Commercial Mortgage Insight®

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Overcoming The Learning Curve Of Commercial Loan Defeasance

When shopping for a defeasance consultant, there are some initial stepping stones a user must get past.

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In its simplest form, a defeasance is a substitution of collateral for a loan that has been securitized in the commercial mortgage-backed securities (CMBS) market. The transaction allows the original borrower to substitute the lien on their property with acceptable replacement collateral in order to extinguish their financial obligations and facilitate a sale or refinance. A new entity is established (the successor borrower) to assume the rights and obligations of the loan and a portfolio of securities - typically, U.S. Treasury bonds - that will meet the remaining debt service requirements of the loan and be held as replacement collateral.

Although the concept of defeasance is easy to summarize, the process itself can be very complicated. Defeasance is both an economic and legal process involving a multitude of players, including the original borrower, borrower's counsel, the loan servicer, servicer's counsel, the new lender, an independent accountant, a securities custodian, a successor borrower entity, the successor borrower's counsel, a title/escrow agent and a special servicer and/or rating agency if required. The new buyer and its legal counsel in the sale transaction become parties to the defeasance as well.

In addition to educating new players to the defeasance process, and providing insight into industry standards, a defeasance consultant generally executes three core functions.

First, the consultant coordinates the activities of the various parties to ensure that the defeasance timeline meets the timeline of the sale or refinance.

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Second, the consultant structures the portfolio of securities so that the coupon payments and return of principal on maturity of the securities will match the remaining debt service payments on the loan as closely as possible. These responsibilities also extend to ensuring that the portfolio adheres to the legal guidelines that support the real estate mortgage investment conduit (REMIC) structure.

And third, a typical defeasance consultant can establish the successor borrower entity that will assume the rights and obligations of the original borrower on the loan.

Cost comparison

There are two key areas to evaluate costs associated with a defeasance. The first is the cost of the portfolio of securities. The Treasury market (and the market for government agency securities when permitted in the loan documents) is typically a very liquid market and securities can be priced quite efficiently. A user should ensure that its defeasance consultant can hold a competitive auction among market players to get the most aggressive pricing on the cost of the collateral.

The user should also inquire as to whether the consultant has a brokering relationship with the bank providing the securities, as any additional fees built into the price of the portfolio will ultimately be paid for by the borrower. Otherwise, a given portfolio price will fluctuate with the market, but should not differ greatly from one consultant to another.

The second area of cost analysis consists of the transaction fees for each of the involved parties. Even though the user's defeasance consultant cannot influence many of the fees associated with a defeasance, the consultant should be able to articulate the basis of his/her consulting fee, as well as to explain which of the additional fees are fixed and which will fluctuate as the deal progresses.

Hidden value

A more elusive area in comparing the value added by a consultant is often not addressed in defeasance estimates. This area - referred to as the "residual value" or "float" - can potentially provide a significant rebate for the original borrower at the loan's maturity. An optimized portfolio of securities will match as closely as possible the incom-

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ing cashflows from the securities to the outgoing cashflows for the remaining payments on the loan.

However, since the maturity dates and coupon payment dates on treasuries will rarely be an exact match for loan payment dates, there is an inevitable mismatch that results in excess funds accruing interest, or float, in the successor borrower's account. Over the remaining life of the loan, this float may be quite small, but if the treasury security with the closest maturity prior to the anticipated repayment date on the loan matures several weeks prior to the balloon payment, or if the outstanding balance on the loan is large, this float can become significant.

So, one of the REMIC rules governing defeasance is that none of this float can be taken into consideration as part of future debt service payments, thus it will sit in the account until the maturity of the loan. The important question is: What happens to this residual value at maturity?

When the successor borrower entity is established, it assumes both the rights and obligations of the loan. One of the rights it assumes is the right to any residual value in the securities account at maturity. However, some consultants will offer up to 75% of this value to be shared back with the original borrower. As previously stated, this can potentially be a significant return in the case of larger loans or of portfolios with a significant mismatch due to the maturity dates of existing treasuries. While this area is more of a return than a reduced upfront cost, any sharing arrangement should be considered when evaluating competitive pricing.

The user's interests

There are three key interests being represented in a defeasance. The original borrower wants to unencumber the property and the original borrowing entity at a minimum cost; the servicer wants to protect the interests of the CMBS bondholders by ensuring that the defeasance meets rating agency(ies) specifications; and the successor borrower wants to minimize its liabilities and maximize any float gained at maturity.

Since the defeasance consultant performs several roles in a transaction (often including the establishment of the successor borrower), there can be conflicts of interest. If the consultant is the sole entity that stands to profit from the residual value in the portfolio, and is also responsible for structuring the portfolio as efficiently as possible, the user should be aware that a conflict may exist. Likewise, if the consultant is representing the user's interests but is also affiliated with the servicer, the user should be aware of the relationship. It is important that the user who is hiring the services of a defeasance consultant understand any such affiliations, and whether the affiliation profits from an upfront transaction fee or by retaining the residual value in the successor borrower's account.

Some of the aspects of the defeasance process will be dictated by the defeasance provisions in the loan documents. The right to establish the successor borrower entity or to hold a competitive auction for the defeasance collateral may be retained or waived by the original lender in these provisions.

The loan language will also dictate whether the use of government agency securities is permitted (lowering the cost of the defeasance collateral) or whether the portfolio must consist of only U.S. Treasury securities. One's defeasance consultant may need to review the provisions of one's loan documents in order to accurately assess the estimated fees and to provide insight as to how the provisions will affect the transaction.

And if a user is placing new debt on the property, the consultant may also be able to assist in reviewing the defeasance provisions of the new loan in order to obtain favorable terms for any future defeasance. ●

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