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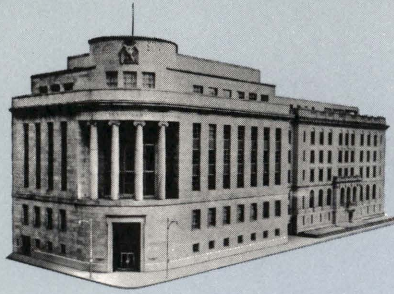

FEDERAL RESERVE BANK OF BOSTON

NEW ENGLAND ECONOMIC REVIEW

Real Estate Investment Trusts: A New Financial Intermediary

This new financial intermediary grew rapidly and became an important source of real estate funds during the tight-money period of the past two years. However, the growth of these trusts will probably level off as monetary restraint eases.

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Real Estate Investment Trusts: A New Financial Intermediary

by PETER A. SCHULKIN

Introduction

WITHIN the last 3 years, real estate investment trusts (REIT's) have become an important source of construction and development loans, as well as of long-term mortgage and real estate equity funds. Much of the rapid growth of REIT's can be explained by the recent tight-money conditions and government restrictions on the traditional real estate lenders. These factors combined to bring about a scarcity of mortgage money and high yields, which in turn provided a favorable climate for new REIT formations. It remains to be seen whether REIT's will continue to grow rapidly during the current period of easing monetary policy. It is most likely, however, that the rate of new REIT formations will slow markedly.

REIT's are in effect financial intermediaries which serve to improve the flow of funds from savers to real estate investors. REIT's obtain their operating funds from many sources including individuals, banks, mutual funds, pension funds, and bank trust accounts. They channel the funds into both real estate ownership positions and different types of mortgage loans, including construction loans.

This article describes the brief history and current state of REIT's. Among the topics included are: types of REIT's and advisers, reasons for their rapid growth, prospects for the future, and questions concerning conflicts of interest and regulation.

What Are REIT's?

REIT's were made possible by 1960 tax legislation which exempts them from Federal corporate income taxes provided that they meet certain requirements. This tax advantage was extended to enable individuals to invest in real estate and mortgages through REIT's in the same way they can buy common stocks through mutual funds. Consequently, the requirements to qualify as a REIT are designed to insure that the REIT is essentially a real estate and mortgage mutual fund.

To qualify for tax exemption, a REIT must meet the following principal requirements:

1. The REIT must be a passive investor rather than an active participant in the operations of its properties. But the active manager of a REIT's properties can own up to 35 percent of the REIT's stock.

2. At the end of each quarter 75 percent of the value of the REIT's total assets must consist of real estate (including mortgages), cash, cash items, and government securities.

3. At least 100 persons must own shares, and five or fewer persons cannot own more than 50 percent of the shares during the last half of any tax year.

4. At least 75 percent of the gross income of the REIT must be derived from rents, mortgage interest, and gains from the sale of real estate.

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5. At least 90 percent of the REIT's ordinary income must be distributed to the shareholders within 1 year after the close of the taxable year.

Although the law allows either the open-end or closed-end form of REIT, all existing REIT's have chosen the closed-end option. That is, they do not redeem shares on request; rather, the owner must sell his shares in the stock market in order to liquidate his investment. Consequently, the market price of a REIT's shares can deviate substantially from the net asset value per share. By being closed-end, REIT's do not have to be greatly concerned with liquidity of their assets.[1] While most REIT's have started business with a public offering, a few have chosen the private placement route.

Types of REIT's

Within the limits imposed by requirements for tax exemption, the investment powers of REIT's are quite broad. Moreover, where a REIT's declaration of trust (equivalent to articles of incorporation) is specific with regard to investment policies, no permanence is implied because changes can be (and in some instances have been) made with shareholder approval. And there have been on occasion changes in legal status from REIT to taxable corporation and vice versa. Nevertheless, REIT's may be classified by their investment policy into one of three broad categories — construction and development loan, long-term investment, and miscellaneous.

