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The mortgage Reit reprise

The last few months have seen a resurgence in mortgage real estate investment trusts (Reits), with over $1.3 billion in mortgage Reit initial public offerings. And it looks like there's more to come. This is just the latest chapter in the long and chequered history of mortgage Reits that dates from the late sixties. By the way, a mortgage Reit is an investment vehicle that is designed to permit investors to pool capital to invest in mortgages and interests in mortgages.

For US federal income tax purposes, a Reit is a corporation that receives special tax treatment. It is exempt from federal income tax at the corporate level to the extent that it distributes its income annually. It is, in general, subject to normal corporate tax on any income that it chooses to retain. In order to qualify as a Reit for tax purposes, an entity must hold substantially all of its assets in real estate related investments. It must also derive substantially all of its income from passive investments in real estate related activity.

In addition to a Reit's special federal income tax treatment, it has certain other regulatory advantages. For example, a Reit may qualify for an exemption under section 3(c)(5)(C) of the US Investment Company Act of 1940, which is available to entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other interests in real estate.

Since the late sixties, there have been a variety of different Reit investment strategies and structural alternatives. And there have been some notable financial successes and some spectacular failures. In the nineties, mortgage Reits boomed. Large Reits, such as American Home Mortgage, Impac, and others, created successful businesses originating and securitising residential and commercial mortgages. A few Reits suffered in the mid-nineties, and some filed for bankruptcy.

Beginning in early 2007, mortgage Reits once again began to feel the heat. The financial crisis wiped out an entire segment of these Reits, which, in general, were in the business of subprime lending.

The new crop of mortgage Reits generally have one of three investment strategies, with some overlap amongst the three: those that acquire government backed mortgage securities and other high quality mortgage securities with leverage; those that primarily acquire, originate and manage mortgages; and those that primarily target distressed debt with the intent to workout.

A number of the new Reits expect to finance their activities through government enabled leverage: the Term Asset-Back Securities Loan facility (Talf), or the Public-Private Investment Program (P-Pip). Under the Talf, the Federal Reserve Bank of New York will provide non-recourse loans to borrowers to fund their purchases of certain assets that now include various asset and mortgage backed securities. Under the P-Pip, certain private investment funds will be established to purchase from financial institutions, certain non-Agency RMBS (residential mortgage-backed securities) and CMBS (commercial mortgage-backed securities). Also under the P-Pip, certain investment funds will be established to purchase troubled loans (including residential and commercial loans) from banks. The latest generation of mortgage Reits believe that these government programs, coupled with extraordinary market conditions, may present unprecedented market opportunities. And it would appear that there are plenty of investors who, at least for the moment, agree with them.