Defusing Defeasance: The Real CMBS Millennium Bug

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With all the hype surrounding the Y2K bug, it is sometimes amazing that commercial mortgage bankers can get any business done. Teams of consultants have been debugging software and creating backup plans and systems. Investors have requested contingency plans and certifications from servicers. Servicers have asked for the same information from borrowers. CMBS transactions now require servicers and trustees to warrant that they are Y2K compliant and indemnify the trust accordingly. It now appears that many in this industry are simply going to shut down in December and retreat to their bunkers until the dust settles. Our theory is that the Y2K bug will trigger the Russian nukes twelve hours earlier than us on January 1st, so we won't be around to worry about it anyway.

Unfounded hysteria aside, what mortgage bankers are likely to find when we return to our offices in January is that the elevators still go to the top of the building and all of our PCs have not spontaneously exploded. We'll realize that all of our important software still works and that our scariest discovery is that the digital coffee machine is blinking "12:00." Soon we'll be kicking ourselves for not closing those last ten loans in December, but we are starting to feel pretty good about the next millennium. Then the real ugliness starts. One of our best borrowers calls wanting to defease his conduit loan.

Here's the problem: Deep within the bowels of most conduit promissory notes executed since 1997 (and as early as 1995), typically in the prepayment section, lurks a time bomb known as defeasance. Defeasance has become the preferred alternative to yield maintenance in the CMBS sector of the commercial mortgage real estate market. It provides for the replacement of the mortgage with U.S. Government securities as a substitute for the collateral for the CMBS bondholders, who want the cash flow preserved. However, most borrowers and their attorneys do not have a clue as to how the defeasance process works or what the costs are. Indeed, very few of us in the industry understand, as only a handful of commercial mortgage loans have been defeased to date. We are all about to get a crash course.

The reason defeasance requests will accelerate in the year 2000 is twofold. First, rates have been historically low. Very few borrowers have felt a need to refinance or sell their income property that they just purchased and/or financed in 1997. Second, real estate mortgage investment conduit (REMIC) tax laws prohibit defeasance within the first two years of securitization. According to Commercial Mortgage Alert, roughly 100 billion in conduit loans have been securitized since January 1997, most of which provide for defeasance. The two year prohibition on these loans will begin cycling out in a big way next year. In addition, older loans with defeasance will be seasoned enough to provide an incentive for borrowers to entertain sale and refinance strategies. This will prompt borrowers and their attorneys to read their loan documents, including the section pertaining to the defeasance requirement, which, in turn, will prompt the borrower to call their friendly mortgage banker to ask them why they did this to them.

The following is an example of how the process might play out:

For purposes of our example, the process actually began in 1997, when our borrower, Dave Developer, asked his local commercial mortgage banker, Bob's Mortgage Company, to help him finance the acquisition of a $5,000,000 ten-year-old office building in suburban Omaha. Dave's a pretty big player in Omaha and had financed a dozen different properties through Bob, with several life insurance companies and Freddie Mac. However, Bob had found a conduit that best matched Dave's requirements with respect to terms and price. The new defeasance language was briefly discussed, but neither party completely focused on this little understood section of the note during the compressed closing process. Besides, Dave felt he would hold the property to maturity (10 years) and the $3,500,000 loan was assumable at the note rate of 8%.

It is now January 2000. The elevator still goes to the top of Dave's office building, which is now worth $7,000,000. Dave gets an e-mail from Bob on his perfectly good PC suggesting that he can now get Dave a 7.5%, $5,250,000 loan on his 98% occupied office building. Dave immediately figures out how he is going to spend the additional loan proceeds and calls his attorney Elliot E. Esquire, because he vaguely remembers he has to defuse his existing loan. Elliot, who now understands defeasance, explains that you defuse a bomb, which is bad. You defease a loan, which is worse.

Elliot recalls that Dave's mortgage was sold into a securitization shortly after it closed and a master servicer was inserted into the transaction. Bob confirms that although he is the primary contact with Dave, he reports and remits payments to Millennium Services, another Y2K compliant servicer. Bob calls Mike Master at Millennium and informs him of Dave's request. Mike arranges a conference call for the following day with Dave, Bob and Elliot. Having had the opportunity to pull Dave's loan documents and review them for defeasance requirements as well as review the pooling and servicing agreement (PSA) governing the securitization, Mike informs the group that he has good news and bad news. The good news is that Dave's loan is past the two year REMIC prohibition and is eligible for defeasance. The bad news is his loan documents and the PSA require Dave to provide the following:

1. A letter from each of the three rating agencies that rated the securitization stating that this action will not cause them to downgrade the current rating they have assigned to the bonds. Mike advises that Millennium will coordinate this requirement with information Dave will supply. Cost to Dave: (For all three letters) $12,500.
2. A counsel opinion letter from Elliot stating, among other things, that Dave's borrowing entity is validly existing, that the REMIC trust has a perfected 1st priority security interest in the defeasance collateral and that all assignments are valid. Cost to Dave: (To be worked out with Elliot E. Esquire) $5,000 (the "E" stands for expensive).
3. A REMIC opinion letter prepared by counsel approved by Millennium stating that the release will not disqualify the trust as a REMIC and will not cause tax to be imposed on the trust fund. Mike advised that he would coordinate this, which usually includes the drafting of all documents used in the defeasance (new borrowing entity, pledges, assignments, assumptions, etc.). Cost to Dave: $20,000.
4. As the property and Dave's borrowing entity will be released in the process, Dave must provide a replacement borrowing entity to hold and pledge the Treasury securities. Mike advises that Millennium can assist in this requirement as other loans in this pool have already defeased and a replacement borrowing entity has already been established. Cost to Dave: Included in #3, above.
5. A comfort letter from a CPA firm acceptable to Millennium stating that the Treasury securities are sufficient to pay all future principal and interest payments and comply with the loan documents. Mike offers Dave a choice of the national CPA firms with whom Millennium has agreements as to the scope and content of the opinion letters. Mike will coordinate this requirement. Cost to Dave: $3,500.
6. A trustee processing fee. Mike alerts Dave that some of the trustees have begun quoting fees for holding, redeeming and accounting for the replacement Treasury securities. Cost to Dave: (Depends on trustee) $2,500.
7. A master servicer processing fee. Mike reminds Dave of the number of items that Millennium was coordinating. Cost to Dave: $2,500.
8. The transaction costs and broker fees associated with actually purchasing the U.S. Government securities. This could be expensive because borrowers like Dave rarely use or have an arrangement with a trading desk. Dave may also have difficulty matching treasuries to his loan amortization schedule, which may force him to buy excess treasuries to accommodate the mismatch in payment stream, adding to his costs. These expenses can vary widely. Cost to Dave: unknown.
9. Last, but not least, Dave must pay the remainder of the defeasance deposit (net of the above costs). This amount is the estimated purchase price of the Treasury securities necessary to pay the future loan payments. Mike advises Dave that the cost to identify and purchase the securities is Dave's responsibility. As a service, Millennium has developed a model to estimate the deposit amount based on current yield curve characteristics. Estimated cost to Dave: $3,880,500 in various maturing treasuries, or $463,000 over Dave's present loan balance of $3,417,500.

The costs and fees in 1–9 above add up to $509,000. The additional costs to underwrite and close the new loan (commitment fees, third party reports, legal, title, etc.) could easily push the out of pocket costs over $600,000, or roughly one-third of Dave's expected cash proceeds. In addition to the above requirements, Mike reminds Dave that all amounts due under the loan must be paid to date, the loan can only be defeased on a payment date and Dave must give at least 30 days written notice of his intent to defease the loan.

Dave is speechless. He recalls the brief discussion at the closing relating to defeasance as an exit strategy for the loan. Somehow, the brief discussion seems so inadequate for such a topic. Dave is wondering whom to blame and directs his anger at Elliot for his inadequate advice. Elliot blames Bob for downplaying an important business issue. Bob blames Mike for imposing such arduous and expensive requirements. Mike blames the investment bank for concocting such a scheme. The investment bank blames the rating agencies because the subordination levels are better under such a scheme. The rating agencies blame the B-piece buyers who drive the economics of the transaction. The B-piece buyers blame CRIIMI MAE like everybody else does about everything else. You get the idea.

In spite of all of the requirements, the toughest part of the defeasance option is stomaching the economics. In a relatively stable, low-rate environment, having to purchase low yielding Treasury securities to replace relatively long, market rate payment streams is a difficult and expensive proposition, especially as the amount of leverage increases on the property. Typically this strategy doesn't make economic sense until you are near the early repayment date — unless you have an extraordinary opportunity for the property as Dave did. It makes absolutely no sense on loans less than $5,000,000, where the out of pocket costs (1–8, above) take a bigger percentage bite out of the borrower's cash proceeds. Once the economic bullet has been bitten, the work of assembling all of the necessary items can begin. The number of players involved hampers the process. Parties to a typical defeasance include the borrower, the borrower's counsel, the servicer, the servicer's counsel, the CPAs and their counsel, the trustee, the title company or escrow agent, and the rating agencies (usually more than one) with their counsel. Throw in a property sale scenario, with a buyer for the property, their counsel and the mortgage banker arranging the new financing, and you have coordination issues that will make you long for the problems of preparing for Y2K.

Like any new process, the pioneers pay the price for those that follow. Certainly, some of the costs associated with the process are greater because this is new territory and there aren't many transactions to spread the costs over. As the process matures and standardization begins to take place, we should see some moderation of the transaction costs and a compression of execution time. As the rating agencies become comfortable with both the mechanics of the process and the servicer's execution, perhaps they will remove the rating letter requirement, which will speed up the process and reduce some of the costs. From a credit perspective, it is clearly better to have U.S. Treasury securities than commercial real estate securing the bonds. Some traders say this actually adds as much as 50 basis points to the price the bonds fetch, which is significant.

So, how do we as an industry defuse the defeasance time bomb? Some thoughts:

1. We must clearly explain to our borrowers what it means and what it costs to defease a conduit loan. This should be done during the application phase when the borrower is considering a number of financing options (attaching a copy of this article to the loan commitment should do it).
2. As mentioned above, we must reduce the number of parties participating in the process, which should shorten the timeline.
3. We need to get the costs under control. Standardization and limiting the participating parties should help. Eliminating or reducing some of the requirements will also help. Some industry focus has already begun on this process. A sub-committee to the CMSA's Post Issuance Committee has been impaneled to look at just these types of issues.
4. Abolish defeasance for loans less than $5,000,000.
5. Streamline the assumption process already provided for in conduit loans. This may be the only economic alternative for some borrowers who wish to sell their property, but the underwriting, processing and approval mechanics in the CMBS environment are currently burdensome and somewhat expensive. Allow more than one assumption on longer-term loans.

There is not much we can do today for borrowers like Dave, save contact and counsel them before they count their chickens. We can, however, help other borrowers in the future by addressing items 1–5, immediately above. If the CMBS sector of commercial real estate finance is to continue to grow and prosper, we must keep in mind that the borrower feeds everyone in the CMBS food chain. The last thing we need to do is add more links to the chain.

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