Construction and Development Loan REIT's (C & D REIT's)

At the present, the most important category of REIT's in terms of total assets consists of those investing mainly in construction and development loans. Construction loans are secured by a first mortgage and are used primarily to finance the construction of single-family homes, apartment houses, and commercial structures.[2] Development loans are used to finance site improvements such as clearing and leveling land and constructing roads.

Construction and development loans have typically earned very attractive yields; in the first half of 1970 they averaged 12 to 14 percent per annum for REIT's. These high yields made existing C & D REIT's very profitable, and encouraged the formation of new ones. During the last half of 1970, however, yields fell sharply.

Some older C & D REIT's have included comparatively low-yielding FHA- and VA-insured permanent mortgages in their portfolios in order to present a less risky balance sheet to banks extending them loans. However, most of the recently-formed C & D REIT's have found that they can make satisfactory credit arrangements without having any FHA- and VA-insured permanent mortgages in their portfolios.

Of the 114 REIT's which are included in the compilation in Table I, 45 are C & D REIT's. Their total assets currently exceed $2 billion, and they are making 7 to 10 percent of the dollar volume of all construction loans.[3]

Long-term Investment REIT's

The second major type of REIT invests primarily in long-term assets. Some are *equity* REIT's specializing in direct ownership of in-

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[1]The potential shortcomings of the open-end REIT were recently highlighted by the problems of a foreign mutual fund that invested heavily in American real estate. This mutual fund, U. S. Investment Fund-Real Estate, was overwhelmed by redemption requests in 1970 and is now in the process of liquidating its operations.

[2]For a description of the construction-loan market by the author, see *Commercial-Bank Construction Lending*, Research Report to the Federal Reserve Bank of Boston, No. 47, and "Construction Lending at Large Commercial Banks, *New England Economic Review*, July/August, 1970, pp. 2–11. Both are available on request from the Research Department of this Bank.

[3]The 7 to 10 percent estimate is based on figures extrapolated from those in the Appendix to "Construction Lending at Large Commercial Banks," *op. cit.*

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Table I

CLASSIFICATION OF REIT'S BY TYPE AND ADVISER, 1970*

(Dollars in millions)

	Total			Affiliation of Adviser: Commercial Bank			Life Insurance Company			Financial Conglomerate			Mortgage Banker			Other		
	Number	*Assets*	*Equity*	*Number*	*Assets*	*Equity*	*Number*	*Assets*	*Equity*	*Number*	*Assets*	*Equity*	*Number*	*Assets*	*Equity*	*Number*	*Assets*	*Equity*
ALL TRUSTS	114	$4310	$3109	22	$847	$750	8	$596	$5[illegible]	[illegible]	$672	$578	13	$415	$290	59	$1780	$924
Construction and Development	45	2181	1539	14	586	500	3	126	[illegible]	[illegible]	327	238	12	354	253	9	788	449
Mixed Maturity	8	470	386	3	92	86	1	150	1[illegible]	[illegible]	40	40	1	61	37	2	127	72
Long-Term	60	1630	1155	5	169	164	4	320	3[illegible]	[illegible]	276	271	—	—	—	48	865	402
Homeowner's Instalment	1	29	29	—	—	—	—	—	[illegible]	[illegible]	29	29	—	—	—	—	—	—

*The REIT's were identified with the aid of a list furnished by the National Association of stated due to accounting practices. Where the type of REIT or adviser did not clearly belong in Estate Investment Funds and standard sources of financial information. The asset and equity fi of the above categories, its designation was arbitrarily determined. The number column includes are based on the latest financial statements available as of December 31, 1970. In the case of new R mall construction and development trust and one small long-term trust, both affiliated with "other" which have not yet issued financial statements, the offering amount was used for both assets and e ers, for which asset and equity figures could not be obtained. Convertible bonds are considered to Asset and equity figures for those REIT's with an ownership interest in properties may be substan component of equity. Totals may not equal sums due to rounding.

come property (principally office buildings, shopping centers, and apartments); some are *long-term mortgage* REIT's specializing in mortgages secured by such property; and some are a hybrid of these two types. From 1961 through 1968, the investments of these REIT's were largely in direct ownership. But since the beginning of 1969, when mortgage credit became difficult to obtain and yields rose sharply, newly-formed long-term REIT's have generally concentrated their investments in long-term mortgages.

