002 vintage transactions. However, significantly less of the 2005 vintages have defeased to date, as shown in Exhibit 8. Defeasance in many early vintage deals is high, which protects the most senior outstanding classes against principal loss, but these classes are still subject to interest shortfalls stemming from specially serviced loans.[4] As a result, even classes with full protection from principal loss stemming from defeasance may still be subject to ratings migration because of interest shortfalls.

EXHIBIT 8

Cumulative Defeasance by Vintage

As of December 2012



Source: Trepp LLC

[4] Interest shortfalls occur when the interest available is insufficient to pay 100% of the interest due on all the certificates. Interest shortfalls are due to special servicing fees, including workout and liquidation fees, appraisal subordinate entitlement reductions (ASERs), loan modifications, extraordinary trust expenses and non-advancing by the master servicer based on a determination of non-recoverability.

Moody's Related Research

Below are links to publications from Moody's related to commercial real estate and credit trend research:

Special Reports:

» U.S. CMBS: Strong Property Appreciation Fuels Defeasance, March 2007 (SF94356)

» U.S. CMBS 2007 Defeasance Activity Sets New Record Despite Midyear Slowdown, March 2008 (SF125196)

» U.S. CMBS: Real Estate Value Declines and Reduced Liquidity Cause 2008 Defeasance Activity To Plummet, March 2009 (SF159454)

» U.S. CMBS: Defeasance Activity Picks Up As Commercial Real Estate Liquidity Improves, May 2011 (SF243635)

» US CMBS: Defeasance Activity Increases As Commercial Real Estate Liquidity Improves, March 2012 (SF280240)

» Q4 2012: US CMBS and CRE CDO Surveillance Review, February 2013 (SF315885)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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