

UNIVERSITY OF NAIROBI

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COLLEGE OF HUMANITIES AND SOCIAL SCIENCES

**ASSESSING KENYA'S LEGAL FRAMEWORK ON REAL ESTATE INVESTMENT
TRUSTS (REITS): MAKING A CASE FOR MORTGAGE REITS**

BY

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2018

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DEDICATION

This thesis is dedicated to my family and especially my godson Theo.

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I acknowledge and appreciate the invaluable guidance from my supervisor Dr. Njaramba Gichuki. I also acknowledge the incisive comments by my reader Dr. Jackson Bett and the Chair of my panel of examiners Dr. Nkatha Kabira which greatly enriched this work.

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LIST OF ABBREVIATIONS

CAHF.....	Centre for Affordable Housing Finance in Africa
CMBS.....	Collateralized Mortgage Based Securities
CMA.....	Capital Markets Authority
CMO.....	Collateral Mortgage Obligations
D-REIT.....	Development REIT
FHLB.....	Federal Home Loan Bank
FRB.....	Federal Reserve Bank
HFCK.....	Housing Finance Company of Kenya
IPO.....	Initial Public Offering
I-REIT.....	Income REIT
MBS.....	Mortgage-Backed Securities
M-REIT.....	Mortgage REITs
NYSE.....	New York Stock Exchange
QRS.....	Qualified D-REITs Subsidiary
RBA.....	Retirement Benefits Act
REIT.....	Real Estate Investment Trust
REMIC.....	Real Estate Mortgage Investment Conduit
RMBS.....	Residential Mortgage-Backed Securities
TBA.....	To-be-Announced
TRS.....	Taxable REIT Subsidiary

LIST OF STATUTES

Kenya

The Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013.

The Constitution of Kenya, 2010

Income Tax Act, Chapter 470 Laws of Kenya

The Insurance Act, Chapter 487 Laws of Kenya (Revised 2013).

The Retirement Benefit Act (RBA), Chapter 197 Laws of Kenya

Stamp Duty Act Chapter 480 of the Laws of Kenya

USA

26 U.S. Code § 856

The Real Estate Investment Trust Act of 1960

Tax Reform Act, 1986

ABSTRACT

The right to a house in Article 43(1)(b) of the Bill of Rights of the Constitution of Kenya is fundamental to enable individuals live in dignity. The Constitution envisages every person having a right to accessible and adequate housing as well as reasonable standards of sanitation. However, access to the right to a house for a majority of Kenyans is elusive owing to the high cost of housing finance. This Thesis explores the viability of Mortgage REITs as an effective method of financing affordable housing in Kenya.

The study acknowledges the existence of a gap in the provision of adequate housing and provides a solution towards filling this gap by assessing the suitability of mortgage REITs as a tool to access affordable housing finance by analyzing the Regulations on REITs and offering a critique on the legislative framework while at the same time appreciating the critical role of REITs.

The study also identifies a gap within the legislation creating REITs in Kenya and explores the viability of that legislative gap by examining the USA legislative framework on REITs as a best practice in achieving affordable housing using Mortgage REITs. It also reviews the mortgage REITs legal framework in the United States of America.

Upon analyzing the REITs legislative framework from a perspective of providing affordable housing, the study concludes by offering appropriate legislative amendments to various legislations such as the Capital Markets (Real Estate Investment Trusts)(Collective Investment Schemes)Regulations 2013 to enable the creation of M-REIT.

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CHAPTER ONE

INTRODUCTION AND BACKGROUND

1.1 Introduction

This study investigates how Kenya can use mortgage REITs as a model of financing affordable housing. This would be done through a comparative review of other jurisdictions like South Africa, United States of America, Asia and European countries that have used mortgage REITs as a tool for achieving affordable housing finance. The right to a house is fundamental to human beings and is placed third in the hierarchy of needs after the right to food and clothing.¹ Various international human right instruments ratified by Kenya have similarly confirmed the centrality of housing rights and dignity of people.²

Mortgage REITs is company whose purpose is to lend money to those who operate real estate using indirect acquisition of loans and/or mortgage-backed securities.³ M-REITs may also refer to “mezzanine” loans or REITs whose purpose is to lend money that is not secured by real estate mortgages.⁴ Credit maybe secured by acquiring loans or mortgage-backed securities. Currently, M-REITs extend mortgage credit only on pre-existing properties.⁵ M-REITs have three characteristics that make them suitable for financing low cost housing: its assets and revenues are limited to real estate together with a limited portfolio of securities. Secondly, M-REITs can avoid paying corporate taxes and in the process avoid double taxation that is associated with public

¹ Everlyn Monyangi Arisi, *Towards an Effective Realization of the Right to Accessible and Adequate Housing in Kenya: A Comparative Study with South Africa* (Unpublished LLM Thesis: University of Nairobi, 2013).

² Article 11(1), International Covenant on Economic, Social and Cultural Rights (ICESCR).

³ Leonard Anthony Jackson, *Lodging REIT Performance and Comparison with other Equity REIT Returns* (PHD Thesis: Oklahoma State University, 2007) at 12.

⁴ R L Block, *Investing in REITs: Real Estate Investment Trusts. 3rd ed* (Bloomberg Press: New York, 2006) at 17.

⁵ Yunjun Luo, *Implementation of Chinese Real Estate Investment Trust* (KTH Architecture and the Build Environment: Stockholm 2009) at 12.

entities. Thirdly, their accounting is distributed to the extent that they are taxable at the investor's level.⁶

According to Nabutola, more than a third of Kenya's do not have decent housing.⁷ Therefore affordable housing is still elusive for most Kenyans with a housing deficit of 2 million housing units.⁸ The issue of affordability has been identified as a major impediment to accessing the right to housing.⁹ For example, the population would determine the level of housing consumption, its credit worthiness, stability and effectiveness of the financial system.¹⁰ Affordability encompasses low income, high inflation and relatively high interest rates charged by banks.¹¹ This makes it difficult for the vast majority of Kenyans to afford even the most basic form of housing.¹² Financing low-income housing is challenging due to risks associated with default on loan repayment by the low-income.¹³ For that matter financial institutions in Kenya avoid advancing credit to low-cost housing.¹⁴ This has been exacerbated by a desire by mortgage institutions to increase interest rates for borrowers in the housing sector hence affecting the ability of low-income groups to borrow.¹⁵

⁶ Campbell R.D. and Sirmans C.F 'Policy Implication of Structural Options in the Development of Real Estate Investment Trusts in Europe: Lessons from the American Experience', (2002) 20 (4) *Journal of Property Investment and Finance* 388-389.

⁷ Wafula Nabutola, *Land Administration and Housing Issues in Informal Environments: Affordable Housing in Kenya: A Case Study of Policy on Informal Settlements*, 3rd FIG Regional Conference Jakarta, Indonesia, October 3-7, 2004.

⁸ Ibid.

⁹ Ibid at 1.

¹⁰ Ibid.

¹¹ Ibid

¹² Alhashimi, H. and W. Dwyer, Is there such an Entity as a Housing Market? Paper presented at the 10th Annual Pacific Rim Real Estate Conference, Bangkok, Jan. 2004.

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Onyango Dan Kidundi, *Profitability of Financing Low-Cost Housing in Kenya* (Laurea University: Laurea, 2010) at 15.

The minimum standards set for the housing right in international legal instruments encapsulates: the protection of tenure rights, regulation of evictions. It also includes facilitating the availability of infrastructure, like safe drinking water, sanitation, affordability of housing for everybody including the poor, state subsidy of housing, protection against arbitrary increases in rent.¹⁶ Kenya's Constitution considers the right to housing as a basic human right¹⁷ and an essential element of human dignity.¹⁸ The state therefore has a duty to make affordable housing available to its citizens in line with the Constitution and other laws.¹⁹ This would include taking all available measures that would ensure access to affordable housing is realized in Article 43 of Kenya's Constitution.²⁰

Using mortgage REITs to access affordable housing finance would leverage on some of the advantages (such as tax incentives) of investing in REITs to lower the cost of finance. An M-REIT is intended to lend money directly to the real estate owners or extend credit indirectly through acquisition of mortgage-backed securities.²¹ Developing mortgage securities would improve housing affordability, capital markets, help smooth housing cycles, increase the flow of funds and better allocation of risks inherent in housing finance.²² However the focus of Kenya's REITs legal framework is based on Development REIT (D-REIT) and income REIT (I-REIT).²³

¹⁶ General Comment No. 4.

¹⁷ Article 43(1)(b), Constitution of Kenya, 2010.

¹⁸ Ibid.

¹⁹ Article 21 (1), Constitution of Kenya, 2010.

²⁰ Ibid at 21 (2).

²¹ Ranajit Kumar Bairagi, *Costs of Raising Equity Capital for U.S. REITs* (Unpublished PHD Thesis: Deakin University, 2012) at 16.

²² World Bank *supra* note 8.

²³ Section 2, the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013.

1.2 Background

The rapid growth of the population in Kenya has had a tremendous effect on the ability of the state to provide housing. From 6 million in 1950, the population grew to 41 million in 2010 and with an annual growth of 2.5% is projected to reach 85 million by 2050.²⁴ The estimated demand for housing in 2010 was 206, 000 units (124, 000 in rural areas and 82,000 in urban centers). Out of this growing population there are only 15,049 residential mortgage accounts.²⁵ Whereas this number pales in comparison to the population of Kenyans who are either self or formally employed, it shows that there is a huge gap that is yet to tap into the property market either as home owners or investors in various property sectors like hotels and commercial property. According to the Ministry of Housing, 50,000 units are constructed every year leaving a deficit of 156,000 units. Cumulatively Kenya has a housing shortage of 2 million housing units.²⁶ Those without houses are homeless, live in temporary shelters or low quality housing in slums. To meet this demand, between 250,000 and 300,000 units need to be constructed each year. However, this is held back by the poor legal and policy framework in housing finance.

Traditional mortgage markets have relied on deposits to fund housing finance. However financial innovation has made it possible to access funding through the secondary mortgage market where credit emanates directly from investors on the securities exchange.²⁷ This mode of financing has failed to bridge the gap in the housing demand due to the high growth in population that has

²⁴ World Bank *supra* note 8 at 34.

²⁵ A Presentation by the Central Bank of Kenya on Mortgage Finance in Kenya at a Workshop on Developing Kenya's Mortgage Market at Crown Plaza Nairobi, Thursday 17TH February 2011, available at (worldbank.org/FINANCIALSECTOR/Resources/_CBK.pdf), accessed on 27 March 2016.

²⁶ World Bank *supra* note 8.

²⁷ *Ibid.* at 40.

fueled demand for larger and better quality housing. This is made worse by a shortage of supply and construction of new units.

REITs as a funding option for affordable housing was first introduced in the USA in 1960, when the REIT Act was signed by President Eisenhower, as part of the Cigar Excise Tax Extension of 1960.²⁸ The Act granted tax-exempt status to REITs as it became a viable housing finance option between 1960s and 1970s.²⁹ An important objective of passing the statute was to enable small scale investors participate in large scale and diversified real estate development that was initially available only to wealthier investors.³⁰

The three classes of REITs are equity (E-REITs), mortgage (M-REITs) and hybrid D-REITs. The purpose of E-REITs is to own and operate income-producing real estate with income being generated from rental properties. It is a company that is involved in real estate activities, such as leasing, maintenance and development of real estate properties, and providing services to tenants.³¹ In the initial stages, a large part of US REITs sector was M-REITs, for example as early as 1965; this was illustrated when the first REIT to be listed on the New York Stock Exchange was Continental Mortgage Investors (M-REIT).³² What differentiates mortgage and equity REITs is the subject of their investments. M-REITs do not own, neither do they operate properties; instead, they manage a portfolio of mortgage-backed securities (MBS).³³ The investment process of M-REITs takes three forms: The M-REIT raises money through an initial

²⁸ National Association of Real Estate Investment Trusts, *REITs: Building Dividends & Diversification* (NAREIT: Washington, 2014) at 4.

²⁹ Ibid.

³⁰ Block *supra* note 4 at 25.

³¹ Ibid.

³² REIT Industry Timeline: Celebrating 50 years of REITs and NAREIT", available at <http://www.reit.com/timeline/timeline.php>, accessed on 15 September 2016.

³³Ibid.

public offering (IPO) and uses the means obtained to buy MBS. The MBS are then used as collateral to borrow more money. Lastly, the preceding step is repeated until the desired leverage ratio is attained. At this point, the M-REIT has sufficiently enough of leveraged assets for paying dividends to its investors.³⁴ The D-REIT on the other hand combines investing in equity and mortgage properties.³⁵

The REITs sector has spread to more countries as a diversified income-producing real estate widely available to individual investors. The growth in REIT to more countries as a diversified investment options to individuals and investors highlights the recognition of REITs as an alternative investment vehicle.³⁶ Globally, more than 400 real estate securities exist with a market value estimated at \$1.5 trillion.³⁷ The motivation has mainly been the low effect by turbulence of domestic, international market on REITs and its potential to provide competitive returns even during the recession.³⁸

The focus of the current study is the fulfillment of the right to affordable housing using the mortgage REIT as a model of financing affordable housing. Kenyans overwhelmingly passed a new Constitution in 2010 with a strong bias towards socio-economic rights. The right to housing in the Bill of Rights is encapsulated in Article 43(1)(b) of the Constitution. The enactment of the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations in 2013 was a good opportunity for Kenya to progressively realize the housing right.

³⁴ Ibid.

³⁵ Ibid.

³⁶ R Anderson, 'REIT Returns and Pricing: The Small Cap Value Stock Factor', (2005) 22 (4) *Journal of Property Research* 267.

³⁷ Ibid.

³⁸ Ibid.

1.3 Statement of the Problem

Access to affordable housing finance is a major challenge in Kenya because existing mortgage facilities are out of reach for a large majority of the population who are poor. The passage of legislation in REITs in 2013 provided an opportunity for using the secondary market to facilitate access to affordable housing. However, Kenya's REITs legislation was passed without providing for M-REITs thus making it difficult for individuals to access affordable housing finance.

Regulation 8 of the Act has limited the scope of REITs in Kenya to D-REIT and I-REIT: It states that: "A real estate investment trust scheme may, be structured as a D-REIT or an I-REIT in accordance with these Regulations."

Similarly, the Islamic REITS contemplated in Part XXVI of the regulations, is limited to those who profess the Islamic faith. Regulation 12 (1), further limits the application of REITs for housing finance.³⁹ Although Regulation 12(2) provides a window within which D-REITs can provide funding for housing finance through mortgages, secured loans and finance and other forms of lending through progressive purchase schemes, it is a facility that is not affordable by a majority of poor Kenyans. The effect of Regulation 8 is to exclude M-REIT as a mortgage financing option.