One of the more unusual long-term REIT's is the Stadium Realty Trust, which provided the $5 million equity financing for the new stadium for the Boston Patriots Football Club. Another unique long-term REIT is the Mutual Real Estate Investment Trust. This REIT, committed to open housing, specializes in the ownership of apartment buildings in mixed racial areas.[4] To support Mutual's social goals, the Ford Foundation has purchased over $1 million of its shares.

Miscellaneous Types

Of the other types of REIT, only the *mixed maturity* type has an appreciable total of assets, currently almost $0.5 billion. Mixed maturity REIT's split their investments between short-term construction loans and long-term real estate assets.

Finally, there is one *homeowner's instalment loan* REIT, Security Mortgage Investors, which buys consumer paper secured by a first or second mortgage on a single-family residence. This REIT deserves special mention for two reasons. First, it is the only REIT with an adviser which owns nearly the maximum permissible amount (50 percent) of total shares. Second, it is the only REIT whose adviser guarantees to buy back any notes that are in default.

[4] The following is a quotation from Mutual's 1969 Annual Report: "We the Trustees and the staff are greatly indebted to all the 9,000 M-REIT shareholders whose faith in the Trust and whose commitment to open housing opportunity has made possible our progress. We will continue to make every endeavor to achieve the Trust's maximum achievement both as an investment and as a social force."

REIT Advisers

A REIT is almost always organized by the management group that will serve as its investment adviser, the primary incentive being to obtain the fee that the adviser charges the REIT. In addition, the adviser may wish to use the REIT to generate business for its allied activities, or to finance some of its real estate ventures. The adviser is an entity which is completely distinct from the REIT in order to comply with the Internal Revenue Code requirement that the REIT itself (but not the adviser) must be a passive investor.

All REIT's have trustees who are elected by, and responsible to, the shareholders of the REIT in the same way that corporation directors are elected by and responsible to corporation shareholders. Carrying the analogy further, the REIT's adviser plays much the same role as the officers of a corporation — the adviser runs the REIT's day-to-day operations and presents investment opportunities to the trustees. As in the election of corporate directors, REIT shareholders are given only one slate of trustees to vote on. Moreover, for most REIT's some of the adviser's officers also sit as trustees. And as in the case of corporate directors, outside trustees are obviously sympathetic to management.

While there are no restrictions on who may act as a REIT adviser, in general the adviser has been a commercial bank, financial conglomerate, mortgage banker, or life insurance company. Moreover, some REIT's are able to operate

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without an adviser. These are small equity REIT's organized by trustees who may be affiliated with companies which collect fees for servicing their REIT's properties.

Commercial Bank Advisers

Besides wishing to earn the advisory fees, commercial banks may have many other motives for forming a REIT and acting as its adviser.[5] For example, a bank may want to form a C & D REIT in part to avoid the existing bank restrictions on land and development loans. Similarly, a bank might want to form an equity REIT to provide its customers with real estate financing which is prohibited for a bank, such as a joint venture or a sale and leaseback. Moreover, since banks have predominantly short-term liabilities, they are generally reluctant to commit funds to either long-term or illiquid assets. As a result they may find REIT management the most satisfactory way to participate in long-term real estate investments.

During a period of tight money, when a bank would like to use its funds to service its regular commercial and industrial customers, it may form a C & D REIT in part to keep its construction-loan staff fully utilized and to avoid having to turn away its construction-loan customers. Moreover, by selling a portion of its C & D loan portfolio to its REIT, a bank can obtain funds to lend to other customers or to rebuild its liquidity.

