
Exit Strategies for Fixed Rate Financing

Comparing Yield Maintenance and Defeasance Alternatives...

by Regan Campbell and Jehane Walsh

When looking to refinance or sell a real estate asset encumbered by fixed-rate commercial mortgage-backed securities debt, borrowers typically are faced with one of two alternatives: yield maintenance or defeasance. The intent of both alternatives is to allow CMBS bondholders to realize the same yield as if the borrower had held the loan to maturity. However, both alternatives potentially can be punitive to borrowers.

Because of this, borrowers often question whether yield maintenance or defeasance will be the most economical choice for exiting a financing. The answer is: It depends. Several factors, including market conditions at the time of repayment and the language dictated by the loan documents, can influence which alternative will be the most cost effective for the borrower.

What Is the Difference?

From an economic standpoint, both yield maintenance and defeasance allow borrowers to achieve the same objective, which is to unencumber the underlying real estate asset. However, from a legal perspective, the two processes are fundamentally different. Yield maintenance is the actual prepayment of the loan, while defeasance entails a substitution of collateral and assumption of the loan by a special purpose entity, commonly referred to as a successor borrower.

A yield maintenance payment usually consists of two portions: the loan's unpaid principal balance and a prepayment penalty. While there is no standard method, the prepayment penalty typically is determined by first calculating the replacement rate. More often than not, the replacement rate is current yield on the U.S. Treasury that

matures closest to the maturity date of the loan. This rate is often quoted from the Federal Reserve's H15 report or another major financial publication. The difference between the rate on the underlying loan and this treasury rate represents the loss in yield that the lender will incur as a result of the prepayment if no penalty is paid.

The yield maintenance penalty is then determined by discounting all of the remaining loan payments at the time of prepayment to a present value using the replacement rate as the discount rate. The sum of these values minus the outstanding principal balance represents the yield maintenance penalty for this loan.

Yield maintenance provisions usually contain language that incorporates a minimum payment between 1 percent and 3 percent of the outstanding principal balance. This language effectively puts a floor amount on the yield maintenance premium that the lender will receive.

With defeasance, the penalty is a function of the cost to purchase a portfolio of securities that replicates the loan's remaining debt service schedule. As previously mentioned, the loan remains in place and the substitute collateral replaces the real estate asset as the collateral securing the loan. The cash flows generated from the securities by means of coupon payments and maturing securities will cover all future loan payments.

Unlike yield maintenance, defeasance provisions do not contain a floor. In some cases, the cost to defease a loan actually may be lower than the loan's outstanding principal balance. When the average yield on the substitute collateral is higher than the coupon on the loan, it will be cheaper to purchase securities to cover the loan's remaining interest and principal payments. One drawback to defeasance is that third-party administrative fees exist in every transaction, typically ranging from \$50,000 to \$100,000 depending on the loan's size and complexity.

Which Costs Less?

The ability to choose yield maintenance or defeasance when exiting a CMBS financing often is decided at loan origination. The method used to exit the financing is determined by the prepayment terms dictated by the loan documents and the state of the markets at the time of repayment.

The differences associated with the cost of yield maintenance and defeasance best can be shown with a hypothetical loan. Table 1 illustrates the loan terms and contemplates a defeasance or prepayment on May 1, 2008.

To illustrate the differences in the cost of the two alternatives, four scenarios were used (Note: The relative terms favorable and unfavorable relate to the borrower's perspective): favorable and unfavorable defeasance provisions and favorable and unfavorable yield maintenance terms. (See Table 2.) Then interest rates were shocked both positively and negatively to show how the different prepayment costs would react.

Table 3 illustrates the cost in millions associated with either prepaying or defeasing based on the terms in the loan documents and the interest rate environment at the time of repayment. The table illustrates two key points: the cost differential between defeasance and yield maintenance given varying interest rates, and the importance of negotiating favorable terms at the time of loan origination.

Assuming the loan contains favorable defeasance provisions, it always will be cheaper to defease a loan with this structure. This is primarily due to the ability to defease using federal agency securities (such as those issued by Fannie Mae or Freddie Mac) as replacement collateral and defeasing to the prepayment period rather than the loan's maturity date. Yield maintenance (containing favorable terms) is the next least-expensive

alternative for this loan in today's interest rate environment.

