CMBS Loan Refinancing With Defeasance

Brokers and borrowers have a choice when prepaying commercial mortgage-backed securities

By Eitan Weinstock

Commercial loan originators should be aware of the looming commercial mortgage-backed securities (CMBS) maturities, estimated to total at least $330 billion from 2015 through 2017. As many as 20 percent of these maturing loans will require additional capital upon refinance or property sale, according to data from Trepp.

The availability of replacement financing at maturity is a mounting concern. In light of the uncertainty that comes with this concern, coupled with the current low interest rates and forecasts of impending rate hikes, savvy borrowers have begun transacting prepayments. As a result, the defeasance industry is expected to become especially active.

Despite the significant uptick in defeasance transactions over the past two years, defeasance remains an unfamiliar topic to many commercial real estate and finance professionals. To help their clients make cost-effective prepayment decisions, brokers should be well-versed in the available defeasance options and the difference between defeasance and yield maintenance.

Yield maintenance vs. defeasance

Settling commercial debt prior to maturity typically requires borrowers to transact one of two common prepayment processes: yield maintenance or defeasance. These options achieve the same goals of enabling borrowers to exit their financing and ensuring that lenders and CMBS investors realize the same yield had the loan been held by the original borrower to maturity.

Despite the identical objective, yield maintenance and defeasance are fundamentally distinct prepayment methods. In short, yield maintenance is the repayment of the loan and defeasance is the substitution of loan collateral.

With yield maintenance, the borrower pays off the loan's unpaid principal balance plus a prepayment penalty of at least 1 percent, and sometimes as much as 3 percent, of the loan balance.

In contrast, with defeasance, a portfolio of securities that continues to make loan payments on the borrower's behalf replaces the real estate collateral underlying the loan. Unlike yield maintenance, there is no minimum prepayment penalty with a defeasance. The penalty is a direct function of the cost to purchase the securities portfolio.

Whether yield maintenance or defeasance is the most cost-effective option for a borrower depends on the parameters written into the original loan documents and the market conditions at the time of prepayment. In general, assuming the prepayment language in the loan documents is favorable to the borrower, in a rising-rate environment, defeasance is the least-expensive option.

Defeasance terms that are favorable to the borrower include the ability to defease to the loan's open window and to use agency securities as permissible defeasance collateral. Conversely, unfavorable defeasance terms require defeasance collateral that will make payments through the loan's maturity date and restricts the defeasance collateral to U.S. Treasuries only.

Favorable yield-maintenance terms dictate that Treasury rates not be decompounded monthly and that payments be calculated to the prepayment date with a minimum 1 percent penalty. Unfavorable terms include decompounding the Treasury rate to a monthly rate and calculating yield-maintenance payments to the maturity date with a minimum 3 percent penalty.

Although yield-maintenance penalties remain standard as a percentage of the loan balance, defeasance penalties are less clear to borrowers when they look to get out of their current fixed-rate loans. The costs associated with defeasance and the potential rewards of opportune timing are best demonstrated with a hypothetical savings scenario.

Savings scenario

The cost to defease is tied directly to the cost of U.S. Treasuries. The greater the cost of Treasuries, the greater the cost to defease. Many owners therefore dismiss defeasance as impractical, especially those with several years remaining until loan maturity. Trends over the past two years show that borrowers are now defeasing loans with longer remaining terms, however.

Although penalties may still range from tens of thousands to tens of millions of dollars, many borrowers can save a considerable amount of money by defeasing early. For borrowers looking to take advantage

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of today's lending market, defeasance presents the opportunity to move 5.5 percent to 7.5 percent rates down into the 3.5 percent to 4.5 percent range and protect themselves against probable interest rate increases over the next few years. In many cases, defeasing early means negating interest rate risk at a minimal cost.

For example, on a loan with an original principal balance of $10 million originated in June 2007 at 6 percent interest, the potential cost savings from defeasing is about $560,000, based on current interest rate forecasts. The total cost to defease is about $1.04 million, and total interest payment savings recognized by locking-in a new 10-year loan at 4 percent interest rather than 5.5 percent interest would be nearly $1.6 million, resulting in a net profit of more than $560,000. Should interest rates go higher than 5.5 percent, these costs will be even more substantial.

Brokers and borrowers who look to lower defeasance costs by waiting for yields on Treasuries to rise should note, however, that this strategy will often have a minimal impact on costs. Should the borrower in the example choose to delay defeasance until the relevant Treasury rates have raised 10 basis points, defeasance savings will be only about $21,000. Although this saving is helpful, it pales in comparison to the potential hundreds of thousands of dollars in increased interest costs that borrowers risk incurring by delaying their refinancing.

Many borrowers view defeasance as a Treasury-rate game, believing they should delay their defeasance as long as possible to lower their costs. The example scenario, however, demonstrates that the rewards associated with defeasing promptly may often outweigh the rewards of waiting.

Defeasance process

The process of defeasance is complicated, and involves the inclusion of an array of professionals, including attorneys, accountants, brokerages, consultants, rating agencies and trustees. Defeasance consulting companies have become a standard component of defeasance transactions. Mortgage professionals often retain these consultants to help their clients maneuver through the process and minimize costs. Although the defeasance process itself is relatively standard, each loan contains unique attributes that knowledgeable consultants can maximize to the benefit of their clients.

In addition to ensuring the process runs smoothly, a defeasance consultant is also responsible for structuring the defeasance portfolio. This portfolio of optimized securities, typically U.S. Treasury or agency securities, will match the debt-service payments of the original loan and adhere to legal and industry standards. Strict guidelines govern how much cash may be included, and month-end balances have limits throughout the life of the loan. Also, a consultant must be well-versed in the diverse array of bonds available from which to construct the portfolio.

Ultimately, because market conditions are subject to indistinct fluctuations, brokers should advise clients to negotiate both yield maintenance and defeasance options in the prepayment clause of new originations to ensure the most cost-effective prepayment options down the road.

If the language of a client's existing loan documents allows for prepayment via defeasance, brokers should encourage borrowers to defease their maturing CMBS loans early to capitalize on favorable market conditions, and at the same time mitigate debt-availability crises come 2017. ■

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