A bank may also want to form a REIT in part because the REIT and its customers would be a source of deposits as well as potential purchasers of other services offered by the bank and its affiliates.

Forming a REIT also allows the bank to capitalize on its reputation. A REIT run by a bank, particularly a large one with a good reputation, undoubtedly creates a favorable image in the mind of investors, thus helping the REIT to attract funds. Justified or not, the feeling may also exist that if the REIT runs into difficulties, the bank will stand behind it, rather than jeopardize the bank's name.

The principal advantage that bank REIT's have vis-à-vis those managed by others, is their easy access to bank lines of credit. Such access is important both for direct borrowing and as a back-up credit line to insure that any commercial paper issued by the REIT can be redeemed if necessary. Furthermore, a bank may also buy its REIT's commercial paper.

Financial Conglomerates

The desire to obtain advisory fees is the primary motivation for financial conglomerates to form and advise REIT's. In addition, the companies can sometimes use their REIT's to promote their other business activities by such methods as tie-in sales to REIT customers, and by using their REIT to finance some of their own real estate ventures.

Insurance Companies

In 1969 and 1970 monetary restraint forced insurance companies to turn down some of the attractive real estate proposals which were offered to them. Moreover, many insurance companies believed that the shortage of long-term real estate funds would persist for years. Thus, in order to increase their own income and to more fully utilize their real estate staff, several insurance companies have formed long-term REIT's during the past year.

Mortgage Bankers

Mortgage bankers, who have always done a limited amount of construction lending, have found C & D REIT's to be a perfect adjunct to their regular business of arranging real estate financing packages.

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[5]The adviser is in some instances the bank itself, but usually it is a subsidiary of a bank holding company.

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Other

This catchall category consists principally of individual enterpreneurs and small companies which form REIT's solely for the advisory fees. In the case of some of the small equity REIT's which do not have an adviser, a motivation for founding was the servicing income generated by the REIT's real estate holdings.

The Recent Growth of REIT's

From the time of the 1960 legislation permitting tax exemption through March 1962, only five new REIT's were formed involving public offerings of $10 million or more. And in the more than 6 years from March 1962 to June 1968 none were formed, while in the remainder of 1968 there were three.[6] By contrast, in 1969 and 1970 there was a steady procession of 53 new REIT's with initial public offerings in excess of $10 million. In all a total of more than $2 billion of new shares were sold since the start of 1969.

What happened to make the REIT's more attractive to investors since 1968? The answer is in part that it was not until then that investors began to recognize REIT's as very profitable and relatively safe. This recognition was closely followed by a long tight-money period which created new opportunities for REIT's and at the same time constrained their competitors.

Impact of Tight Money on Thrift Institutions

During the recent tight-money period, lending activities of savings and loan associations and mutual savings banks were severely restricted. Thrift institutions were locked into low-rate mortgage assets and could not afford to compete for savers' dollars as interest rates rose. Fearing for the safety of these institutions, Federal regulatory authorities placed ceilings on the rates that they could pay for savings money and on the rates that could be paid by their competitors, commercial banks. The rate ceilings protected the thrift institutions from serious financial difficulties but also limited their deposit inflows and lending.

Since REIT's were not restricted by rate ceilings, they were able to compete with high yields for the savings dollar.[7] And since the thrift institutions did not have enough funds to accommodate all of their builders, some became REIT customers.

Commercial Banks

Deposit rate ceilings seriously hindered the commercial banks' ability to raise funds which were needed to satisfy a strong loan demand. Banks, therefore, increased loan rates and rationed loans among existing customers. Under these circumstances, banks were very willing to sell some of their C & D loans to REIT's, both to their own REIT (if they formed one) or to REIT's sponsored by others. As in the case of thrift institutions, rate ceilings placed banks at a competitive disadvantage with respect to REIT's.