Constitutionally, the country is mandated to implement fundamental and freedoms in the Bill of Rights.⁴⁰ Article 43 (1)(b) of Kenya's Constitution provides that access to adequate housing would be provided progressively by the Government. The duty of the state is to all measures available that would facilitate in the achievement housing rights envisaged in Article 43 of the

³⁹ *Supra* note 23, Regulation 12 (1).

⁴⁰ Article 21(1), Constitution of Kenya, 2010.

Constitution. In this context, the state has an obligation to use every opportunity including M-REITs to provide affordable housing finance to its citizens.

Therefore failure to enact laws on M-REITs would amount to a violation of the Constitution that protects the right to adequate housing. M-REITs would leverage on the advantages of REITs in general (such as tax advantages) to deliver affordable housing finance to a majority of Kenyans who are currently unable to afford housing finance offered by commercial banks. Express provisions on MREITs would go a long way in the realization of the objective of affordable housing in Kenya.

1.4 Objectives

- 1) To determine whether Kenya's legal framework on REITs is adequate in providing affordable housing.
- 2) To assess the Legal framework of Mortgage REITs in the USA as a best practice in providing a model for affordable housing finance in Kenya.

1.5 Research Question

- 1) To what extent is Kenya's legal framework on REITs adequate in providing affordable housing?
- 2) What lessons can Kenya learn from the USA Legal framework on Mortgage REITs as a model for affordable housing finance in Kenya?

1.6 Hypothesis

Although Kenya has a legal framework on REITs, it is inadequate in so far as enabling Kenyans access affordable housing finance.

1.7 Significance of the study

This study endeavors to contribute to the knowledge by linking mortgage REITs to affordable housing finance because few scholars have researched in this area. The vision is that it will offer information and act as a resource material for policy makers and other researchers. It further encourages amendment to existing legislation to give provision for mortgage REIT as an alternative form of accessing affordable housing and bridge the gap in the right to housing.

1.8 Theoretical framework

The theoretical foundation of affordable housing can be explained using the economic theory of law and the theory of social choice. The economic theory of law explains the demand and supply side of housing while the social choice theory explains the role of the state, the necessity and effect of state regulation of the housing industry in Kenya.

1.8.1 Posner's Economic Theory of Law

The high cost of accessing mortgages in Kenya has made it difficult for individuals to access affordable housing. Posner's theory of law is a useful starting point in the economic analysis of law in demonstrating the limits and strength of the theory. He propounds an economic theory of law whose thesis is that the aim of positive law should aim at maximizing the efficient use of

resources to solve legal problems.⁴¹ Efficiency is defined as “exploiting economic resources in such a way that human satisfaction as measured by aggregated consumer willingness to pay for goods and services is maximized.”⁴² According to him the promotion of efficiency in law satisfies the positive criteria of law that operates on incentives having a rational structure. For it to have rational structure, it must be public to be effective with fact finding machinery.⁴³ For that matter efficiency is viewed as the end game of all legal issues that would arise.⁴⁴

The gist of Posner’ theory is that the law should always be alive to the economic effects of legal decisions and the ability to understand the control and implication of proposed economic solutions to problems posed to legal decision makers.⁴⁵ He also believes that the law should be concerned with the minimization of transaction costs by assigning rights to those capable of buying the subject of the right. He also has a strong belief in the capacity of the market as being critical in solving economic and legal problems over other considerations such as politics or social forces.⁴⁶ Thus accordingly, the market should mimic the distribution of legal rights,⁴⁷ to that extent; all laws should not only improve the market but assure the operation of the efficient market.

The theory has two major theses relevant to this study. The first relates to scarcity of resources as compared to what ordinary individuals wish to consume. The result is that people have to make

⁴¹ Richard A. Posner, *Economic Analysis of Law* (Little, Brown and Company: Boston, 1973) at 8.

⁴² *Ibid.*

⁴³ *Ibid.* 393-94.

⁴⁴ *Ibid.*

⁴⁵ Calvin Woodward, ‘The Limits of Legal Realism: An Historical Perspective’, (1968) 54 *VA. L. REV.* 689.

⁴⁶ *Ibid.* at 360.

⁴⁷ Posner *supra* note 41 at 11-12.

rational choices between various resources referred to as ‘tradeoffs’.⁴⁸ The tradeoffs should reflect people’s desires, wants and what they can afford. The second thesis concerns the price theory which explains how individuals make the tradeoffs. In economic theory, people behave rationally in making decisions so that when given a choice between smaller and larger numbers at the same price, people would choose the larger number.⁴⁹ In other words people choose resources in a way that would maximize their personal utility. This is further enhanced by the law of supply and demand which says that anytime the price of goods or services is increased, its demand goes down.

According to the law of demand, increases in price has two effects: the substitution effect and the income effect. The former refers to other goods becoming cheaper that are substituted due to the low prices. The latter refers to circumstances when prices of goods go up a resulting into the decline of incomes with less purchasing power.⁵⁰ This would mean that the high cost of mortgages has a negative effect on the affordability of housing despite the high demand for housing. The poor are therefore compelled to stay in houses that is of poor quality. Inversely if mortgage REITs lowered the cost of housing, it would increase the demand thereby making the housing market not only efficient but more affordable.

The theory however has a number of weaknesses as it assumes the existence of perfect markets and fails to account for other non-economic factors that affect positive law especially the issue of distribution, equity and the role of politics among others. Its pre-occupation with efficiency

⁴⁸ Paul A Samuelson, *Economics* (McGraw-Hill: New York, 2004) at 18-23

⁴⁹ George M. Cohent, ‘Posnerian Jurisprudence and Economic Analysis of Law: The View from the Bench’, (1985) 113 *University of Pennsylvania Law Review* 1120.

⁵⁰ *Ibid.* at 1119.

disregards the possibility of purchasing efficiency at the expense of the community or equality which may have greater political significance than increased production.⁵¹ Besides, it is limited to micro-economics analysis and disregards macro-economic factors which provide greater influence in terms of monetary policy that includes numerous legal institutions and activities.

1.8.2 The Social Choice Theory

Before the introduction of REIT as a secondary market at the securities exchange, investment in real estate was a preserve of rich or financially enabled individuals who could access loans from commercial banks for purposes of investment. In the process, the poor were excluded due to barriers such as the absence of an enabling legal framework for investment in real estate. With the enactment of REITs guidelines, a window has been opened for those with as little as Ksh. 20,000 to be able to invest in real estate. The social choice theory stands for the proposition that people should have the freedom to make choices that they would benefit from, and the law should play a facilitative role. Social choice theorists were motivated by the desire to avoid instability and arbitrariness in matters of social choices.⁵² It addresses the complexity of making choices that are agreeable to a large segment of the population. The theory was elaborated by Sen that the difficult choices in financial services is similar to those in social justice that motivated the social justice theories.⁵³ The problem for both theories is how to make judgments in society on matters of public welfare, public interest and poverty in a world with diverse concerns, predicament and different individuals. According to Sen, social choice theory reduces

⁵¹ Ibid.

⁵² Amartya Sen, *The Idea of Justice* (Belkan Press: London, 2009) at 22.

⁵³ Ibid.

the negative effects of social justice. This is because the social choice theory focuses on injustices and not on an ideal system of justice as is common with social justice theories.

According to the social choices theory social justice can only be served by social choices theory. The theory together with the capability approach is an economic approach developed by economists like Sen provides information that forms the basis of social decisions. The capability approach is focused on information that creates advantages for individuals and opportunities rather than on how society should function. It points to the role of inequalities of capabilities in the assessment of social disparities. The human development index is a byproduct of the capability approach as a measure of human welfare as opposed to other static indicators such as per capita income, gross domestic product to mention but a few. Social choices theory is concerned with the shortcomings of the social justice theory. Social choice theory is therefore a formula for making social decisions related to justice and using the theory as a basis for discussing matters of justice such as housing and housing finance.

1.9 Literature review

Many scholars have generally written on the challenges of accessing mortgage financing as a mode of housing finance. However, little exists on access to housing for those who are not rich. The relationship between the right to housing and the possibility of using REITs as a model of financing affordable housing is a new area of study that scholars have not yet addressed in Kenya. Further the link between REITs and affordable housing is not clear as well. This section will analyze literature on the relationship between mortgage REITs and access to housing finance as one of the critical barriers to the right to housing.

1.9.1 Suitability of Mortgage REITs in Accessing Affordable Housing Finance

According to Ozeri,⁵⁴ REITs forms part of a growing investment option with limitless opportunities. This is because it has created categories of REITs (mortgage, equity, hybrid, mixed portfolio and development) instruments that could take care of every class of investor. To the author what stands out as being critical is the attractive nature of REITs in accessing cheaper housing finance as compared to existing structures represented by commercial banks and mortgage finance companies.

Ozeri's study which is based on the US approach to REITs in accessing housing finance has observed a growing emphasis on mortgage lending. This is illustrated by the increased capitalization of REITs that has tremendously increased. Part of the advantages of mortgage REITs is that it generates its income from mortgages and mortgage backed securities. REITs and mortgage REITs in particular are required by law to meet certain minimum requirements that make them an ideal candidate for housing finance.

The advantages include ability to pay at 90% of taxable income to shareholders, 100 shareholders need to have less than 5 ownership of more than 50% of the company's outstanding shares. In particular, 90% of gross income is required to emanate from rent. It also needs to 75% of gross income from real property interest, gains on the sale of real property, and shares of other trusts and other real estate sources. The asset value of a REIT should be least 75% of the total assets. These are the requirements M-REITs should meet in the US, however, opportunities for

⁵⁴ Jasmin Vittrup Ozeri, *A Study of Real Estate Investment Trusts in a Mixed: Asset Portfolio* (Aarhus University: New York, 2016).

similar benefits exist in Kenya which could be leveraged upon to facilitate access to affordable housing finance.⁵⁵

Mortgages REITs operate and exist to direct and distribute mortgages to investors who invest in MBS REITs for the purposes of buying agency and non-agency mortgages. Agency mortgages are government supported and therefore all investors are guaranteed of repayment. It is observed that mortgage REITs is sensitive to interest rates since performance is affected by the performance of MBS REITs. Mortgage REITs are sensitive to interest rates because they rely on short term loans to finance long term mortgage loans. Better still price movements of REITs have little relationship with actual changes in the interest rate. To that extent, mortgage REITs act as a hedge against rising and falling interest rates.

Ozeri's analysis underscores a critical role that could be played by the adoption of a legislative framework on mortgage REITs. By outlining the benefits of REITs as against other mortgage service providers, it is clear that mortgage REITs provide opportunities that could be explored to access affordable housing finance. However, to the extent that the analysis is based on findings from a developed nation, the same conditions are unlikely to obtain in Kenya. This is a gap this study will endeavor to fill.

1.9.2 Barriers to Investment in REIT

According to the Centre for Affordable Housing Finance in Africa (CAHF)⁵⁶ Africa's housing backlog is growing considerably; especially in urban areas where urbanization rates are rapidly

⁵⁵ Hilda Marigu Njeru, *Real Estate Investment Trusts: An Alternative Source of Funding for Construction and Development in Kenya* (Unpublished LLM Thesis: University of Nairobi, 2014).

increasing. This demand is coupled with limited supply and unsophisticated housing and housing finance markets. Investor's generally face the challenge of accessing limited investment targets in the residential real estate sector sufficiently enough to warrant attention. Many investors either at the international or domestic level seek large investment targets that would realize economies of scale. Other than South Africa, the rest of Africa lacks capacity to facilitate large scale investment. In some cases, there is perceived risk in investing in affordable housing in Africa.

CAHF has observed changing investor perception arising from large infrastructural investments (in roads, energy, even telecommunications). The effect would be a reduction in transaction costs that is associated with housing developments thus opening up opportunities of investment in the housing sector. The introduction REITs is one of the most significant of these innovations for creating an investment vehicle that is understood and trust by investors. For example, it enables investors' aggregate diverse sources of funding through to households by turning them into a portfolio that extends beyond the limitations of individual projects.

REIT as an investment vehicle is novel phenomenon and it is found on the African continent it was developed through legislation. This was the case in South Africa, Nigeria, Tanzania, Kenya, Ghana, Morocco, Rwanda, Uganda, and Zimbabwe.

⁵⁶ Centre for Affordable Housing Finance in Africa, *Residential REITs (Real Estate Investment Trusts) and their Potential to Increase Investment in, and Access to Affordable Housing Finance in Africa* (CAHF: Johannesburg, 2016).

1.9.3 Obstacles to Accessing Affordable Housing Finance

The establishment of REITs in the USA was meant to enable individual investors' pool resources and enjoy resources initially available to institutional investors. The legislation put in place at the time had similar objectives.⁵⁷ According to Block it enabled small investors have access to affordable housing finance.⁵⁸ The other objective was to spread D-REIT to more people and not restrict it to just a few individuals.⁵⁹ This was unlike other collective investments schemes, REITs is usually closed ended due to the fixed nature of property investment.⁶⁰ If REITs was open ended, it would mean that the investment would be liquidated into cash based investment thus the managers and administrators would be forced to keep a large portion of investment in cash thus dampening long term investments.⁶¹ Generally, REITs are close ended for this very reason which is advantageous because an investor buys a trust unit and not physical asset which allows him or her to have access to cash flows from rental income generated from real estate.⁶²

The close ended nature of REITs however acts as a barrier to investment since retail investors wish to have an investment product that they can easily and quickly pull out. REITs is restrictive because being closed ended it would be disadvantageous to individual investors in Kenya.⁶³ Block's analysis offers background information into the development and eventual spread of REITs from the USA and how it has evolved to markets like Kenya. It enumerates the original objectives of REIT that are still valid to date as demonstrated by its replication in other markets including Kenya. However, the analysis is based on a market that is far more developed and

⁵⁷ Block *supra* note 4 at 1.

⁵⁸ Ibid.

⁵⁹ McCall J. H., 'A Primer on Real Estate Trusts: The Legal Basics of Reits', (2001) *The James L. Clayton Center for Entrepreneurial Law of the University of Tennessee College of Law* 3.

⁶⁰ Block *supra* note 4 at 2.

⁶¹ Ibid at 67.

⁶² Ibid.

⁶³ Njeru *supra* note 55 at 13.

although the reality is very different in theory, it offers lessons that would if adopted improve REITs in developing markets like the one existing in Kenya.

According to the World Bank⁶⁴ Kenya's mortgage market is the third largest and most developed in Sub Saharan Africa with assets of 2.5% of GDP after South Africa and Namibia. Kenya has a housing gap due to a growing population especially in urban centers. It believes that the housing gap can be partially bridged through the availability of mortgages. Although mortgages are available from commercial banks, the interest rate attached to them is high and therefore unaffordable. Lack of affordability is caused by incomes, volatile inflation regime and price barrier that makes it difficult for the majority to afford even the most basic housing.

