

A New Look

NORTHEASTERN CMBS LOANS RIPE FOR DEFEASANCE

Borrowers May Save Hundreds Of Thousands Over Life Of Mortgage

BY EITAN WEINSTOCK | SPECIAL TO THE COMMERCIAL RECORD

With real estate fundamentals returning to pre-crisis levels, the northeastern commercial real estate market is particularly primed for a significant increase in sales and refinances.

Considering the strength of the commercial real estate market, which boasts low vacancy rates and rising property values, the low interest rate environment, and improvements in the lending arena, borrowers are incentivized to defease their existing commercial mortgage-backed security (CMBS) loans to facilitate the sale or refinancing of their properties.

Currently, according to data from Trepp, almost 3,000 CMBS loans meet the criteria for defeasance. Of these loans, many are backed by properties in Connecticut and Massachusetts.

Borrowers are often fearful of defeasance, but why? As loans originated from 2005 to 2007 approach maturity, defeasance can actually be cost-beneficial for many commercial property owners. Looking at the average rate on the aforementioned 3,000 loans that qualify for prepayment, there may be enough return opportunity in a refinance or cash out via defeasance.

Most often used in commercial real estate as the prepayment requirement 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 simultaneously either refinance or sell their property free and clear.

With the cost to defease tied directly to the cost of U.S. Treasuries (i.e. the higher the cost of Treasuries, the higher the cost

to defease), many owners have dismissed defeasance as impractical, especially those with several years remaining until loan maturity. Since 2008, the cost to defease has ranged from 4 to 6 points per year remaining on the loan, leading many borrowers to sit on their loans rather than sell or refinance. However, Moody's reported a significant rise in U.S. CMBS defeasances in 2013, increasing 123 percent from 2012; and what's more, 2013 data shows borrowers are defeasing loans with longer remaining terms than in 2012.

While penalties still range from tens of thousands to tens of millions of dollars, many borrowers can actually save considerable amounts by defeasing now (see chart). For borrowers looking to take advantage of today's lending market, defeasance presents the opportunity to move from 5.5 to 7.5 percent rates into 3.5 to 4.5 percent rates, while protecting themselves against probable in-

terest rate increases over the next few years. In many cases, defeasing today means negating interest rate risk at a minimal cost.

Moreover, for borrowers looking to lower their defeasance costs by waiting for yields on Treasuries to rise, it should be noted that this strategy will most often have only a minimal impact on costs.

For example, should the borrower on the loan in the chart choose to delay their defeasance until the relevant Treasury rates have raised 10 basis points, their 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 the example in the chart illustrates, the rewards associated with defeasing today can often outweigh the rewards of delay. ■

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Defeasance Savings Scenario		
Original Loan Amount - \$100,000		Term - 10 Year
Interest Rate - 6%		Amortization - 30 year
Defeasance Date: Feb 1, 2015		Maturity Date: June 1, 2017
Defeasance Now	Wait Until Maturity	Potential Cost Savings by Defeasing Now
DV01 \$2,119	Remaining Interest	
Defeasance Cost	\$1,065,712.83	
\$1,040,451.03	New Loan Interest	
New Loan Interest @4%	@5.5%	
\$3,672,181.25	\$4,209,014.07	\$562,094.63
Total Cost (10 Year)	Total Cost (10 Year)	
\$4,712,632.27	\$5,274,726.90	