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Defeasing CMBS Loans

Low interest rates fuel loan prepayments.

by Eitan Weinstock

With the real estate market on a significant upswing and lenders across the U.S. loosening their purse strings, defeasance activity has picked up substantially over the past two years. According to industry reports, more than $13.2 billion of commercial mortgage backed securities loans were defeased in 2013, representing a 123 percent increase from the previous year.

With Treasury yields keeping defeasance costs relatively high, defeasance activity has been driven primarily by borrowers looking to capitalize on the current low interest rate environment and the improved lending arena in general, both for purchases and refinances. A major impetus behind defeasance is an increase in property value. The defeasance process allows borrowers to extract equity out of their properties and lock in new, long-term financing. With property values rising and sales activity increasing, the result is that more loans are becoming attractive to defease.

Considering the high volume of loans nearing maturity over the next few years, the already booming defeasance industry is expected to be exceedingly active, with Trepp projecting a significant increase in 2014 defeasance volume over 2013.

The majority of loans defeased in 2013 were retail, office, and multifamily properties, accounting for 82 percent of total activity. Similarly, for the first half of 2014, retail and multifamily properties led the way as the most commonly defeased loans by asset type, followed by office, hospitality, and self-storage properties, according to AST Defeasance consultants. Moreover, the short-term trends of the last few years are changing with 2013 data from Moody's showing that borrowers are defeasing loans with longer remaining terms than in 2012.

Defeasance Explained

Despite the rebound in defeasance transactions over the past two years, defeasance remains an unfamiliar topic to many professionals in the commercial real estate and finance arenas. Most often used in commercial real estate as the prepayment penalty on conduit/CMBS loans, defeasance is the process of releasing a commercial property from the lien of the mortgage and replacing it with a portfolio of U.S. government securities. Once a loan is defeased, the securities portfolio effectively replaces the borrower's payment stream and makes the remaining mortgage payments on the loan, allowing the borrower to either refinance or sell the property free and clear.

The process of defeasance is highly coordinated and involves an array of professionals, including accountants, attorneys, brokers, consultants, rating agency personnel, and trustees. Defeasance consulting firms have become a standard component to defeasance transactions, retained by borrowers to help maneuver the process and minimize costs.

While the defeasance process itself is relatively standard, each loan contains unique attributes that consultants maximize to the benefit of their clients. In addition to ensuring the process runs smoothly, the defeasance consultant is also responsible for structuring the defeasance portfolio. This portfolio of optimized securities, typically U.S. Treasurys or Agency securities, will match the debt service payments of the

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original loan while still adhering to legal and industry standards. Strict guidelines govern how much cash may be included, month-end balances have limits throughout the life of the loan, and a large universe of bonds exists from which to construct the portfolio.

Timing Defeasance

Defeasance can be a preferred option in many different market environments, the most obvious being when interest rates are falling and borrowers can obtain lower interest rate loans on their properties by refinancing. However, defeasance can also make sense in a higher interest rate environment when borrowers have enough equity in their properties to cover the prepayment penalty.

While penalties still range from tens of thousands to tens of millions of dollars, many borrowers can save considerable amounts by defeasing in today's lending market. Defeasance presents the opportunity to move interest rates from 5.5–7.5 percent to 3.5–4.5 percent, while offering protection against probable interest rate increases over the next few years. In many cases, defeasing today means negating interest rate risk at a minimal cost.

For example, for a borrower with an original principal loan balance of $10,000,000 originated in June 2007 at a 6 percent interest rate with a 10-year term, the potential cost savings from defeasing now will be approximately $562,094.63, based on current interest rate forecasts. As illustrated in the graphic below, while the total cost to defease today is approximately $1,040,000, total interest payment savings from locking in a new 10-year loan at 4 percent interest today rather than 5.5 percent interest in 2017 will be approximately $1,600,000, resulting in a net profit of approximately $560,000. Should interest rates move above 5.5 percent by 2017, these savings will be even more substantial.

Moreover, for borrowers looking to lower their defeasance costs by waiting for yields on Treasurys to rise, it should be noted that this strategy will most often have only a minimal impact on costs. For example, should the borrower choose to delay defeasance until the relevant Treasury rates increase by 10 basis points, the defeasance savings will be only approximately $21,000. Obviously, while these savings are certainly helpful, they pale in comparison to the potentially hundreds of thousands of dollars in increased interest costs that borrowers risk incurring by delaying their refinance.

Indeed, most borrowers view defeasance as a Treasury-rate game, believing that they should delay their defeasance as long as possible to lower their costs. However, as demonstrated by the savings in the graphic below, the rewards associated with defeasing today can often outweigh the rewards of delay.

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