Mortgage lending in Kenya is undertaken by banks with one licensed mortgage finance company, HFC Limited which is a wholly owned subsidiary of HF Group, previously known as Housing Finance Company of Kenya (HFCK) Ltd. The Central Bank of Kenya can only authorize two types of lending namely, ordinary banks and mortgage finance companies. Banks and mortgage finance companies are governed by the Banking Act Cap 488, Laws of Kenya as well as prudential guidelines issued by the Central Bank of Kenya and thus compete on a level playing field.

In the view of the World Bank, another barrier to housing finance is related to risk management. There are deficiencies in lenders ability to capture or understand risks which means that lenders have to charge higher premiums. This arises from the fact that credit reference bureaus do not

⁶⁴ The International Bank for Reconstruction and Development, *Developing Kenya's Mortgage Market* (World Bank: Washington, 2011) at 5.

offer comprehensive credit history. With a high level of informality, collateral is affected by deficiencies in foreclosure process, resale market and the process of valuation. Housing finance has a systemic barrier of long-term financing. This is the biggest obstacle that notwithstanding the high liquidity of the banks, much of it is designed for short term financing. This is made worse by high land, housing and construction costs that affect home ownership. In particular, existing multiple land registration systems that are inefficient and complex have a negative impact on affordable housing.

Although the World Bank has not explicitly said that Kenya needs to introduce mortgage REITs, its suggestion that there is need to develop a secondary market for mortgage financing comes close to it. This is the gap this study envisages to fill in discussing one form of secondary market, the mortgage REIT that specializes in offering affordable housing finance. The essence of such a facility is to mobilize large amounts of financial resources of private capital and the introduction of new products such as mortgage as well as a unified and simplified mortgage law.

1.9.4 Best Practices

The World Bank has analyzed global housing finance trends and observes that capital markets are an important source of long-term financing for housing finance which has been facilitated by the growth in institutional investors' skills to manage complex risks associated with housing finance. Creating mortgage related securities has provided multiple instruments within which housing lenders can access important sources of funding, management and allocation of risks.

Mortgage related securities to finance housing have a long history in industrialized countries beginning as far back as the 18th century up to the present. This development has moved to some

developing countries in creation of secondary market for housing finance. The popular view propounded by the World Bank is that the instrument helps lenders mobilize domestic savings for housing as it has been done in developed countries. The strong appeal for financing housing in developing countries using the capital market is faced with the challenge of developing mortgage securities. The success of the mortgage securities would depend on the development of a regulatory regime in a liberalized financial environment.

1.10 Research Methodology

This is a qualitative research that relied on secondary and primary sources of information. It involved a desk top review of secondary data namely text books, journal articles, electronic media, reports and conference papers. It also involved analysis of primary data will especially laws, the Constitution of Kenya and unpublished research projects.

1.11 Chapter Breakdown

Chapter One: Introduction.

Introduction to the study will analyze the context of the study, the problem to be addressed, objectives, research questions, hypothesis, theoretical framework, the literature review and the research methodology.

Chapter Two: Analysis of Kenya's legal framework on REITs.

Kenya's legal framework in REITs, types of REITs, the effectiveness of Kenya's legal framework and how it can be used to achieve affordable housing finance.

Chapter Three; A Comparative Analysis and Best Practice in Affordable Housing Finance Using MREIT

The chapter provides a comparative overview of international best practices in M-REITs investment analysis of Mortgage REITS and its legal framework in the USA and the lessons Kenya can learn from it.

Chapter Four: Conclusion and recommendation.

Makes conclusions on how REITs can be used to achieve affordable housing in Kenya. The conclusion will summarize the issues addressed in each chapter followed by the recommendations or way forward on how the M-REITs can be made more responsive and affordable.

CHAPTER TWO

ANALYSIS OF KENYA'S LEGAL FRAMEWORK ON REITS

2.1 Introduction

This chapter makes an assessment of Kenya's REITs legal framework in the context of whether it is a suitable vehicle for achieving the right to financing affordable housing. The development of REITs in Kenya was informed by various factors such as similar developments in other jurisdictions and flagship projects encapsulated in vision 2030. In particular the legal framework was careful to avoid the pitfalls experienced in other jurisdictions like those that led to economic turmoil in 2008-2010.⁶⁵ Therefore the establishment of a legal framework had to be cognizant of this reality in departing from tradition in developing REITs outside existing income generating real estate.⁶⁶ REITs legal framework was introduced in Kenya in the year 2013 with the objective of introducing alternative investment in the real estate sector mainly to leverage on the advantages of REITs to other investment vehicles.⁶⁷ Associated benefits are tax breaks, higher returns, better management of investment portfolios to mention but a few.

REITs companies benefit from these advantages when a number of minimum legal requirements are met namely: companies or corporations should have invested at least 75% of their fund activities in Real Estate,⁶⁸ the balance of 25% which could be freely invested.⁶⁹ REITs are prohibited from investing in companies that are not involved in real estate for more than 10%

⁶⁵ Erkan Yönder, *REIT Investment Decisions: Governance, Behavior, and Sustainability* (Unpublished PHD Thesis: Maastricht University, 2013) at 13.

⁶⁶ McCall *supra* note 59 at 10.

⁶⁷ Njeru *supra* note 55.

⁶⁸ Mario Abbadessa, *REIT: A Different Investment Opportunity?*

The Market (REITs) Surrounding September 11 (Unpublished Master Thesis: University of Amsterdam) at 4.

⁶⁹ *Ibid.*

and no more than 5% can be allocated in one company.⁷⁰ REITs need to have 95% of gross income that derives from real estate related activities. 90% of revenues should be distributed as a dividend to the shareholders.⁷¹ The organizational structure needs to subscribe to the mantra of “five or fewer”, which means that no five or fewer investors should be allowed to own more than 50% of a REIT investment.⁷²

2.2 Establishment of a REIT

REITs in Kenya are established pursuant to the provisions of the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Act, 2013 upon fulfillment of certain requirements. For a trust, scheme, arrangement or any other collective investment scheme to qualify as a REIT, it has to comply with regulation 18 as an authorized scheme.⁷³ It should further conform to regulations and requirements of the Capital Markets Authority. A promoter wishing to invest, vest, sell, assign or transfer real estate to a REIT and which is regulated by another body or authority should first obtain consent of that body or authority.⁷⁴ However, failure to obtain such consent shall not act to disable any transaction entered into prior to authorization from pursuing remedies.⁷⁵

Assets of a REIT are held in the name and under the control of a trustee for the benefit of the REIT security holders as beneficiaries.⁷⁶ The rights and obligations of trustee are contained in

⁷⁰ Ibid at 4.

⁷¹ Ibid.

⁷² Ibid at 5.

⁷³ *Supra* note 23, Regulation 3(1)(a).

⁷⁴ Ibid Regulation 4(1).

⁷⁵ Ibid. 4(2).

⁷⁶ Ibid. 7(1).

the trust deed.⁷⁷ A trust deed in the context of REITs is a document that sets out the terms as to powers or functions of trustee or manager appointed in respect of the trust. Its contents include any variation to the rights of beneficiaries under the trust including REIT security holders.⁷⁸ A trustee is required to be independent of the REIT manager and promoter so long as the requirements of the regulations are satisfied.⁷⁹

2.3 Classification of REITs

REITs can be generally classified into various forms, first they can be classified into types and second by organizational structure. Classification by types brings out three classes namely: equity REITs, mortgage REITs and hybrid D-REITs.⁸⁰ REITs can also be classified according to organizational structure namely, public (traded) REITs and private (non-traded) REITs.⁸¹ It is a legal requirement that both public and private REITs comply with regulating standards of the state where they are established.⁸²

2.3.1 Organizational Structure

Classification according to organizational structure of REITs comprises public traded REITs, private (or non-traded) REITs.⁸³ Public and exchange traded D-REITs benefit lenders and

⁷⁷ Ibid. 2.

⁷⁸ Ibid.

⁷⁹ Ibid. 5(c).

⁸⁰ Ibid.

⁸¹ Husson T., McCann C. and Taveras C., *A Primer on Non-Traded-Reits and Other Alternative Real Estate Investments* (Securities Litigation and Consulting Group Inc.: Virginia, 2012) at 8.

⁸² Ibid.

⁸³ Ibid at 8.

investors since they need to comply with regulatory frameworks and standards that target quantity and type of information that is disclosed.⁸⁴

Traded D-REITs prepare public prospectus to facilitate the issuance of shares, financial statements to investors and stakeholders.⁸⁵ Traded D-REITs can either be bought or sold through the securities exchange. Public REITs provide investors with advantages of liquid investment which have a definite value.⁸⁶ Traded and non-traded D-REITs however, require regulation by a regulation agency of the country where REITs has been established.⁸⁷

Non-traded D-REITs offer similar benefits on information reporting though its shares lack liquidity for investors other than REITs itself.⁸⁸ Although non-traded D-REITs are registered, they are not listed or traded on a securities exchange.⁸⁹ Private REITs ensure that they avoid expensive and challenging regulations required of public corporations. Investors avoid private REITs due to absence of disclosure and limited access to equity capital.⁹⁰ Private REITs are not regulated with regulatory institutions like the stock exchange. Instead they are sold through private placement. Liquidity problems facing private REITs are similar to those faced by non-traded D-REITs.⁹¹

⁸⁴ Sheppard N.C, 'Lending to Real Estate Investment Trusts', (2012) *The Risk Management Association Journal* 23.

⁸⁵ Husson *supra* note 82 at 8.

⁸⁶ Sheppard *supra* note 85 at 25.

⁸⁷ Husson *supra* note 82.

⁸⁸ *Ibid.*

⁸⁹ *Ibid.*

⁹⁰ Sheppard *supra* note 85 at 25.

⁹¹ *Ibid.*

2.4 Kenya's REITS Legal Framework

In Kenya REITs are classified into: income REIT (I-REIT), development and construction REIT (D-REIT)⁹² and Islamic REITs.⁹³ This will be the focus of this chapter. The regulations aim to introduce two types of REIT. D-REIT, I-REIT and Islamic REIT only differ in their objectives. Islamic REIT is unique because it caters for persons of the Islamic faith, however it should comply with the Capital Markets Act and the conditions stipulated in the regulations.⁹⁴

2.4.1 Development and Construction REIT (D-REIT)

The Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Act, defines a D-REIT as a development and construction REIT that complies with the provisions of the parent statute.⁹⁵ The D-REIT is structured either as an open or closed ended fund with the option of converting it into an I-REIT.⁹⁶ An open ended fund refers to “subject to any limits on redemption that might be included in the scheme documents, a fund in which a person may invest from time to time by acquiring REIT securities and may dispose of the investment by having the REIT securities redeemed by the trustee and where the value of the investment and the redemption price per unit is determined by the net asset value per unit as calculated from time to time in accordance with the scheme documents and where the size of the fund may expand or contract as investors acquire or dispose REIT securities.”⁹⁷ The minimum value of the

⁹² Regulation 8, the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Regulations, 2013.

⁹³ Ibid Regulation 122.

⁹⁴ Mohamed Ebrahim, An Introduction to Real Estate Investment Trusts (REIT's) in Kenya, 2014, available at www.academia.edu/18681211/Sharia_Compliant_Real_Estate_investment_Trusts, accessed on 16 June 2018.

⁹⁵ *Supra* note 23, Regulation 2

⁹⁶ Ibid Regulation 9.

⁹⁷ Ibid. Regulation 2.

D-REIT is Ksh. 100 million,⁹⁸ which is offered only to professional investors in minimum parcels of 5 million each. For purposes of registration, each REIT is expected to have a minimum of 7 investors.⁹⁹

The objectives of the D-REIT as stated in the regulations include the acquisition, investment and development of eligible real estate.¹⁰⁰ This is in addition to development projects like housing projects, commercial and other real estate related development and construction projects.¹⁰¹ D-REIT also market, manage and sell real estate assets with a singular objective of earning income from the assets.¹⁰²

2.4.2 Organizational Structure of a D-REIT

D-REITs are required to invest its assets, develop and construct projects for purposes of either selling, retention or leasing. It is an income earning project formed for purposes of producing or buying houses to let, development or sale. It is further supposed to provide shelter, housing and accommodation.¹⁰³ A D-REIT may also provide mortgage and other forms of secured financing that enables investors (tenants or purchaser) to acquire housing.¹⁰⁴ Within one year of authorization, a D-REIT is required to invest 30% of its total asset value directly into

⁹⁸ Ibid Regulation 27 (3).

⁹⁹ Ibid Regulation 27(2).

¹⁰⁰ Ibid Regulation 10.

¹⁰¹ Ibid Regulation 10 (a).

¹⁰² Ibid Regulation 10 (b-d).

¹⁰³ Ibid Regulation 10 (a).

¹⁰⁴ Ibid. Regulation 12(2).

development and construction projects.¹⁰⁵ In the alternative, it should invest in income generating real estate which the D-REIT has developed or constructed.¹⁰⁶

The power of borrowing by a trustee of a D-REIT or investee company or trust shall not exceed in aggregate 60% of the total asset value at the time of the liability is incurred.¹⁰⁷ The exception is that upon approval by the REIT security holders, it is allowed to borrow up to a maximum of 75% by way of ordinary resolution of its total asset value for a temporary purpose for a term not exceeding six months.¹⁰⁸ If a D-REIT exceeds its borrowing limit, it may lose its classification as a REIT for purposes of taxation.¹⁰⁹ This may be done in two ways: first, security holders may institute a cause of action against the trustee or REIT manager. Similarly, the CMA may use regulation 18 to revoke the authorization issued herein under.¹¹⁰ The gist of the borrowing restrictions is meant to protect investor interests and limit the level of indebtedness that would otherwise have a negative impact on its mandate.

2.4.3 Ownership of D-REIT

Offers of owning D-REIT can only be made as a restricted offer to professional investors,¹¹¹ in parcels of Ksh. 5 million shillings.¹¹² Subsequent transfers can be made to those who qualify under the statute. A D-REIT is required to have a minimum of 7 investors,¹¹³ with minimum

¹⁰⁵ Ibid Regulation 76 (6)(a).

¹⁰⁶ Ibid Regulation 76 (6)(b).

¹⁰⁷ Ibid Regulation 81 (3).

¹⁰⁸ Ibid Regulation 81 (4).

¹⁰⁹ Ibid Regulation 81 (6)(a).

¹¹⁰ Ibid Regulation 81 (6)(c).

¹¹¹ Ibid. 27(1)(a).

¹¹² Ibid. 27(1)(b).