Notice also that the yield maintenance penalty is linear until rates rise by 1.5 percent above today's rates, at which time the minimum penalty kicks in. The defeasance cost always is linear as there typically is no minimum defeasance penalty. Therefore, as rates rise, defeasance becomes the best alternative no matter what type of defeasance provisions the loan contains.

The answer is less clear-cut if rates are lower than the loan rate at the time of prepayment. With the exception of a loan with favorable defeasance terms, there is very little difference in the prepayment premium.

Table 3 illustrates that a cost differential exists between yield maintenance and defeasance. However, there is no definitive choice for borrowers when it comes to exiting fixed-rate CMBS debt. The cost differential is affected by a combination of the loan document provisions and prevailing interest rates. Borrowers have no control over the absolute levels of interest rates at the time of repayments, but they do have control over the terms in their loan documents. As such, it is crucial that borrowers focus on their loan exit terms at origination.

Exit Strategies to Consider at Origination

The right loan language can save borrowers a considerable amount of money in yield maintenance or defeasance costs. Because provisions cannot be modified once loans are securitized, borrowers must negotiate favorable terms at origination. Table 3 identifies terms that have the largest impact on future exit costs.

For yield maintenance the basic rule is to have the replacement treasury rate be as high as possible. Loan documents should not call for the replacement rate to be compounded to a monthly rate. Treasury rates typically compound semi-annually and are quoted as annual rates. Your

loan rate is also quoted to you as an annual rate. Decomposing the replacement rate to a monthly rate serves to decrease the overall replacement rate and the subsequent discount rate used to calculate the yield maintenance penalty. A lower discount rate means a higher present value and therefore a higher penalty.

To further reduce future yield maintenance costs the loan documents can call for a basis increase to the prevailing treasury rate. Typically this is achieved with language stating that *"the replacement rate will equal the yield on the U.S. Treasury that matures on a date equal to the loan's maturity plus [XX] basis points."*

Borrowers can reduce their future defeasance costs as well. As mentioned previously, the ability to use agency securities as collateral will result in the most cost effective portfolio possible. However, specific language must be included in the loan provisions such which define the replacement collateral as *"government securities within the meaning of Section 2(a)(16) of the Investment Company Act of 1940."*

Another factor that reduces defeasance costs for borrowers is the ability to recoup a portion of the residual value that may exist in the defeasance collateral account once the loan matures. Residual value arises from a mismatch between the maturity and coupon dates of the securities used for the defeasance, and the payment dates of the loan. For example, a security may mature and pay in to the collateral account on the 15th of the month while the loan payment is not due until the 1st. The funds will sit in an interest bearing account for 15-16 days until they are used to make the mortgage payment. The interest earned cannot be used to make any debt service payments and cannot be withdrawn until the loan matures. This accrued interest can be significant especially when the loan has a large balloon payment. Residual value is the sole property of the successor borrowers; however, original borrowers may realize a portion of this value if they enter into sharing arrangements with the successor borrowers.

In order for borrowers to ensure they receive a portion of the residual value, the loan documents should contain a provision that allows them to designate successor borrowers. While the sharing of this value does not decrease the upfront costs of defeasances it does offer a form of rebate for borrowers, either upon final payment of the loan or the present value of the projected residual value at defeasance closing.

Ultimately, if it is economically feasible, borrowers should attempt to include both yield maintenance and defeasance provisions in their loan documents at origination as this will allow for maximum flexibility when exiting the financing. Including favorable defeasance and/or yield maintenance provisions will allow borrowers to make the most cost-effective choice when exiting a CMBS fixed-rate loan.

Regan Campbell and Jehane Walsh are consultants at Chatham Financial, a debt strategy advisory firm that serves the capital markets. Contact Campbell at (484) 731-0207 or rcampbell@chathamfinancial.com. Contact Walsh at (720) 221-3514 jwalsh@chathamfinancial.com.

