



FOR YOUR FILES

Conduit Prepayment Issues

Defeasance vs. Yield Maintenance

Questions & Answers

Q: Why are capital market-oriented lenders (conduits and federal agencies) pushing defeasance as a "prepayment" structure?

A: Defeasance gives the CMBS buyer a secure payment stream for the entire length of the loan. Avoiding early payoffs allows the CMBS issuer to get top dollar for an interest-only (IO) strip. Also, a secure maturity date makes the CMBS useful for swaps, hedges and other derivatives.

Q: Has defeasance been around for a while?

A: Yes, in the area of municipal bonds defeasance is common. However, in real estate this is a new practice. This method of prepayment only became standard practice in CMBS lending since 1999.

Q: Is it true, the loan does not actually pay off?

A: That is correct. The real estate is released from the security for the loan and U.S. Treasury instruments, a combination of bonds and strips, are substituted as collateral.

Q: Will I need to maintain the partnership or LLC, such as filing annual tax returns for the life of the loan?

A: Unfortunately, yes. However, we expect mortgage firms, such as Newmark, soon to offer to take over these partnerships for a fee. Such a defeasance service firm will receive the semi-annual payments on the T-Bills, make the monthly mortgage payments, maintain the borrowing entity, and pay all necessary fees and taxes.

Q: Will there be tax consequences to defeasance?

A: Yes. Unless a non-related entity defeases the loan, the prepayment penalty may not be written off when it occurs. Certain elections need to be made to minimize tax effects during the life of the defeased loan. Also, a 1031 exchange may be complicated or disqualified. Newmark advises reviewing these issues with a tax specialist.

Q: What are the transaction costs associated with defeasance?

A: Besides the commissions on the bonds, the partnership will need to supply an opinion from an accounting firm on the adequacy of the cash flows from the Treasury bonds and strips to meet mortgage payments and the ending loan balance. Also, a law firm must issue a legal opinion that the borrowing entity is bankruptcy remote.

What is a typical yield-maintenance penalty?

- A yield maintenance prepayment penalty is typically the larger of (1) a minimum penalty, say 1%, or (2) the result of a formula that subtracts the mortgage balance from the sum of all remaining mortgage payments discounted at a reinvestment rate. This reinvestment rate is usually the yield on U.S. Treasury Notes with terms equal to the remaining mortgage term. The concept of a yield maintenance prepayment penalty is for the lender to replace the paid-off loan with T-Bills and preserve its yield. We know the lender is not going to buy T-Bills with the money. So, isn't this punitive? Yes, that is why they call it a prepayment penalty.

What is defeasance?

- In defeasance the T-Bills that are a fiction in the yield-maintenance formula are actually purchased, not by the lender but instead by the borrower. Except for the transaction costs of defeasance, the economics are similar to yield maintenance. The arrangement allows the borrower to get the real estate released as security from the loan substituting Treasury instruments or other approved securities (Fannie Mae accepts Fannie Mae obligations versus Treasury Notes). The CMBS (commercial mortgage-backed securities) holder gets mortgage payments to the last day of the loan.

Why defeasance?

- The certainty of fixed payments for the entire loan term allows the CMBS issuer to achieve a higher value for its mortgage pool by being able to sell off an IO (interest only) strip as well as increase the universe of CMBS buyers.

Does defeasance offer any advantages for the borrower?

- Yes, if rates go up substantially, the real estate can be released from the mortgage substituting Treasury instruments as collateral which cost less to purchase than the remaining balance on the loan; equivalent, to paying the loan off at a discount.

What are the disadvantages for the borrower?

- You sell the property but keep the loan. This could mess up a balance sheet. The borrowing entity continues to exist. There are tax effects and there are transaction costs to buy the bonds and obtain necessary legal and accounting opinions. Also, since the bonds will need to be purchased and put into escrow before the property sells, your bond broker may want a guarantee or large deposit.

Warning – Seek tax advice regarding future 1031's

- One of the advantages of real estate is the ability to do a 1031 exchange to postpone capital gain taxes. Some tax attorneys worry that defeasance may be ruled as not being a like-kind exchange, in that the sold property is exchanged for the equity in the new property, plus T-Bills which are securities and not real property.



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