¹¹³ Ibid. Regulation 27(2).

value in real estate at 100 million.¹¹⁴ Out of the total, 25% of REITs securities in the trust should be free float.¹¹⁵ However, this does not apply where additional REIT securities are issued to the promoter, REIT manager or any other parties that are associated or connected with either of the two.¹¹⁶ A minimum free float of 25% of the REIT securities on issue at any time shall be held by investors that have no connection with the promoter or the REIT manager.¹¹⁷ The trustee is prohibited from registering, issuing or transferring of any REIT security if he/she has reasonable grounds to believe that the issue or transfer would breach the provision in relation to the minimum requirements for the free float.¹¹⁸ The trustee in refusing to issue a transfer of a REIT security relies on a certification issued by subscriber or transferee that is not a connected person or associated with the promoter or the REIT manager.¹¹⁹ These provisions help in avoiding situations where REIT managers and stakeholders can take advantage of REIT organizational structure to benefit them.¹²⁰ Since the majority of real estate in Kenya is mainly family owned, they may be unwilling to lose control of the real estate assets.¹²¹

The regulations of REITs in Kenya do not contemplate the partial ownership of real estate assets.¹²² For example real estate on freehold land is required to be wholly owned and controlled from the time of its acquisition by the trustee. The trustee exercises all the rights, interests and benefits enjoyed an owner without any form of interference.¹²³ Whereas in a real estate held on

¹¹⁴ Ibid Regulation 27(3).

¹¹⁵ Ibid Regulation 2.

¹¹⁶ Ibid Regulation 27(4).

¹¹⁷ Ibid Regulation 27(5).

¹¹⁸ Ibid Regulation 27(6).

¹¹⁹ Ibid Regulation 27(5).

¹²⁰ Ibid Regulation 27(2).

¹²¹ Ibid.

¹²² Ibid Regulation 79(a).

¹²³ Ibid. Regulation 79(1).

leasehold, the trustee exercises all rights, interests and benefits that are enjoyed by a lessee subject to the terms of the lease and rights of a lessor.¹²⁴

Further limitations on partial ownership does apply to D-REIT which has been developed, constructed and sold as part of an interest in a completed project to another person. It does not also apply to a D-REIT related to installment sale or other similar transactions.¹²⁵ The total investment by D-REIT in the property of the company shares should not in total, exceed 10% of the total asset value.¹²⁶

2.4.4 Management of D-REITS

Property development and construction is a complex exercise and requires professionally trained persons and managers to develop and construct REIT.¹²⁷ The average investor is unlikely to have mastered the expertise.¹²⁸ The promoter of REIT who should be licensed as corporation in line with the Capital Markets Authority (CMA) is required to appoint a trustee of the REIT.¹²⁹ The corporation in turn should have sufficient financial, technical, operational resources and experience necessary to enable it effectively conduct its business and carry out its obligations as a trustee of a real estate investment trust and real estate investment trust scheme.¹³⁰

The trustee is should not only be licensed by CMA but be independent of both the promoter and the fund manager.¹³¹ The obligation of the trustee is to act in good faith in the best interest of the

¹²⁴ Ibid Regulation 79(2).

¹²⁵ Ibid Regulation 79(4).

¹²⁶ Ibid Regulation 79(3)

¹²⁷ McCall *supra* note 59 at 10.

¹²⁸ Ibid.

¹²⁹ Ibid. Regulation 2 and 43(1).

¹³⁰ Ibid. Regulation 44(c).

¹³¹ Ibid Regulation 44 (2)(b).

REIT security holders being beneficiaries of the REITs. The function of the trustee is to fulfill all other obligations and duties that have been established by the scheme documents.¹³² The trustee appoints the REIT manager whose duty is to acquire, manage, maintain and if possible, dispose of assets of the D-REIT if a need arises.¹³³ The REIT manager has a fiduciary duty on behalf of the REIT securities, holders to exercise a duty of care and diligence. This should be exercised by a reasonable and skilled person would in the best interest of REIT security holders.¹³⁴

In other jurisdictions such as Malaysia, REITs management has been limited to a subsidiary of a company that is involved in financial services or a property development company or property investment holding company or any institution permitted by the securities exchange.¹³⁵ This is for purposes of sustainability and competent management, Kenya may need to learn from Malaysia for the same reasons.

The REIT manager in turn appoints a project manager certifier whose duty is to, *inter alia*, monitor and report on construction and development projects by the REIT.¹³⁶ The skills required of a project manager certifier include project management and quantity surveying. In addition, the project manager is required to be a member of a property related professional association.¹³⁷

The structural engineer¹³⁸ and the valuer¹³⁹ are appointed by the REIT manager in consultation with the trustee. The structural engineer is in charge of appraisal for the real estate property to be

¹³² Ibid Regulation 45.

¹³³ Ibid.

¹³⁴ Ibid.

¹³⁵ Block *supra* note 4 at 66.

¹³⁶ Ibid. Regulation 63 (1).

¹³⁷ Ibid Regulation 63 (5).

¹³⁸ Ibid Regulation 62(1).

¹³⁹ Ibid Regulation 111(a).

acquired by the D-REIT.¹⁴⁰ The role of the valuer is to value the real estate assets that are either vested in the trust or acquired by the trust. Valuers of D-REIT should be licensed and registered as valuers by the Valuers Registration Board pursuant to the Valuers Act.

2.4.5 Distribution of Income

It is the duty of the trustee to distribute income arising from the D-REIT.¹⁴¹ This is however done on recommendation of the REIT manager according to the requirements of the documents of the scheme. The trustee in fulfilling his/her distribution mandate is guided by a number of factors such as income for the period, total returns for the period, cash flow available for distribution the objectives of the D-REIT, its liabilities and the financial obligations of the REIT.¹⁴²

2.4.6 Taxation of D-REIT

In the event a Trustee fails to distribute capital gains that have not been invested within 2 years from the date of their realization nor distribute the capital gains within 2 months of the second year of such realization, the D-REIT may be classified as a real estate investment trust scheme for taxation purposes.¹⁴³ In these circumstances, when a Trustee fails to make a distribution, the available remedy to the REITS security holders is, subject to the scheme documents, to institute, if they so wish, a cause of action against the Trustees or the REIT manager.¹⁴⁴

However, the regulations are not clear on how D-REIT should be treated for purposes of income taxation especially when the income is not being distributed. In the absence of specific

¹⁴⁰ Ibid Regulation 62 (4)(a).

¹⁴¹ Ibid Regulation 82.

¹⁴² Ibid Regulation 82(2).

¹⁴³ Ibid. Regulation 83.

¹⁴⁴ Ibid Regulation 83(3)(b).

provisions, this gap exposes shareholders to similar taxation similar to that of ordinary corporations.

2.4.7 Affordability of D-REIT

Investment in housing is a long-term scheme that requires stability on the part of a REIT. However, the D-REIT faces many challenges that may not make it a suitable vehicle for affordable housing. The first challenge is the organizational structure of the D-REITs described as open ended or closed ended fund with an option of conversion to another status.¹⁴⁵This exposes D-REIT to challenges on its operations more so at the conversion point of one REIT to the other. It could simply give investors an avenue to flee from a D-REIT that is underperforming to undermine the sustainability of the REIT.

This is exacerbated by the fact that D-REIT is only available for investment by professional investors who can afford a minimum subscription of Ksh. 5 million.¹⁴⁶The minimum value of the initial assets of D-REIT has been set at Ksh100 million thus limiting the number of people who can invest in a D-REIT.¹⁴⁷ It is noted that only a handful of Kenyans can afford this level of investment.¹⁴⁸

The relationship between trustees and the manager may give rise to conflict of interest. This arises where property companies that manage assets in the REIT is in direct competition with the one owned by the management company. This gap has not been mitigated to offer clarity,

¹⁴⁵ McCall *supra* note 59 at 11.

¹⁴⁶ *Supra* note 23, Regulation 27(1)(b).

¹⁴⁷ *Ibid* Regulation 27 (3).

¹⁴⁸ Crompton S., 'REITS: There's just no one else', (2010) 28 *International Financial Law Review* 4.

certainty and predictability by the regulations.¹⁴⁹ Additionally according to some scholars, share prices for public D-REIT show volatility as compared to private REITs.¹⁵⁰ For that matter investors need to be aware of the challenges of D-REITs before investing.

2.5 Income REIT (I-REIT)

I-REIT is established pursuant to Regulation 64 of the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Act of 2013. Its objectives as set out in the trust deed are to acquire long term investment, market, sell and manage real estate assets with the sole objective of earning income from the assets. Similarly, it undertakes the development and construction of real estate activities as laid out in statute.¹⁵¹ The focus of the I-REIT is investment in portfolios that are purely income generating instruments such as real estate, cash deposits, bonds, securities and money market instruments, so long as the shares or REIT securities are listed on an approved securities exchange.¹⁵²

I-REIT is however required to make its investment within the stipulated two year period and hold at least 75% of the total net asset value in income producing real estate.¹⁵³ Both the trustee and the REIT manager should ensure that the REIT is not only rented out to commercial rent paying tenants, but it has a good and competitive future free from any encumbrances.¹⁵⁴

¹⁴⁹ Njeru *supra* note 55 at 67.

¹⁵⁰ Byron Gumbs, *The Viability of the REIT Structure as a Vehicle for Real Estate Development* (Unpublished Master of Science in Real Estate Development Thesis: Massachusetts Institute of Technology, 2001) at 48.

¹⁵¹ *Supra* note 23, Regulation 65

¹⁵² *Ibid* Regulation 65 (1)(d).

¹⁵³ *Ibid* Regulation 65(6).

¹⁵⁴ *Ibid* Regulation 65(7).

2.5.1 I-REIT Income Component

The regulations require that I-REIT shall in each financial year after the second anniversary of its authorization earn at least 70% of its income either from rent, license fees or access or usage rights or other income options generated by eligible investments in income producing real estate.¹⁵⁵ In determining the income, all profits or capital gains from sales are excluded.¹⁵⁶ An I-REIT is allowed to dispose of real estate that has been an asset of the trust for at least three years¹⁵⁷ and reinvest the funds received from the disposal within 2 years from the completion of the disposal. It is even allowed to distribute to its REIT security holders to reduce its assets.¹⁵⁸

2.6 Islamic REITs

The Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Act 2013,¹⁵⁹ has rules that govern Islamic REIT's.¹⁶⁰ It is a regime and asset class that is compliant with sharia investment.

The first Islamic REITs in the world was launched in Malaysia in 2006.¹⁶¹ Ever since, Islamic REITs has registered encouraging growth and presents strong prospects to augment the Islamic wealth using Shariah principles.¹⁶² Islamic REITs has practiced in Kuwait, United Arab Emirates, Singapore and Bahrain.¹⁶³

¹⁵⁵ Ibid Regulation 69 (1).

¹⁵⁶ Ibid Regulation 69 (2).

¹⁵⁷ Ibid Regulation 69 (3).

¹⁵⁸ Ibid.

¹⁵⁹ Legal notice no. 116, 2013.

¹⁶⁰ *Supra* note 23, Part XXVI, Regulation 122.

¹⁶¹ Ibrahim *supra* note 95 at 12.

¹⁶² Ibid.

¹⁶³ Ibid.

Income and fund management of the Islamic REIT are required to observe principles of Shariah.¹⁶⁴ According to the regulations, Islamic REITs are managed through the appointment of a Shariah Advisor.¹⁶⁵ Shariah adviser is a person appointed as such under regulation 122.

This would involve acquisition and leasing of real estate (including tenancies and sub-tenancies), where the activities and operations are Shariah-compliant.¹⁶⁶ Certain prohibited transactions are, conventional banking services, gambling and casino operations and the sale of liquor.¹⁶⁷ In mixed tenancies that operate mixed activities, the proportion of rentals from the operation of non-permissible activities should not exceed 20%.¹⁶⁸

The potential for Islamic REITs to develop into thriving global wealth management product is enormous.¹⁶⁹ The preferred real asset investments for among Muslim investors and institutions that is aligned with the Islamic finance principles which advocate link between the real economy and the financial sector is the Islamic REIT. Successes of Islamic REITs registered in Malaysia and Singapore give credence to the idea of Islamic REITs as lucrative global alternative secondary markets investments.¹⁷⁰ There added advantage is exemption from tax payments provided it distributes most of its income (80% in Kenya) to investors.¹⁷¹

¹⁶⁴ *Supra* note 23, Regulation 122(1)(a).

¹⁶⁵ *Ibid* Regulation 2.

¹⁶⁶ Ibrahim *supra* note 162 at .

¹⁶⁷ *Ibid*.

¹⁶⁸ *Ibid*.

¹⁶⁹ *Ibid*.

¹⁷⁰ *Ibid*.

¹⁷¹ Section 20 (1), Income Tax Act.

2.6.1 Suitability of Islamic REIT for Affordable Housing

Islamic REIT would have been a good starting point for the poor to achieve affordable housing in line with Article 43 of the Constitution of Kenya. Additionally, since it is based on strict Islamic rules, it would be expected that the management of Islamic REIT would be transparent and more accountable. However, to the extent that it is only available to those who profess Islamic faith shows that it has a limited reach.¹⁷²

2.7 Critique of Kenya's REIT Legal Framework

Kenya passed the REIT legal framework in 2013 to regulate investments in REITs. However, it faces a number of challenges that relate to its regulatory procedures, limited tax incentives, price volatility, conflict of interest and affordability of REITs. Due to these challenges the REITs legal regime in Kenya has a long way to go before it becomes a suitable vehicle for achieving financing of affordable housing.

2.7.1 Regulatory Procedures

It has been shown in other jurisdictions¹⁷³ that cumbersome regulations mechanisms, uncertain tax regimes and other factors linked to financial management pose the greatest challenge to the growth of REITs.¹⁷⁴ This is not unique to Kenya as the CMA is not an easy legislation to understand and operationalize. First it is complex with confusing provisions that are too technical that would need the intervention of experts at every stage.

¹⁷² Ibrahim, *supra* note 162.

¹⁷³ Robinson, A, *Asia-Pacific REIT Survey* (Trust Company (Asia) Limited: Singapore, 2009) at 12.

¹⁷⁴ *Ibid.*

2.7.2 Access, Ownership and Establishment of REITs

The legal requirement for establishing REITs is restrictive as it allows only professional investors to invest in REITs. The Regulations require a minimum subscription of Ksh.5 million to invest in REIT.¹⁷⁵ Other limitations are found in Regulation 28 that limits listing and trading at the securities' exchange. The Retirement Benefit Act (RBA).¹⁷⁶ It has further restricted the maximum investment in quoted equity of any corporation to 30% of its total market value of assets.¹⁷⁷ The implication is that pension fund entities can only invest 30% of its total assets in a REIT. The effect of this provision is to restrict the ability of pension fund managers to invest some of their high value assets with REITs.

The Insurance Act of Kenya¹⁷⁸ on its part has further restricted investment options available to insurance companies. The options are government securities, debentures, commercial paper, preference shares and ordinary shares quoted on the securities exchange. Provisions have not been made available for investors in collective investment schemes such as REITs. Restrictions highlighted under the RBA and the Insurance Act as holders of high value assets is a major drawback to the development of REITs.¹⁷⁹

2.7.3 Restriction on provision of loans or mortgages by REITs

Regulation 12 is perhaps the most important one for purposes of financing affordable housing. It provides that either a D-REIT or I-REIT shall not engage in the provision of mortgages or any

¹⁷⁵ *Supra* note 23, Regulation 27 (1)(b).