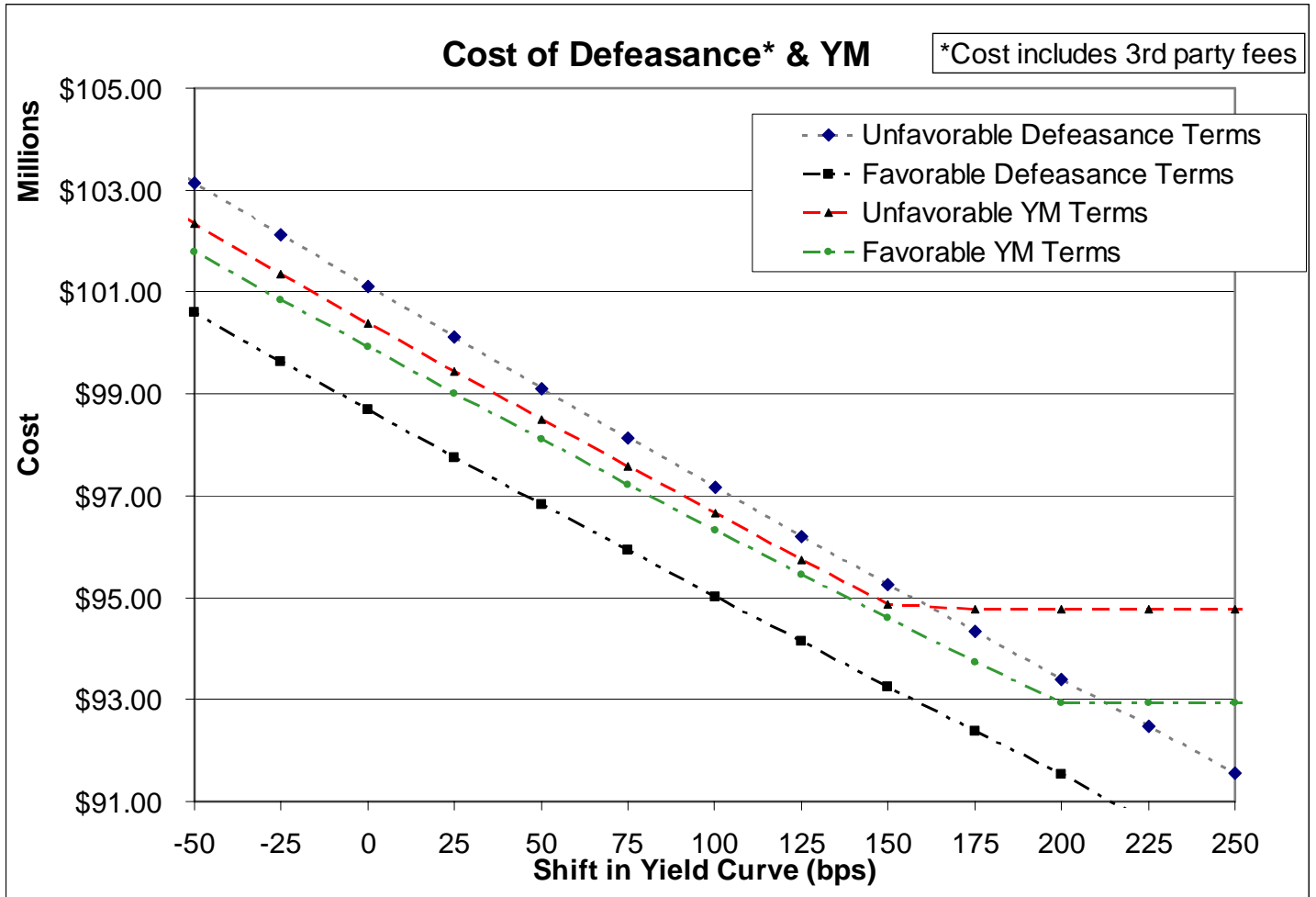
Table 1

Loan Terms	
Original balance	\$100 million
Interest rate	5.0%
Type	Balloon
Amortization	30 years
Start date	Jan. 1, 2003
Maturity date	Dec. 1, 2012
Prepayment at par window	3 months
Prepayment or Defeasance Date	May 1, 2008

Table 2

Defeasance and Yield Maintenance Terms			
Defeasance		Yield Maintenance	
Favorable	Unfavorable	Favorable	Unfavorable
Permitted to use agency securities as defeasance collateral	Must use U.S. Treasuries as defeasance collateral	Treasury rate is not decompounded to a monthly rate	Treasury rate is decompounded to a monthly rate
Permitted to purchase defeasance collateral that makes payments through any payment date within the prepayment window	Must purchase defeasance collateral that will make payments through the maturity date	Yield maintenance payments are calculated to the prepayment date instead of the maturity date with a minimum 1% penalty	Yield maintenance payments are calculated to the maturity date with a minimum 3% penalty

Table 3



Based on rates as of Feb. 19, 2008 (10-year U.S. Treasury 3.89%; 5-year U.S. Treasury 2.93%)

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