Defeasance: An Overview

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Defeasance is a common prepayment penalty structure found with conduit loans. Many borrowers may not know or fully understand what it is or how it affects them.

What is defeasance?
Simply put, defeasance is a substitution of collateral for a loan that has been securitized. The actual prepayment penalty related to defeasance is similar to a yield maintenance prepayment penalty, and can actually be less depending on Treasury yields. The substitution allows a borrower to replace the lien on the property with acceptable replacement collateral. This is usually done to facilitate a sale or refinance of the mortgaged property. The collateral replacing the property is a portfolio of U.S. Government securities and the cash flow from these securities are used to cover the debt service requirements for the remaining term of the loan. With the U.S. government’s current policy of keeping rates low, the result is that defeasance prepayment penalties are high.

How does the borrower start the defeasance process?
Borrowers typically engage the services of a company experienced in the defeasance process. These companies are usually able to coordinate the process and the various parties involved, which makes the process fairly seamless to the borrower. Some lenders have also started to offer defeasance services to their customers.

The process begins once the borrower sends the good-faith deposit to the company handling the defeasance. This deposit will be applied toward certain costs and fees incurred in connection with the defeasance closing. The defeasance transaction costs are typically in the $50,000 to $70,000 range. In addition to the borrower and servicer, typical parties to the defeasance process include the borrower’s counsel, a certifying accountant and/or accounting firm, a securities intermediary, a successor borrower and an escrow agent.

What is a successor borrower?
The successor borrower is a newly created entity that takes the place of the existing borrower. The original borrower executes all of the defeasance documents pledging the government securities as collateral for the loan, and the successor borrower then assumes all of the original borrower’s liabilities under the note and the defeasance pledge documents. As outlined below there are some
profits typically realized by the successor borrower after a loan is defeased and the original borrower may be able to share in these.

**Considerations for a borrower:**
When negotiating loan terms for a new loan that contains a defeasance clause, borrowers should request that the substitute collateral include other U.S. Government obligations such as GNMA and Sallie Mae securities. These securities typically trade at a higher yield than treasuries, which reduces the cost of purchasing the substitute collateral, effectively reducing the prepay penalty.

After a loan is defeased, the successor borrower makes the payments to the bond holders that are due using the scheduled proceeds from the collateral pool of securities. The bond payments are typically due on the 15th day of each month and there is a two week float of interest each month realized by the successor borrower. A borrower may be able to negotiate a sharing of this interest float particularly if a large loan is being defeased – say $20 million or larger. In addition, there are often payments at the end of the term (during the open period of prepayment) that the defeasance company/successor borrower also enjoys. For a 90 day open window, two loan payments are in effect retained by the successor borrower as they can pay off the loan once the open prepay is available. These “windfalls” can potentially be shared by the borrower if negotiated prior to entering a defeasance transaction. Alternatively, when negotiating a new loan some lenders may agree to have the period of defeasance end when the open prepayment period starts versus the end of the loan term. This also reduces the cost of purchasing the substitute collateral.

Finally, be aware that the cost of the defeasance is tax deductible in the year of the defeasance. To better understand this process and see if refinancing an existing loan makes sense for you, or how the sale of your property is affected by defeasance, give us a call today.

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