¹⁷⁶ Chapter 197 Laws of Kenya.

¹⁷⁷ *Ibid* Section 31 (1) (b).

¹⁷⁸ Chapter 487 Laws of Kenya (Revised 2013).

¹⁷⁹ Section 50, The Insurance Act, Cap 487 Laws of Kenya.

other form of lending or for debt finance for that matter.¹⁸⁰ However the second part of the provision seems to override the first provision by providing a window of hope for financing affordable housing.¹⁸¹ The gist of the regulation is that even when a D-REIT is converted to an I-REIT at under no circumstance shall it engage in housing mortgage financing. Claw-back provisions as illustrated Regulation 12 have a negative impact on the realization of affordable housing finance.

The use of the term ‘shall’ in Regulation 12 (1), connotes a mandatory provision prohibiting the provision of loans or mortgages by REITs for purposes of housing finance. Regulation 12 (2), seems to allow a mortgage, or other form of secured loan using D-REITs, but only for the purpose of assisting a tenant or purchaser acquire housing from the D-REIT.

It is important to note that Regulation 12 is titled Restriction on Provision of Loans or mortgages by REITS hence by its very definition, it is deliberately limiting in scope and application and it expressly bars any other form of lending other than what is provided for. Suffice is to say that the Regulation 12 expressly bars Mortgage REITS. The essence of a Mortgage REIT is to lend money directly or provide debt finance to a real estate owner or operator and which lending is prohibited by the Regulations. The effect on this limitation is that a REIT is prevented from accessing finance and its ability to provide or achieve affordable housing is restricted.

¹⁸⁰ *Supra* note 23, Regulation 12 (1).

¹⁸¹ *Ibid* Regulation 12 (2).

2.8 Suitability of D-REIT and I-REIT for Affordable Housing

The suitability of a REIT for purposes of achieving affordable housing depends on its ability to create investments products that make it easy for individuals to borrow long term credit at lower interest rates, with tax incentives that make it possible for more people to access credit. This section is a critic of the D-REIT and I-REIT in the context of affordable housing.

2.8.1 Tax Incentives

The growth of REITs can be enhanced if the government played a positive role by introducing tax incentives. Tax is compulsory levy that is imposed by a Government institution for the benefit of the public.¹⁸² The state can do so by defining the legal macro and micro environment within which a particular sector should operate.¹⁸³ Changes in tax policy and legal frameworks would offer incentives for the development of REITs. Taxation is an important state function that helps in raising state funds. However the State needs to balance the public interest of getting resources and encouraging investments.¹⁸⁴ The need for tax incentives cannot be over-emphasized as fiscal measures can be used to attract investment capital (both local and foreign) to specific economic sectors.¹⁸⁵ Tax incentives are directed at encouraging the private sector participate in economic and social programs where the state plays a critical role.¹⁸⁶ However, it should be made clear that tax incentives have the potential to distort tax policy, less transparent and predictability. It could as well lead to an investor tax system that is unstable.¹⁸⁷

¹⁸² Williams D.W., Morse, G., *Principles of Tax Law* 5th Edition (Sweet and Maxwell: London 2004) at 3.

¹⁸³ Buening, M., 'Reits Take Shape in Draft Law', (2006) 17 (52) *International Tax Review* 3.

¹⁸⁴ *Ibid.* at 1.

¹⁸⁵ Williams and Morse *supra* note 183 at 6.

¹⁸⁶ *Ibid.*

¹⁸⁷ *Ibid.*

2.8.2 Role of Tax Incentives for REITs

The first REITs legislation in the USA known as the Real Estate Investment Trust Act of 1960, set a tradition of tax incentives to be applied in REITs. This tradition is still alive in most jurisdictions.¹⁸⁸ A regulated investment in that it distributes 90% of its ordinary income is taxed only on its undistributed income. Therefore, it avoids the imposition of corporate tax.¹⁸⁹ For that REITs are not liable for corporate taxation thus avoiding double taxation that is common to most corporations and shareholders.¹⁹⁰ In that respect section 20 of the Income Tax Act is relevant as it exempts revenues invested in registered unit trusts from income tax.¹⁹¹

The import of this provision is that REITs are exempted from the payment of withholding tax on income and dividends for purposes of tax earnings on REITs so long as it is distributed as rental income, capital gains and not as interest or dividends as the case may be. The exemption of REIT from corporate tax is not therefore automatic; it should be applied for through the income tax registration under the Income Tax Act Registered Unit Trust/Collective Investment Schemes Rules, 2003.¹⁹² So long as a REIT is registered with the Commissioner of Income Tax, dividends earned attract a withholding tax of 5% for that resident in East Africa and 10% for nonresidents.

A number of qualifications are however required before a REIT is exempted from corporate tax: first the Commissioner for Income Tax must be satisfied that the REIT shall undertake portfolio investments to carry on investments in accordance with the policies and guidelines under the

¹⁸⁸ McCall *supra* note 59 at 15.

¹⁸⁹ PwC, 'Worldwide Real Estate Investment Trust Regimes: Country Summaries', (2011) PwC 1018.

¹⁹⁰ *Ibid.*

¹⁹¹ Section 20, Income Tax Act.

¹⁹² Chapter 470, Laws of Kenya as amended by the Finance Act 2012.

Capital Markets Act. Secondly, it should be clear that the sole purpose of the REIT is to carry on investments on behalf of the unit holders. Thirdly, and more importantly after six months of registration or exemption no member shall hold more than 12.5% of the units at any one time and that the REIT shall within six months of its commencement maintain at least 25 unit holders at any particular time.¹⁹³

It is noted that this incentive is only available for investment schemes that have been established by employer for their employees. By implication no tax incentive exists for REITs that are formed by investors making investments as groups.¹⁹⁴ For purposes of encouraging investment in REITs it would be prudent for the Kenya government to amend section 20 of the Income Tax Act that would exempt REITs from income tax.

2.8.3 Stamp Duty

The Stamp Duty Act¹⁹⁵ does not define the scope of stamp duty.¹⁹⁶ Stamp duty is one of the oldest forms of tax that is imposed on any transfer of immovable property or shares held directly or indirectly in immovable property.¹⁹⁷ In Kenya section 96 of the Stamp Duty Act is instructive and provides that all instruments relating to transactions carried out and enforceable in Kenya should bear the minimum stamp duty. Stamp duty is charged at 4% of the value of the transaction for transfer of land within the municipality. For transfer of land outside the

¹⁹³ PKF Kenya, Real Estate Investment Trust; Tax Treatment, available at www.pkfea.com accessed on July 12, 2013, available at www.pkfea.com accessed on 17 June 2018.

¹⁹⁴ Section 20, Income Tax Act.

¹⁹⁵ Chapter 480 of the Laws of Kenya.

¹⁹⁶ Preamble, Stamp Duty Act.

¹⁹⁷ McCall *supra* note 66 at 16.

municipality the duty is 2% of the total value. Stamp duty for transfer of shares is 1%.¹⁹⁸ This would translate into a colossal amount of money taking into account the value of real estate.

2.9 Conclusion

In conclusion, REITs in Kenya are classified into three namely: D-REIT, I-REIT and Islamic REIT. D-REIT is concerned with investment in real estate through development and construction of real estate assets. I-REIT relates to investment in real estate for purposes of income generation through facilities such as rents and license fees. Islamic REIT has been developed to address unique demands of Islamic investors who desire to make investments in real estate in conformity with Sharia principles.

Overall, Kenya's legal framework was not developed as an option to bridge the housing shortage through the provision of financing affordable housing. But rather as an alternative form of investment. Therefore, Kenya's REITs legal framework faces many challenges such as high investment cost, limited tax incentives, complex and contradictory provisions that make it difficult for long term mortgage financing for affordable housing.

Chapter three makes an analysis of the concept of mortgage REIT with a view of finding out whether it would deliver affordable housing in line Article 43(1)(b) of the Constitution on affordable housing.

¹⁹⁸ Hamilton, Harrison and Mathews, 'A Guide to Investing and Doing Business in Kenya', (2012) Hamilton Harrison and Mathews, available at hbm.co.ke/wp-content/uploads/2015/06/HHM-ALERTS-May-2015-Issue-01.pdf . accessed on 1 September 2018 at 6.

CHAPTER THREE

A COMPARATIVE ANALYSIS AND BEST PRACTICE IN AFFORDABLE HOUSING FINANCE USING M-REIT

3.1 Introduction

This chapter analyzes the USA M-REIT legal framework as a suitable model and best practice for affordable housing finance in Kenya. This would be in fulfillment of the right to housing in Kenya. The reason why the USA has been chosen is because it has a vibrant housing market where M-REIT has played a leading role especially after the financial crisis of 2008. It begins by exploring the concept of mortgage REITs (M-REITs). The issues to be evaluated would include ownership and organizational structure of M-REITs, tax and regulating advantages and its disadvantages in achieving affordable housing in Kenya. The main focus would be how the concept of M-REITs applies to affordable housing in Kenya.

The other areas to be examined include an assessment of systemic risks to financial markets especially those affecting M-REIT and how they have been mitigated. The focus is on the creation of mechanism to reduce the risks inherent in mortgage investment, in particular the creation of agency M-REIT investments in mortgage backed securities using commonly used risk management practices. The strategy involved the establishment of companies with an effective capability of managing interest risks, counterparty credit risks, prepayment risks and risks to liquidity. The chosen methods were important for two reasons: they were unlikely to initiate but and secondly in the event of such an eventuality, the shocks would be transmitted to the entire financial system.

3.2 Overview of the USA M-REIT Market

The USA has seen a resurgence of M-REIT largely driven by the financial crisis of 2008-2010 that resulted in massive foreclosure of mortgage loans.¹⁹⁹ This was motivated by a simple business strategy of buying high yielding or distressed mortgage assets at a bargain, securitizing them and selling them off for a profit. This depicts an emerging trend in the USA where none bank lenders and securities take advantage of tax breaks to use M-REIT organizational structure to participate in mortgage financing rather than the heavily regulated banks. This growth is closely linked to the support given by the US government where 90% of all new residential mortgages are guaranteed by the government.²⁰⁰ This support has seen many M-REITs enter the market.

M-REITs that developed after the crisis consisted of three types. The first one was modeled on acquired government backed MRS and other leveraged MBS. These are good mortgage assets as they earn reasonable profit. Assets used in this strategy are RMBS and MBS.²⁰¹ The second M-REIT invested in distressed mortgage loans. This was a tricky form of investment model because it formed part and parcel of foreclosed property. It is advantageous for shareholders as M-REIT can temporarily foreclose a mortgage loan, earn income on it eventually passing it to shareholders. This would only happen if the M-REIT does not take advantage of foreclosure rules to acquire mortgage loan with the intention of foreclosing. In the alternative it can acquire property in a TRS so as to avoid foreclosure property rules.

¹⁹⁹ Sebrina Pellerin, *M-REITs and their Risks*, Federal Reserve Bank of Richmond, Working Paper No. 13-19R, November 2013, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_, accessed on 18 June 2018.

²⁰⁰ Congressional Budget Office, Fannie Mae, Freddie Mac and the Federal Role in the Secondary Mortgage Market (2010) at 3, available at www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/.../12-23-fanniefreddie.pdf, accessed on 16 June 2018.

²⁰¹Pellerin *supra* note 200 at 3.

In the third model, an M-REIT not only acquires and originates residential or commercial loans but it uses TRS for non-qualifying activities. This model securitizes mortgage loans for purposes of enhancing profitability.²⁰² The fourth category is a *sui generis* model that is externally managed. In this category, M-REIT employs a manager who manages its assets. This is in sharp contrast with traditional models where internal management is the norm. It has been suggested by some scholars that using managers creates conflicts of interest that are not in the best interest of the shareholders.²⁰³

3.3 Developing M-REIT Legal Framework

The earliest forms of M-REIT legislation in the USA were in the form of construction bank loans in the 1960s. Construction loan REITs however went bankrupt in the 1970s.²⁰⁴ M-REITs of the 1980s were constructed around non-conforming mortgage loans that were sold at 90% senior interest in loans to investors while retaining 10% subordinated interest. Each strategic mortgage investment (SMI) obtained permission from IRS to the extent that so long as it sold its senior interest, no gain would be recognized on sale.²⁰⁵

In 1985, the IRS revoked these favorable treatment forcing M-REITs to adopt a strategy that gave way to countrywide M-REITs. Countrywide REIT in turn originated residential REIT mortgage loans that were later sold to taxable subsidiary that were securitized.²⁰⁶ Profits from the securitized loans were not earned at the level of a REIT since prohibited transactions were not

²⁰² Ibid.

²⁰³ Ibid.

²⁰⁴ Pellerin *supra* note 200 at 5.

²⁰⁵ Ibid.

²⁰⁶ Ibid at 6.

offered. Similarly, countrywide REITs began issuing collateral mortgage obligations (CMO) out of REITs. These were treated as borrowings and not sales for purposes of federal income tax without any gain. Investment through taxable activities in TRS and QRS provided the foundation up on which M-REITs developed.²⁰⁷

Through the Tax Reform Act, 1986 the House of Congress enacted the Real Estate Mortgage Investment Conduit (REMIC) legislation. The purpose of REMIC was to facilitate mortgage loan securitization as the only model to securitize multiple-class mortgages. REITs securities formed this way could potentially be subject to a 100% prohibited transactions tax on any gain that it realized on the sale. In place of REMIC, REITs issued mortgage backed securities treated as debt for purposes of federal income tax. The result was that any residual income from CMO when paid to a REIT shareholder would be treated as ‘excess inclusion income’ which is not offset by shareholder net operating loss.²⁰⁸

The current M-REIT legal framework in the US is a by-product of the economic crisis that resulted in a tightening of regulations around banks and mortgage financing in particular. This was juxtaposed by a loosening of regulations on non-bank participants. Limiting these requirements meant that profit margins for banks became diminished. “Significant increases in regulation and public policy are influencing which investors will have the financial ability to hold real estate-related assets. We believe that private non-bank capital will represent an increasing share of these assets in the years to come.”²⁰⁹ Besides, banks are required to maintain loan loss reserves against mortgage assets with vigorous regulating requirements having

²⁰⁷ Ibid.

²⁰⁸ Ibid.

²⁰⁹ Ibid

additional capital requirements.²¹⁰ Non-bank participants are exempt from the formal capital requirements though they will be closely monitored but less strictly than banks.

