Mortgage REITs - A Primer, What Could be Next,
and Opinion on the Current Mortgage Environment

Mortgage REITs are an important part of the mortgage finance landscape and will likely grow in importance given the initiatives underway to shrink Fannie Mae and Freddie Mac. In addition a previous mortgage REIT model could reemerge to address tight credit conditions.

A REIT is a corporation that has elected to be taxed as a Real Estate Investment Trust, or REIT. As long as a REIT pays out 90% of its taxable earnings in a given year it isn't taxed. REITs attract investors that like dividend income, including institution and retail investors.

There are two basic types of mortgage REITs, identified by their assets: REITs that hold Agency MBS ("Agency REITs"), and REITs that hold 'credit pieces' of securitizations ("Credit REITs"). Of the Agency REITs, most hold either Fannie Mae or Freddie Mac MBS, and not Ginnie Mae MBS as they have long payment delays. Credit REITs typically securitize pools of loans, sell off the senior pieces of those securitizations, and retain the subordinate first-loss (credit) pieces.

There will soon be a rebirth of a third and potentially large mortgage REIT type, the "Active REIT". Active REITs are typically closely associated with a mortgage originator and have the ability to 'originate' mortgage assets directly for the REIT portfolio. More on that below.

Mortgage REITs have some notable restrictions that govern how they operate. In terms of ownership, the most important restriction pertains to who owns a REIT. The five largest investors combined can own no more than 50% of a particular REIT. In the case of a mutual fund, the ownership counts according to the number of holders in the fund, not according to the fund itself. The fund is known as a look-through entity and doesn't count as a single investor.

Other important restrictions pertain to the income and assets of a REIT. Simply put, the goal of these rules is to insure REITs receive the majority of their income directly from REIT eligible assets, those being either real estate or mortgage loans.

Recently there's been an explosion in the amount of capital raised in the mortgage REIT space. Since January, 2010 existing mortgage REITs have raised in excess of $11 billion of equity capital. Virtually all of this capital was used to purchase Agency MBS, likely in the neighborhood of $70 billion of such assets. $70 billion of MBS is exactly half of the amount the Federal Reserve plans on selling over the coming year and gives some context about the possible importance of mortgage REITs going forward.

REIT vary by size and by asset type. Currently there are approximately 40 publicly traded mortgage REITs with combined assets of approximately$240 billion. Approximately 85% of the assets held on mortgage REIT balance sheets are Agency MBS, with the remainder being a combination of non-Agency MBS, and whole loans. The largest mortgage REIT as measured by asset size is Annaly, an Agency REIT that is approaching $100 billion in assets.

REITs have risks commensurate with the type of assets they hold and how they finance those assets. In the case of an Agency REIT risks pertain to changes in interest rates, and to short term liquidity.

Liquidity is important because Agency REITs use leverage to ramp up the buying power of their equity. Typically for every dollar of equity an Agency REIT holds, they hold seven dollars of Agency MBS assets (7x leveraged). In other words they borrow six dollars in the short term 'repo' market to finance every seven dollars of MBS purchases. Before the mortgage market meltdown of 2007 and 2008 Agency REITs were generally leveraged 10 to 12 times, not the current seven times. With today's steep yield curve the higher leverage isn't necessary nor is it desirable given liquidity disruptions during the mortgage meltdown. During the meltdown REITs, along with many other types of leveraged entities, had to sell assets and deleverage due to problems in the short term (repo and commercial paper) markets resulting from MBS downgrades and resulting devaluations. Many of the forced liquidations actually pertained to non-Agency MBS, which were not uncommon assets for REITs.

Changes in interest rates are also an issue for Agency REITs. As Agency REITs are leveraged, the assets they borrow against, the Agency MBS, are marked-to-market daily by the repo counterparty. The repo counterparty is the party that lends the Agency REIT the capital needed to hold the assets. In the case of increasing interest rates, as the value of MBS decrease, repo counterparties will reduce the loan amount they will extend against a given MBS asset. In that case a REIT has to make up the difference by using more of its equity to cover the difference between the size of the MBS asset and the repo loan amount. This creates problems for Agency REITs in rising interest rate environments. Hedges can be put in place to help mitigate this risk but hedging mortgage assets is never an exact science given the difficulty in predicting individual borrower's behavior, and hedging typically will decrease current period income for a REIT.

Credit REITs typically don't hold assets with repo leverage and thus have other concerns. Credit REITs hold subordinate classes ("Subs") of non-Agency mortgage securitizations, typically with little or no leverage. Subs are the first pieces of securitizations that take losses resulting from borrowers defaulting on their loans. Every dollar of loss in a Sub goes directly against the equity of the REIT holding that Sub. Credit REITs make money by receiving the difference in rate between the coupon on the loans in the securitization and the rate paid out to the holders of the senior ('AAA' rated) securitization pieces. Redwood Trust is the best known of the Credit REITs.

Active REITs are the type that could become the most interesting going forward. Active REITs are REITs that are closely associated with a mortgage originator, or a group of originators, can choose either an Agency, Credit or combined strategy, and in effect have the ability to create the mortgage assets they want to hold. One such entity recently filed for an IPO.

The reason Active REITs could become important is they effectively create a closed mortgage ecosystem not reliant on outside parties, depending on their strategy, other than for equity capital. In the extreme Active REITs could affect the amount and type of mortgage assets available to other investors. The best example of an Active REIT is Thornburg Mortgage, a jumbo lender best known for making the right credit decisions and doing so in a common sense approach.

Relative to jumbo lending, Active REITs could prove very important. In effect the originator/REIT combination becomes a bank with the ability to portfolio loans. In this day of 'regulatory-heavy' tight bank lending standards and coming risk retention/QRM initiatives, this model could expand further by lenders that don't have a problem with skin in the game and are frustrated by the lack of underwriting common sense used by today's depository loan investors.

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Thanks to Henry Coffey of Sterne Agee for the market facts.

Whole Loan Capital's Principal has almost 15 years of mortgage REIT experience, including managing the loan purchase efforts and the whole loan portfolio at Thornburg Mortgage, and starting and running the first Active REIT to IPO, New York Mortgage Trust.