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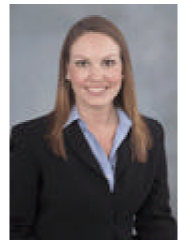
Defeasance Made Simple

Although structuring a defeasance transaction isn't easy, borrowers should be familiar with the process so they can evaluate alternatives for extracting equity from their properties and make the most profitable decision.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Chances are you've been hearing a great deal about defeasance lately. Why? As reported in a March 2006 special report by Moody's Investors Service, "the growing use of defeasance has been fueled by strong real estate appreciation, a low interest rate environment and a growing base of loans eligible for defeasance." Both capital growth in real estate and defeasance volume set records in 2005, with commercial real estate appreciation at 12.7 percent and a defeasance volume four times greater than the previous year. At nearly 13 percent growth in property values, it's no surprise that borrowers are looking for opportunities to extract the equity from their properties. For borrowers with loans securitized in the commercial mortgage-backed securities (CMBS) market — many of which prohibit mezzanine financing -- the two primary means of accessing equity are selling or refinancing. However, nearly all fixed-rate CMBS loans originated after 1998 prohibit a 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 just 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 in place, and debt service payments are made as scheduled.

That is, of course, an oversimplification of the process. A defeasance transaction is complex, and structuring one is no easy task. It involves finding and buying qualified Treasury or comparable securities that mature prior to, but as close as possible to, each remaining payment date in amounts sufficient to make all remaining payments as they become due. For a loan with 5 years remaining in its term, the defeasance collateral could consist of as many as 40 individual securities. That's the easy part. The more difficult part of the process involves coordinating a host of professionals, including a loan servicer, attorneys, an accountant, rating agencies, a securities intermediary, the title company, the refinance lender or the buyer's lender. It's the myriad of moving parts that determines how long the defeasance process will take and whether delays in the defeasance transaction will cause a refinancing property owner to lose a rate lock or a selling property owner to miss a purchase contract deadline.

One of the biggest stumbling blocks to selling or refinancing a conduit loan is the perceived cost of defeasance in a historically low interest rate environment. However, the ability to tap equity from increased property values now and reinvest them in a new project often outweigh the premium incurred from defeasing the loan. 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 6.5 percent interest rate, the borrower may have to purchase some $16.5 million in bonds in order to defease the loan, because the bonds are only yielding 4.5 percent. 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, the borrower may be able to borrow $19 million against the property. Even after paying the $1.5 million defeasance premium, there is still $2.5 million of equity in the borrower's pocket on which the borrower may earn a return to further offset the cost associated with defeasing and capturing the equity.

Conversely, in a rising 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 the proceeds available on a new loan will decline at a faster rate. If the borrower waits a few years until average yields on the securities are more than 7 percent, the defeasance premium may be reduced to zero, but the amount of proceeds available from a new loan at the correspondingly higher interest rate (say 8.5 percent) could reduce the new loan amount to $16.9 million. In other words, the net equity in the borrower's pocket has been reduced by $600,000 and the borrower missed the opportunity to earn a return on the $2.5 million that he could have reinvested a few years earlier, had he proceeded with the defeasance despite the high defeasance premium.

Is now the time to defease?

The decisions whether to defease a loan and when to defease depend on several factors. The first and most obvious is whether or not the loan requires defeasance. If the loan is a fixed-rate 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 securitized during which the loan cannot be defeased. However, older defeasance provisions sometimes state a longer lock-out period of 3 or 4 years from the date the loan was closed.

If the loan requires defeasance, and it is beyond the lock-out period, the borrower should next 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. An experienced broker or mortgage banker can help a borrower consider the options by comparing the costs of (a) defeasing now and obtaining a new loan, (b) obtaining mezzanine financing now and refinancing at maturity at prevailing rates or (c) doing nothing now and refinancing at maturity at prevailing rates. There are also online calculators to help with the analysis (www.defeasewithease.com).

When evaluating alternatives for extracting the equity from a property subject to a loan that requires defeasance, the most important thing a borrower can do is to complete the whole analysis and not be deterred by a high defeasance premium. The results of a thorough comparison of the alternatives may make defeasing now 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.

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