On paper, banking institutions would appear to have an upstart with better access to short and long term funding.²¹¹ For the past 10 years accessing long term finance has been the biggest challenge for M-REITs resulting in liquidity disruptions that led to either terminations or reduction in credit lines.²¹² On the other hand, banks were able to have access to a broader and stable source of financing such as customer deposits and access to Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB).²¹³ Non-bank mortgage companies and M-REITs in particular have no access to these facilities. It therefore turns out that operating successful M-REITs requires a complex liability management programme that emphasizes on diversification of sources and creativity of sources in difficult times.²¹⁴

3.4 Registration Requirements for M-REIT

The registration of M-REIT requires certain minimum criteria outlined as: centralized management, transferable shares, corporation for tax purposes, not a financial institution or insurance company, widely held (5 or fewer test, 100 shareholder requirements), income and assets tests and distribution requirements.²¹⁵

²¹⁰ Pellerin *supra* note 200 at 3.

²¹¹ Ibid.

²¹² Ibid.

²¹³ Ibid.

²¹⁴ Ibid at 4.

²¹⁵ Section 856(a), 26 U.S. Code § 856.

3.4.1 Taxation Requirements for M-REIT

The most distinguishing aspect of an M-REIT is the taxation requirements for registration. These fall into two categories which include: income and asset test. For an M-REIT to be registered, it needs to meet certain income test requirements. It should have at least 75% of what a REIT's gross income should consist of, rents from real property, interest on obligations secured by mortgages on real property or on interests in real property, gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) which is not dealer property. With respect to dividends or other distributions on, and gain (other than gain from prohibited transactions) from the sale or other disposition of, shares in other REITs.²¹⁶ Additionally, abatements and refunds of taxes should be derived from real property, income and gain derived from foreclosure property, commitment fees. Other sources comprise gains from the sale or other disposition of a real estate asset which is not a prohibited transaction and qualified temporary investment income.²¹⁷

The second test provides that at least 95% of the REIT's gross income must be derived from items that meet the 75% income test, other dividends, other interest and gains from the sale or other disposition of stock or securities that are not dealer property.²¹⁸

3.4.1.1 Prohibited Transactions Tax

A REIT is subject to a 100% tax on net income derived from prohibited transactions. Prohibited transaction is any sale or other disposition of dealer property. Dealer property is: "stock in trade

²¹⁶ Ibid.

²¹⁷ Ibid.

²¹⁸ Ibid.

of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.”²¹⁹ But if held by a TRS, prohibited transactions would not apply but would be liable to corporate tax arising from the modification.

A REIT may enter into otherwise prohibited activities through a taxable REIT subsidiary (TRS). The TRS itself is taxable as a corporation. For purposes of the asset tests, 25% of a REIT’s assets can be held in TRSs. With respect to the income tests, the Code allows the TRS to perform non-customary services which would otherwise not qualify as good income.²²⁰

3.4.2 Asset Test

The registration of M-REITs should meet certain asset requirements that provide for at least 75% of the value of the REIT’s total assets is represented by real estate assets, cash and cash items (including receivables), and Government securities (base securities).²²¹ There is also a 25% asset test, which provides that not more than 25% of the value of the REIT’s total assets should be represented by securities (other than base securities) or 25% asset test where not more than 25% of the value of the REIT’s total assets is represented by securities of one or more TRSs. The 5% or 10% asset tests: except for TRSs and base securities. In other instance not more than 5% of the value of the REIT’s total assets should be represented by securities of any one issuer. This REIT does not hold securities possessing more than 10% of the total voting power of the outstanding securities of any one issuer. The REIT does not at the same time hold securities

²¹⁹ Ibid.

²²⁰ Ibid.

²²¹ Ibid.

having a value of more than 10% of the total value of the outstanding securities of any one issuer.²²²

3.4.3 Distribution Requirements of M-REIT

The REIT provisions do not apply to an entity for a taxable year unless the deduction for dividends paid during the taxable year equals or exceeds: the sum of 90% of the real estate investment trust taxable income for the taxable year (determined without regard to the deduction for dividends paid and by excluding any net capital gain); and 90% of the excess of the net income from foreclosure property over the tax imposed on such income by any excess noncash income.²²³

3.5 Ownership and Organizational Structure of M-REIT

The most important distinction between M-REIT and other REITs has everything to do with its relationship with tax issues. These come into nine categories namely: loan origination income, servicing income, real estate mortgages and related assets, distressed real estate mortgages, securitizations and sales hedging transactions, foreclosure property, TRS issues and phantom income.²²⁴

3.5.1 Distressed Real Estate

M-REITs expanded and grew during and after the financial crisis in 2008 by acquiring distressed or mortgages in default.²²⁵ The net effect of the crisis is that the value of the real estate collateral

²²² Ibid.

²²³ Section 857(b)(4)(A), Code.

²²⁴ K. Peter Ritter, 'Mortgage REITs: A Primer', (2011) 9 (4) *Journal of Taxation of Financial Products* 29.

²²⁵ Ibid. 34.

significantly dropped. In the alternative, M-REITs may invest in mortgages that are in default thereby modifying or foreclose distressed mortgages which eventually raise certain tax issues.

The first issue may relate to the difficulty of satisfying assets and income tests so as to retain its REIT status especially if the outstanding balance is in excess of the fair market value of the real estate on the purchase date and where the loan is secured by other property. This may not qualify on account of 75% gross assets test as it is considered as not being good real estate.²²⁶

The second issue that may arise is with respect to the modification of a distressed mortgage using a 'workout'.²²⁷ Such modification is considered as taxable income as it constitutes a charge on its yield.²²⁸ An M-REIT that engages in modifying too many loans is considered as a 'dealer' and therefore forming part of prohibited transaction which attracts 100% tax on the phantom income.²²⁹

In the third instance where an M-REIT holds a non-performing loan, it may be required to report interest income on the loan though no actual interest is paid.²³⁰ Due to the challenges in holding distressed mortgages that are foreclosed, the need for a M-REIT to hold distressed mortgages for purposes of workouts, modifications, foreclosure and sales in a TRS cannot be over-emphasized.²³¹

²²⁶ Reg. §1.856-5(c).

²²⁷ Reg. Section 1.1001-3 Code.

²²⁸ Ibid.

²²⁹ Ibid.

²³⁰ John Kaufmann, 'The Treatment of Payments on Distressed Debt Instruments', (2008) 26 *J. TAX'N INV* 13.

²³¹ Andrew W. Needham, 'Do the Market Discount Rules Apply to Distressed Debt? Probably Not', (2009) 8 *J. TAX'N FIN'L PRODS.* 25.

3.5.2 Real Estate Mortgage and Related Assets

Mortgage loans qualify as real estate assets for purposes of 75% asset and interest on the loans. Thus they qualify for both gross income tests on meeting certain minimum requirements.²³² The first requirement is that the highest amount of loan during the tax year should not exceed the market value of the real estate property securing the loan.²³³ In meeting this requirement, the fair market value of the real property securing the loan should equal or exceed the principal amount of the loan. In this case 100% of the interest on the loan shall be treated as qualifying income while the entire loan should qualify as good real estate asset. On the contrary if the loan is secured by real property and other property such as personal property, an apportionment should be made based on the loan value of the real property²³⁴ and the amount of the loan.²³⁵ For interest on income, the amount allocated to real property should be equal to amount of interest income multiplied by a fraction.²³⁶

The second requirement is that participating interest is determined either by fiscal percentage or percentage of gross revenues but not net income or profits.²³⁷ REIT provisions of the Code and treasury regulations are not addressed by loans that are not directly secured by real property but by an interest in a special purpose vehicle owning real property.²³⁸ Compliance with this requirement could mean that a loan is treated as good real estate asset for purposes of 75% asset and the interest on the loan.

²³² Reg. Section, 1.856-5(c), Code.

²³³ Ibid.

²³⁴ Reg. Section, 1.856-5(c).

²³⁵ Reg. §1.856-5(c).

²³⁶ Reg. §1.856-5(c).

²³⁷ Rev. Proc. 2011-16, IRB 2011-5, 1.

²³⁸ Rev. Proc. 2003-65, 2003-2 CB 336.

M-REITs may also enter into sale and repurchase agreements that would enable them sell mortgages or mortgage backed securities. These agreements are treated as borrowing transactions. Such a REIT should be treated as owning these assets for purposes of REIT income and asset test.²³⁹ M-REITs may also purchase assets using ‘to be announced’ forward contracts (TBA). In a TBA, an M-REIT purchase for future use mortgage backed securities having principal, interest terms and other underlying collateral. As a forward contract, the possibility of value shifting is extremely high which puts in doubt whether TBAs are qualifying assets for purposes of the 75% asset test.²⁴⁰

Interests in REMIC are qualifying real estate assets.²⁴¹ For purposes of gross income tests, it contributes to qualifying income in proportion to real estate assets that are held by REMIC unless 95% of REMIC assets are real estate. All income from these interests qualifies.²⁴² Income that is derived from a debt institution issued by CMO and held by a REIT that is not directly secured by real property is qualifying income for purposes of 95% gross income test but not 75%. An M-REIT that holds a REMIC interest as an investment generates non cash ‘phantom income’ referred to by the code as ‘excess inclusion income’²⁴³ which flows to shareholders. Excess exclusion which exceeds REIT taxable income is allocated a proportion among M-REIT shareholders. This has the capacity of tainting REIT dividends leading to negative tax effects.²⁴⁴ The amount cannot be offset by any net operating loss available to shareholders²⁴⁵ or treated as

²³⁹ Rev. Rul. 77-59, 1977-1 CB 196; FSA 001769 (Mar. 5, 1996).

²⁴⁰ Ibid.

²⁴¹ Code Sec. 856(c)(5)(E).

²⁴² Ibid.

²⁴³ Ibid Sec. 860E(c).

²⁴⁴ Ibid Sec. 860E(d); Reg. §1.860E-1(b).

²⁴⁵ Ibid. Sec. 860E(a)(3).

unrelated business taxable income exempt from income tax.²⁴⁶ The amount may however be subject to a 30% gross income withholding tax for non USA shareholders without regard to otherwise applicable income tax treaty provisions.²⁴⁷ The M-REIT may also be subject to tax on excess inclusion income that is allocated to shareholders of ‘disqualified organizations’.²⁴⁸ It is for this reason that M-REITs avoid holding REMIC residential interests and may prohibit disqualified organizations from holding such stock.²⁴⁹

3.5.3 Loan origination income

Loan origination income consists of income that arises from loans that represent a charge for loan originating services.²⁵⁰ This income is not qualified either for equity REITs or M-REITs for purposes of gross income REITs. Therefore, a REIT loan origination income when combined with other ‘non-qualifying’ gross income is expected to exceed or equal 5% of REITs gross income. Activities that give rise to such income should be conducted by a TRS of the M-REIT.²⁵¹

3.5.4 Servicing income

The income that is earned from servicing mortgages held by third parties is not part of the qualifying income for purposes of gross income test. M-REITs generally conduct such activities using TRS, on the other hand it could choose to retain servicing rights to its loan whose income qualifies the requirement for M-REIT gross income test.²⁵²

²⁴⁶ Ibid. Sec. 860E(b).

²⁴⁷ Ibid. Sec. 860E(e)(6).

²⁴⁸ Ibid.

²⁴⁹ Ibid. Sec. 860E(e)(6)(A).

²⁵⁰ Ritter *supra* note 203 at 34.

²⁵¹ Reg. Section, 1.856-5(c).

²⁵² Ibid.

3.5.5 Securitization Sales

A REIT distributes 90% of its taxable income each year and due to this, it cannot rely on profits to general capital and therefore needs to find alternative forms of financing for purposes of investment. M-REITs can reinvest principle payments received on its mortgage loans and distributed earnings like interest from the loans. For that matter, an M-REIT sells or securitizes mortgage loans to enable it generate income for investments and acquisitions. The danger is that sales and securitization maybe characterized as ‘prohibited transactions’ in which case it would be liable for 100% tax. A prohibited transaction is a sales or disposition of property held by a REIT for sale to customers in ordinary course of trade, business like inventory.²⁵³

A REIT selling mortgage loans it originates is deemed to have created and sold inventory and therefore entered into a prohibited transaction, in which case the loan sales are conducted through a TRS.²⁵⁴

3.5.6 Hedging Transactions

The survival of M-REITs is based on hedging their transactions as a measure of protecting themselves against interest rate fluctuations that is likely to affect its profitability arising from changes in interest rates on their borrowing and mortgage related assets.²⁵⁵ The code limits the REITs ability to be fully hedged and hedging transactions are excluded from REITs gross income for purposes of 75% and 95% gross income tests. In accord with these rules, hedging transactions are entered into to manage risk and interest rate or price changes or currency

²⁵³ Code Sec. 857(b)(6)(B).

²⁵⁴ Ritter *supra* note 203 at 34.

²⁵⁵ Ibid.at 37.

fluctuations with respect to borrowings made or ordinary obligations incurred by the REIT. This is however limited to clearly identify hedging transactions that are in line with detailed identification requirements. The second limitation is with respect to hedging indebtedness that is incurred or to be incurred to acquire or carry real estate assets.²⁵⁶ The rest of the income is excluded. At a general level, assets created by REITs hedging would not constitute qualify asset for purpose of the 75% asset test.

3.5.7 Foreclosed Property

Foreclosure property comprises any real property and personal property acquired by a REIT as a result of a REIT having bid on such property at foreclosure or having otherwise reduced such property to ownership or possession by agreement or process of law.²⁵⁷ This happens after there has been default or imminent default on a lease of such property.²⁵⁸ A REIT has a choice of either construing this property as foreclosed which would then include real property obtained by default following a default on a mortgage.²⁵⁹

Foreclosed property is not considered as such if the loan with respect of the default was entered into by a REIT with the intention of evicting or foreclosure when REIT knew of that default. This would only occur with improper knowledge.²⁶⁰ Improper knowledge by the REIT is determined at the time the REIT enters binding commitments in acquisition of the loan. For example, a REIT that acquires a distressed or non-performing loan and eventually acquires real

²⁵⁶ Code Sec. 856(c)(5)(G)(i).

²⁵⁷ Ibid.

²⁵⁸ Code Sec. 856(e)(1).

²⁵⁹ Ibid. Sec. 856(e)(5).

²⁶⁰ Ibid. Section,1.856-6(b)(3).

property through foreclosure. Even if the IRS asserts that REIT had improper knowledge, real property would not qualify as foreclosed property.²⁶¹ Foreclosed property also accrues certain benefits: first, foreclosed property cannot be treated as prohibited property and therefore benefits from 100% tax rebate.²⁶² Secondly, the income and gains from foreclosed property is part of the qualifying income for purposes of REIT gross income tests.

3.5.8 TRS Issues

A TRS is subsidiary of a REIT that allows it to invest in prohibited transactions without losing its tax advantages. Not being a REIT, a TRS is subject to corporate taxation and should not consist of more than 25% of a REITs total asset value. M-REITs conduct certain activities that they may not be able to accomplish using TRS. Using TRS presents certain challenges. First the transactions between REIT and its TRS need to be conducted at arms-length. TRS can use certain tools to ensure that this is done such as, deducting interest paid or accrued by a TRS to prevent a REIT being subjected to limitations.²⁶³ Additionally, 100% excise tax is imposed on transactions between TRS and parent REIT that is not conducted at arms-length.²⁶⁴ Much more importantly, the aggregate value of REITs and TRS should not violate the 25% TRS limit at the end of any calendar quarter.

M-REITs may also use qualified D-REITs Subsidiary (QRS) to engage in REITs compliant activities. This shows that Mortgage lending involves a mixture of investment activities and

²⁶¹ Ritter *supra* note 203 at 34.

²⁶² Ibid. Sec. 857(b)(6)(B)(iii).

²⁶³ Ibid. Sec. 857(b)(7).

²⁶⁴ Ibid. Sec. 857(b)(7)(E).

assets that could either be REIT compliant or not. In particular, M-REITs operate through many structures as principles publicly held as well as TRS and QRS.

3.5.9 Phantom Income

Phantom income consists of taxable income that does not have corresponding cash.²⁶⁵ In this category are original issue discount interest, cancellation of indebtedness income and excess inclusion income from securitization transactions.²⁶⁶ Phantom income is excluded from 90% distribution requirement so long as it exceeds 5% of the M-REIT taxable income.²⁶⁷ Such a REIT is subject to corporate income tax on the income that is not distributed, including phantom income.²⁶⁸

²⁶⁵ Ibid. Sec. 856(c)(5)(E).

²⁶⁶ Ibid.

²⁶⁷ Ibid. Sec. 857(e)(1).

²⁶⁸ Ibid. Sec. 856(c)(5)(E).

3.6 Approaches and Diversification of M-REIT

M-REIT is generally known to focus on residential or commercial markets, while others invest in both.²⁶⁹ These categories of M-REIT have special features that have enabled the market manage majority of risks in M-REIT investment.

3.6.1 Residential M-REIT

Residential M-REIT invest in agency M-REIT which is a government sponsored facility and credit risk free as it is guaranteed by the state. The terms of the guarantee are that in the event of default, the principle and interest can be paid by the government.²⁷⁰ Other residential M-REIT invest in non-agency or private label issued by other government financial institutions and residential mortgage loans not eligible for the purchase or securitization. Non-agency M-REIT are backed by underlying collateral that does not qualify for conventional mortgage underwriting standards. Non-agency M-REIT have credit risks if the borrower defaults on any payment. They bear higher interest rate payments to compensate for the risks.²⁷¹

The credit risk depends on the credit performance of residential REIT, structure of security and the amount of categorization. A security structured with multiple classes may have those that should be paid quickly with short maturities and slow ones with longer maturities. Where it is over-categorized (or where the amount exceeds mortgage loans held exceeds the amount of security issued). Non-agency M-REIT may as well invest in agency M-REIT.

²⁶⁹ NAREIT *supra* note 28 at 4.

²⁷⁰ *Ibid.*

²⁷¹ *Ibid.*

3.6.2 Commercial M-REIT

Commercial M-REIT provide financing to commercial real estate by investing in commercial mortgages and commercial real estate loans in rated and unrated mortgage-backed securities (CMBS) like subordinated securities and construction loans.²⁷² Traditional commercial REITs are financial solutions to buyers of commercial real estate.

3.6.3 M-REIT Listed on Security's Exchange

Similar to E-REIT a majority of M-REIT are listed on the New York Stock Exchange (NYSE) NASDAQ that enables many investors purchase shares. Listed M-REITs facilitate holding of equity on the mortgage market that offers advantages of liquidity and transparency of publicly traded equities that are not available to direct investments in mortgage loans. The growth in M-REITs is attributed to having access to public markets with more choosing agency M-REITs as a result of the financial crisis.²⁷³

3.6.4 Agency M-REIT

The growth of agency M-REIT was partly motivated by the global financial crisis in 2008. The crisis led to private investors pulling back from the mortgage market. This rapid growth was facilitated by having access to public debt and equity markets to bring capital to the housing finance by investing in agency residential mortgage-backed securities (RMBS).²⁷⁴ Agency M-REIT use debt financing by issuing equity securities that are liquid, publicly traded investments

²⁷² Ibid at 5.

²⁷³ Ibid.

²⁷⁴ Federal Reserve Bank of New York, Economic Policy Review, Special Issue: The Stability of Funding Models.

that pay regular dividends and offer potential for capital appreciation. Increasing regulatory framework of agency M-REIT provides housing finance for a long time.²⁷⁵

3.6.5 Business Model

Like other REITs, the operation of agency M-REIT complies with provisions of Inland Revenue code. The most important one being distribution of taxable income yearly to shareholders. Three consequences accrue from this benefit in terms of financial stability. First, agency M-REIT reverts back to the capital market for investment financing and therefore scrutiny by investors, analysts and the media. This makes companies more disciplined and financially stable. Secondly, agency M-REIT is compelled to pay higher rates of dividends that provide income to investors. Thirdly, high income returns contribute to diversification in investment portfolio like those provided by E-REIT.

The risks faced by agency M-REIT are similar to those of other financial institutions such as those to interest rate, prepayment and liquidity risks. Agency M-REIT has developed certain mechanisms of managing risks that facilitate the navigation of these risks.

3.7 Market Characteristics of Agency M-REIT

A better understanding of the market agency M-REIT operates in is critical appreciation of the characteristics. Agency M-REIT comprise the largest liquid securities market that has been in existence for over 40 years.²⁷⁶ The focus of agency M-REIT is institutional where micro-prudential risks are managed and reduced and it helps in reducing macro-prudential risks.

²⁷⁵ Ibid.

²⁷⁶ NAREIT *supra* note 28 at 9

Globally the worth of agency M-REIT is more than €6 trillion, which makes it the largest securities market in the world.²⁷⁷ It's a broad investment with diverse participants such as mutual funds, pension funds, M-REIT, foreign investors, Federal Reserve System among other institutional investors. The diversification of capita base introduced by the varied markets improves liquidity, enhances market ability to absorb asset sales thereby reducing systemic risk of fire sales.²⁷⁸

3.7.1 Asset Quality and Liquidity

Agency M-REIT comprises the deepest and most liquid market. Its spread remained narrow even during the period of the financial crisis which enabled trading that had little impact on the market. Liquid markets facilitate large scale trading in securities and in the process the risk of unanticipated sales of large agency M-REIT.²⁷⁹

3.7.2 Institutional Features of Agency M-REIT

A number of attributes help agency M-REIT to effectively manage their risks, provide capital in the housing market and to operate in a stable manner. These are access to public capital market, moderate financial leverage, disciplined use of capital and listing standards required by the public stock exchange. Although agency M-REIT have not been around for a long time, they have had access to capital markets in good and bad times that allowed companies to raise equity capital for purposes of strengthening the balance sheet and support for asset growth while

²⁷⁷ Federal Reserve Bank, Financial Accounts of USA.

²⁷⁸ Ibid.

²⁷⁹ NAREIT *supra* note 28 at 9.

reducing leverage.²⁸⁰ Access to public capital markets allows agency M-REIT to provide and facilitate private sector capital to sustain and finance home mortgage markets after the financial crisis.²⁸¹

3.7.3 Moderate Use of Public Markets

The ability of agency M-REIT to access public markets enables it to raise equity and limit leverage. Moderate leverage on the other hand helps it maintain stability of the balance and therefore reduces the possibility of shocks to the financial market. Leverage ratio is an interest bearing liability divided by total equity.²⁸² REITs in general are required by law to distribute their taxable income to the shareholders. This has the effect of limiting their growth through a mechanism most companies are accustomed to of using retained earnings. Therefore, agency M-REIT maximizes their reliance on public market financing. For that very reason agency M-REIT become more responsive to market discipline than other financial institutions that are allowed to retain earnings.²⁸³ This improves not only the effectiveness of market discipline to limit excessive growth, restrain leverage, incentivize prudent risk management, encourage transparency and promote good corporate governance.²⁸⁴

3.7.4 Stock Exchange Listing

Assets of agency M-REIT are mainly held by companies on the stock exchange (NASDAQ and NYSE). The stock exchange provides additional standards to companies that list in relation to

²⁸⁰ Ibid.

²⁸¹ Ibid.

²⁸² NAREIT *supra* note 28 at 8.

²⁸³ Ibid.

²⁸⁴ Ibid.

public information on portfolio investments, asset maturity, interest rates, liquidity and capital resources, cash flows, hedge positions and strategies to risk management. The effect of transparency is that it allows investors to assess risk exposure, strengthens the effectiveness of market place discipline in a timely manner.²⁸⁵

3.8 Risk Management Practices

There is an overlap between the risk management practices of agency M-REITs and the characteristics of the Agency RMBS market. This facilitates in the management of risk thus reducing the ability of agency M-REIT to create significant risks or contribute to financial instability.²⁸⁶ It is for this reason that companies with a robust framework for managing interest rate risk, counterparty credit risk, prepayment risk and liquidity risk are unlikely to initiate or transmit shocks to the broader financial system.²⁸⁷

Agency M-REIT was purposely developed with strategies and financial institutions to address risks posed by agency RMBS investors. These tools have helped in addressing risks and strengthen financial stability. These strategies are grouped into three: hedging strategies, active liability management and active asset management. In addition, the depth, liquidity and asset quality of the agency RMBS market help provide a stable market environment for agency M-REIT operations.²⁸⁸

²⁸⁵ Ibid.

²⁸⁶ International Monetary Fund, Global Financial Stability Report, October 2013 at 9-11.

²⁸⁷ Ibid. at 10.

²⁸⁸ Martin *supra* note 346 at 318.

3.8.1 Hedging Strategies Using Financial Instruments

Investors in agency RMBS market including agency M-REIT manage risks associated with their short term borrowing through conventional hedging strategies like the use of interest rate swaps, interest rate collars or using caps on other financial derivatives. These financial markets are liquid and were able to cope well during the financial crisis that facilitated agency RMBS to adjust their hedges in line with the market dynamics.²⁸⁹ It is however, important to remember that hedging does not completely eliminate risk that would arise from changes in short and long term interest rates. What it does is to reduce the impact of the changes on the level of interest rate on an agency M-REIT's net worth, liquidity and funding demands. It further reduces risks to the possibility of a leveraged long-term asset funded with short term finance is likely to generate.

3.8.2 Active Liability Management

A number of existing active liability management strategies enable agency M-REIT to manage interest rates and financing risks. In so doing, companies reduce the potential of shocks to the financial system or those originating from any other part of the market.²⁹⁰

3.8.3 Liability Maturity Extension

The repo market (sale and repurchase agreements) often is mistakenly described as the “overnight” funding of longer-maturity assets. However, there also is a liquid market for repo financing offering contracts with maturities that extend well beyond overnight, often referred to as “term repo.” Overnight contracts constitute less than 10 percent of the repo market. Agency RMBS can be funded in this portion of the market with maturities beyond 90 days, and indeed,

²⁸⁹ Ibid.

²⁹⁰ NAREIT *supra* note 28 at 10.

repo funding is available for terms of up to several years. In 2013: Q4, for example, Agency M-REITs extended the weighted average maturity of their repo liabilities to 73 days in order to reduce risk in a market of elevated interest rate volatility. The average maturity of repo liabilities for the largest Agency M-REITs is even longer, helping to shorten meaningfully the duration mismatch between assets and liabilities.

3.8.4 Liability Maturity Staggering

In a process known as liability maturity staggering, agency M-REIT by their very nature avoids having a large portion of liability to mature over a short period of time. This has the effect of reducing risks that are associated with temporary dislocation in financial markets and if that were to happen, the ability of agency M-REIT to fund mortgage investment would be seriously impaired.²⁹¹

3.8.5 Balance Sheet Stress

Operators of agency M-REIT have adopted banking practices that simulate possible effects of short and long term interest rates on the value of their assets and hedges. Such type of risk analysis helps agency M-REIT to anticipate and prepare for future liquidity and funding requirements in times of financial distress. It is for that reason that many creditors require results of the stress tests that helps to enhance market discipline.²⁹²

²⁹¹ Congressional Budget Office *supra* note 201 at 12.

²⁹² *Ibid.*

3.8.6 Alternative Financing Sources

Other than repo financing, agency M-REIT require other forms of financial sources in the form of equity, convertible bonds, covered bonds, medium term notes and unsecured corporate bonds.²⁹³ Because of the way agency M-REIT is structured, they keep diverse roll of parties to void relying on a single stream of financing in a process known as counter-party management.²⁹⁴ The effect of this is to reduce risks of liquidity shortfall if and when they become unable to meet their funding obligations with a specific lender.

3.8.7 Active Asset Management

Other than using active liability management practices and access to the capital markets, using active asset management practices enables companies to reduce the potential of their short term liability and repo financing maturing. If this were left to happen, it would introduce distress to the financial system which would lead to diminished confidence in the market. Similarly, it would indicate whether the companies' participation in the market contributed to causing shocks in the market.²⁹⁵

3.9 Advantages of M-REIT over Non-REIT Financing

M-REITs have compelling reasons than non-REIT to undertake housing finance. M-REITs have the ability to hold mortgage assets portfolio for a long period of time. Historically, M-REIT enjoy tax advantages generally enjoyed by other REITs in the USA. The advantages are particularly important for enterprises that depend on net interest income or spread given than imposing corporate tax on income reduces the overall yields as compared to single level of

²⁹³ NAREIT *supra* note 28 at 11.

²⁹⁴ Ibid.

²⁹⁵ Ibid at 12.

taxation in REIT shareholding. Additionally, M-REITs structure has a long term orientation towards holding of mortgage and real estate assets as opposed to non-REIT entities that are oriented towards short term profits.

After the financial crisis, non REIT entities have shied away from long term USA mortgage financing. Those still holding onto mortgage assets are under a lot of pressure to reduce their portfolio in favor of M-REITs. Further, banks that initially provided term financing are exceedingly subject to increased capital requirements in holding long term assets and have therefore more incentives to sell off their assets while leaving securitization to other investors notably M-REITs. The effect of the financial crisis is that most institutional investors never recovered to participate in long term asset financing, when they do so, it would be under stricter guidelines with less focus on holding mortgage assets.

3.9.1 M-REIT Tax Advantages

REIT is generally described as a corporation that receives special tax treatment, for example the M-REIT is exempted from federal tax at the corporate level so long as it distributes its annual income. However, M-REIT is subject to corporate tax on any retained income. For an M-REIT to qualify for tax exemption, all its assets must be held in real estate investments. It should also earn 95% of its gross income from passive sources that are held at 75% of its gross income from real estate and other related sources. A 100% penalty is levied on income arising from the sale 'dealer property'. Dealer property is the sale or disposition of property held by the taxpayer as

inventory or primarily for sale to customers in the ordinary course of its trade or business, excluding certain foreclosure property.²⁹⁶

M-REIT is limited to passive investments in mortgage loans. For that matter, M-REITs have adopted securitization structures, where the M-REIT originates mortgages and finances them by offering MBS that are treated as borrowings against mortgages for federal income tax purposes.²⁹⁷

3.9.2 Regulating Advantages of M-REIT

Other than the special federal income tax advantages, M-REIT enjoy regulating advantages too. M-REIT qualify for exemption under section 3(c)(5)(c) of the Investment Company Act of 1940 which caters for entities engaged in the business of purchasing or acquiring mortgage and liens and interest in real estate. This applies if 55% of M-REIT assets comprise of qualifying assets and 80% of its assets are qualifying assets that are related to real estate. Qualifying assets encompass mortgage loans and assets equivalent to mortgage loans.

The advantages envisaged under the Investment Company Act of 1940 are twofold: first the inability to conform to strict asset tests in section 3(c)(5)(c) which results in the determination that an M-REIT is an investment Company and therefore inconsistent with M-REIT. Secondly, the tests applied by section 2 of mortgage holding securities (GSE or private) have proved not only technical but difficult to monitor.

²⁹⁶ Morrison & Foerster *supra* note 202 at 5.

²⁹⁷ Ibid.

3.10 Challenges of Funding M-REITs

The most critical challenge facing M-REIT is how to balance and maintain long term financing using short term sources of funding.²⁹⁸ A case study of IndyMac REITs discloses that to avoid, it had to seek more stable sources of financing by acquiring a bank in the year 2000 which it used to control the mortgage business. It eventually terminated its REIT status and continued to operate as a bank.²⁹⁹ This was an exceptional case, a M-REIT should have capacity to arrange its liability in a manner that makes it survive a credit crisis. The key is to diversify funding and financial sources. The sources should in turn be committed to the purpose of financing housing.

Potential sources would include but not limited to bank term loans, bank revolving lines of credit, bank-supplied warehouse lines of credit, warehouse lines supplied by non-bank finance companies, hedge funds or asset-backed commercial paper vehicles, the issuance of commercial paper at the corporate level, the issuance of public debt securities, the issuance of senior securitization interests, which constitute debt on the mortgage REIT's balance sheet and equity offerings by the REIT.³⁰⁰

Additionally, the interests and maturity profiles of M-REIT need to be matched by liability structures through monitoring of interest rates and other derivative instruments. The key to survival would largely depend on professional diligence and the management of the liability aspects of M-REIT.³⁰¹

²⁹⁸ Morrison & Foerster *supra* note 202 at 10.

²⁹⁹ *Ibid.*

³⁰⁰ *Ibid.*

³⁰¹ *Ibid* at 9.

3.11 Conclusion

The current success of the US M-REIT market is a historical fact following the financial crisis of 2008 when most M-REITs collapsed. The new ones that were created after the crisis known as agency M-REIT had one big advantage of being guaranteed by the US government. They adopted a simple business strategy of buying high yielding distressed assets cheaply, leverage them with debt financing at low interest rate and finally realize profits when the assets liquidate. This is further attributed to the ability of managing risk attendant to short term borrowing for long term investment. All these would however not be possible without a tax advantaged legal regime. This has helped in reducing the possibility of initiating shocks in the market while spreading distress throughout the market.

The financial crisis wreaked havoc on the US mortgage industry to the extent that the ones that survived depended on the government for survival. The emergence of a private market for mortgage is emerging with a reduced government support for mortgage loans provided by banks with corresponding increase in support for M-REITs. Increasingly M-REITs are playing a leading role in mortgage finance arising from advantages associated with long time portfolio investment, securitization and loans that have fewer regulations than those provided by banks. Additionally, M-REITs enjoy tax breaks which make them ideal vehicles for affordable housing in Kenya.

Whereas M-REIT have shown to be complex creatures considering that they require numerous and complicated qualifying criteria to satisfy REIT status. They may not provide an ideal structure for achieving affordable housing in all circumstances. As an illustration if a corporation

were to comply with all the requirements, it would be difficult for it to operate for the purpose of maximizing profits putting in mind the nature of REIT gross income and asset test qualifications. However, where a company converts to an M-REIT status, the tax advantages and other benefits would be an ideal platform for achieving affordable housing mortgage.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

This study set out with two objectives, to assess Kenya's legal framework on REITs. Secondly, this was compared with an assessment of the legal framework of mortgage REITs in the United States of America. Thirdly, some international best practices were analyzed to determine which lessons Kenya can learn. These objectives were set to answer the question as to what extent mortgage REITs would assist in achieving affordable housing in Kenya.

4.2 Conclusion

The study established that, REITs in Kenya are classified into three namely: D-REIT, I-REIT and Islamic REIT. D-REIT is concerned with investment in real estate through development and construction of real estate assets. I-REIT relates to investment in real estate for purposes of income generation through facilities such as rent and license fees. Islamic REIT has been developed to address unique demands of Islamic investors who desire to make investments in real estate in conformity with Sharia principles. Overall, Kenya's legal framework was not developed as an option to bridge the housing shortage through financing of affordable housing but rather as an alternative form of investment. Therefore, Kenya's REITs legal framework faces many challenges such as high investment cost, limited tax incentives, complex and contradictory provisions that make it difficult for long term mortgage financing for affordable housing.

Chapter two made an analysis of the concept of mortgage REIT with a view of finding out whether it would deliver affordable housing in line Article 43(1)(b) of the Constitution on

affordable housing. The reason why the USA was chosen is because it has a vibrant housing market where M-REIT have played an important role especially after the financial crisis. It begins by exploring the concept of mortgage REITs (M-REITs). The issues to be evaluated would include ownership and organizational structure of M-REITs, tax and regulating advantages and its disadvantages in achieving affordable housing in Kenya. The main focus would be how the concept of M-REITs applies to affordable housing in Kenya.

It is established that although the financial crisis wreaked havoc on the US mortgage industry, the ones that survived depended on the government for survival. The emergence of a private market for mortgages is emerging with reduced government support for mortgage loans provided by banks with corresponding increase in support for M-REITs. M-REITs are playing an increasing role in mortgage finance arising from advantages such as long term portfolio investment, securitization and loans having fewer regulations than banks. M-REITs similarly enjoy tax breaks that make it an ideal vehicle for affordable housing in Kenya.

Whereas M-REIT have shown to be complex creatures considering that they require numerous and complicated qualifying criteria to satisfy REIT status, they may not provide an ideal structure for achieving affordable housing in all circumstances. As an illustration if a corporation were to comply with all the requirements, it would be difficult for it to operate for the purpose of maximizing profits putting in mind the nature of REIT gross income and asset test qualifications. However, where a company converts to an M-REIT status, the tax advantages and other benefits would be an ideal platform for achieving affordable housing. Chapter three is a comparative

analysis of how the M-REIT legal framework has been operationalized in other jurisdictions not only to achieve affordable housing but fulfill the right to housing.

Chapter three also provides a comparative overview of international best practices in mortgage REITs investment. The chapter evaluates best practices in M-REITs from the perspective of other jurisdictions especially the USA and the lessons Kenya can learn in making M-REIT a reality. It examines the resilience and growth of the USA M-REIT market after the financial crisis of 2008. The reason the USA was chosen is because its legislation on REITs and in particular Mortgage REITs is advanced and worthy of replication in the Kenyan legislative context. By way of example, in the USA M-REITs may also enter into sale and repurchase agreements that would enable them sell mortgages or mortgage backed securities. These agreements are treated as borrowing transactions. Such a REIT should be treated as owning these assets for purposes of REIT income and asset test.³⁰² M-REITs may also purchase assets using ‘to be announced’ forward contracts (TBA). In a TBA, an M-REIT purchase for future use mortgage backed securities having principal, interest terms and other underlying collateral. This type of advancement is what Kenya’s legislation on REITs needs.

The focus is on the creation of mechanisms that reduced the risks inherent in mortgage investment, in particular the creation of agency M-REIT investments in mortgage backed securities using commonly used risk management practices. The strategy involved the establishment of companies with an effective capability of managing interest risks, counterparty credit risks, prepayment risks and risks to liquidity. The chosen method was important because

³⁰² Rev. Rul. 77-59, 1977-1 CB 196; FSA 001769 (Mar. 5, 1996).

once such an eventuality materialized, the shocks would be transmitted to the entire financial system.

Finally, it is clear that the current success of the US M-REIT market is a historical fact following the financial crisis of 2008 when most M-REITs collapsed giving rise to agency M-REITs. The new ones created after the crisis (agency M-REIT) had one big advantage of being guaranteed by the US government. They adopted a simple business strategy of buying high yielding distressed assets cheaply, leverage them with debt financing at low interest rate and finally realize profits when the assets liquidate. This is further attributed to the ability of managing risk attendant to short term borrowing for long term investment. All these would however not be possible without a tax advantaged legal regime. This has helped in reducing the possibility of initiating shocks in the market while spreading distress throughout the market.

4.3 Recommendations

4.3.1 Amendment of the REITs Legal Framework

It is recommended that the Capital Markets (Real Estate Investment Trusts) (Collective Investment Schemes) Act and Regulations be amended to specifically provide for M-REIT with the aim of making REITs more attractive to investors as well as increase uptake of REITS. Amendment to the Retirement Benefits Act, Capital Markets Act, Insurance Act and the Income Tax Act would be critical as will be shown below. Kenya's legal framework on REITs³⁰³ has classified D-REIT into: income REIT (I-REIT), development and construction REIT (D-REIT)³⁰⁴ and Islamic REITs.³⁰⁵ This means that Kenya's legal system does not envisage M-

³⁰³ *Supra* note 23, Regulation 2.

³⁰⁴ *Ibid* Regulation 8.

REITs as a form of financing affordable housing other than for the purpose of assisting a tenant or purchaser acquire housing from a D-REIT. Again, this form of lending is restricted to a D-REIT.

4.3.1.1 Lift Cap on Investment Vehicles

It is recommended that caps on the types of investment available to insurance firms be lifted. The Insurance Act 160 sets out the specified investment vehicles in which insurance companies may invest in. Section 50 outlines some of the investments as government securities, debentures, commercial paper, preference shares or ordinary shares of public companies whose shares are quoted on the stock exchange in Kenya and instruments of title to immovable property in Kenya. The Act does not have provision for investment in collective investment schemes or pooled funds akin to REITs. The limitations on pension funds and insurance companies are a big hindrance because pension funds and insurance companies are by their very nature highly liquid and ,they would provide a solid financial backing for Mortgage REITS.

4.3.1.2 Enhance Tax Incentives

It is recommended that the tax regime on REITs be enhanced to further make investing in the sector more attractive. To ensure effective implementation of the tax neutrality provision provided for under the Income Tax Act through the amendment made to section 20 in 2012, a new sub section should be introduced to provide that a real estate investment trust and its trustee or trustees, shall be exempt from income tax on any gains or profits derived or accrued from Kenya. Section 35 should be amended to indicate that for purposes of exemption of distributions from taxation any reference to a person also includes a real estate investment trust.

³⁰⁵ Ibid. Regulation 122

4.3.1.3 Removal of Limitation on Investment of Pension Funds

It is recommended that the current limitation on investment of pension funds be lifted to enable the firms invest more in MREITs. For example, the Retirement Benefits Act³⁰⁶ restricts the maximum investment in the quoted equity of any one company to thirty per centum of the aggregate market value of the total assets of the scheme, or pooled fund.³⁰⁷ This means that a pension fund can only invest up to thirty percent of the value of its assets in a REIT. This is very restrictive because pension funds usually have high value assets under their management and should be allowed to invest larger proportions of their funds in REITs. This would allow more pension funds to be used as capital in REITs.

4.3.1.4 Abolish Barriers to Investment

It is recommended that barriers to entry for investment into MREITs should be abolished. Due to high entry requirements many investors are discouraged from investing into the secondary market thus making it inaccessible to a greater majority of investors. This would further enable more investor's access real estate through the secondary market. This is opposed to the current situation where property investment is done directly through purchase of property or through private placement of equity or debt of privately held real estate or property.

4.3.1.5 Use of Mobile Technology

It is recommended that REITs should take advantage of existing mobile money models to make investing in REITs more accessible. This would involve tapping into new mobile money technologies by creation of options to buy REITs via mobile phone Other models have been

³⁰⁶ Chapter 197 Laws of Kenya.

³⁰⁷ Section 31 (1) (b), the Retirement Benefits Act.

more successful, for example, RBA has an Mbao investment plan that allows *Jua kali* artisans and people in the informal sector of the economy to save Kshs 20 per day for their retirement. This would not only enable smaller investors participate in REIT market but increase uptake of M-REITs as well.

4.3.2 Creation of Alternative Financing Sources

It is recommended that other forms of financial sources in the form of equity, convertible bonds, covered bonds, medium term notes and unsecured corporate bonds. This is because of the way agency M-REIT are structured, they keep diverse roll of parties to avoid relying on a single stream of financing in a process known as counter-party management. The effect of this is to reduce risks of liquidity shortfall if and when they become unable to meet their funding obligations with a specific lender.

4.3.3 Introduction of Hedging Strategies Using Financial Instruments

It is recommended that hedging strategies using financial instruments be introduced to investors to assist in the management of risks associated with short term borrowing. This is because these financial markets are liquid and were able to cope well during the financial crisis that facilitated agency RMBS to adjust their hedges in line with the market dynamics. It is however, important to remember that hedging does not completely eliminate risk that would arise from changes in short and long-term interest rates. What it does is to reduce the impact of the changes on the level of interest rate on an agency M-REIT's net worth, liquidity and funding demands. It further reduces risks to the possibility of a leveraged long-term asset funded with short term finance is likely to generate.

4.3.4 Proper and Effective Management of Interest Rate Risk

It is recommended that a proper and effective management of interest rate risk is introduced to limit escalation of interest rates on loans. This is because an effective agency M-REIT requires a proper management of short and long-term interest rates. Any variation in short term interest has the ability to affect cost net interest margin as a measure of difference between interest income from its longer maturity assets and interest expense of its shorter maturity liability and is the fundamental source of earnings. Similarly, long term interest rates and the market value of longer maturity mortgage assets have an effect on net worth of a corporation. Agency M-REIT has a way of managing interest rate risk using hedging strategies that involves strategic asset selection and liability management and the use of derivatives.

4.3.5 Diversification of Income Sources

It is further recommended that REITs should diversify its sources of financing. The most critical challenge facing M-REIT is how to balance and maintain long term financing using short term sources of funding. An M-REIT should have capacity to arrange its liability in a manner that makes it survive a credit crisis. The key is to diversify funding and financial sources. The sources should in turn be committed to the purpose of financing housing. Potential sources would include but not limited to bank term loans, bank revolving lines of credit, bank-supplied warehouse lines of credit, warehouse lines supplied by non-bank finance companies, hedge funds or asset-backed commercial paper vehicles, the issuance of commercial paper at the corporate level, the issuance of public debt securities, the issuance of senior securitization interests, which constitute debt on the mortgage REIT's balance sheet and equity offerings by the REIT.

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