Life Insurance Companies

During the 1969-70 period of monetary restraint insurance companies found their real estate lending restricted by a heavy policy loan demand and by a slowdown in mortgage prepayments. Since virtually all new real estate financing by insurance companies is for income properties, the insurance company cutbacks provided many profitable investment opportunities for new long-term REIT's.

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[6]The figures through 1968 were obtained from William B. Smith and Benjamin R. Jacobson, "Real Estate Investment Trusts: In the Money and Here to Stay," *Real Estate Forum* (October, 1970), pp. 26 ff.

[7]REIT shares with their high dividend rates and low prices (generally less than $30 per share) have been considered somewhat competitive with savings deposits. Cf. "The Boom in Real Estate Investment Trusts: Good News or Bad?" *Savings and Loan News*, October, 1970, pp. 34–40. One very successful REIT pays dividends monthly, thereby heightening the competition with thrift institutions.

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The Future of REIT's

Tight money and growing investor acceptance have benefited REIT's substantially in the recent past. Over the longer run their continued growth will depend on the relative impacts of their inherent advantages and disadvantages. These are discussed below.

Tax Exemption

REIT's have an advantage over competing taxable corporations, in that REIT's do not have to share their net operating incomes or capital gains with the Federal Government.[8] However, this advantage is partly offset by the requirement that a minimum of 90 percent of net earnings must be paid out in dividends, thus eliminating the possible conversion of retained earnings into shareholder capital gains.

Possible Shareholder Capital Gains

Although virtually all the earnings of long-term mortgage and C & D REIT's are paid out in dividends,[9] the prices of the shares of these REIT's can and in some instances have, appreciated substantially. Price appreciation can result from three factors. First, the legally-required dividend payout may be high enough to cause the price of a REIT's shares to increase. Second, if a REIT can profitably leverage, i.e., exploit the difference between its lending and borrowing rates, a REIT can increase its earnings (and dividends) per share and cause its share price to rise. Third, if a REIT is able to sell new shares at a price such that the dividend yield on its shares is lower than the yield it can obtain on invested funds, it can increase its earnings per share and share price, i.e., the REIT can "leverage" by exploiting the difference between its cost of equity capital and the rate it obtains on invested funds. This phenomenon has been called "negative dilution."[10]

Lack of Regulation

As noted earlier, REIT's are subject to very few restrictions. Their investment flexibility gives them an advantage in areas where the traditional real estate lenders have their hands tied, such as in land, development, and equity financing. Moreover, unlike the institutional lenders, REIT's can work with whatever debt and equity structure they deem appropriate and are subject to no restrictions on the rates that they can pay for borrowed funds.

High Cost of Funds

Compared with competing depository institutions, REIT's have a high cost of funds. In 1969 the average cost of funds was about 5½ percent for savings and loan associations and mutual savings banks and about 3½ percent for commercial banks.[11] By contrast the average cost of funds for REIT's was in the area of 10 percent.[12]

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[8]In the case of long-term capital gains, REIT's may either pay them to the shareholders or retain them and pay the capital gains tax.

[9]Equity REIT's can in effect retain earnings since depreciation allowed by tax laws usually exceeds actual depreciation. In fact, in many instances property appreciates. However, because equity REIT's cannot assign a value other than book value to a property until it is sold, the stock market often does not translate increases in the actual value of assets into increases in share prices. While a small number of equity REIT's and real estate corporations have published appraised value figures for their real estate holdings, the SEC strongly frowns on such disclosures due to the uncertainties associated with appraised values. Moreover, reputable accounting firms will not permit appraised values to appear on balance sheets.

[10]Since a rising share price is necessary for negative dilution, REIT advisers generally pursue the same indirect means of support employed by corporations — favorable press releases, meetings with financial analysts, listings of shares on a national stock exchange, etc. A direct means of support that both REIT advisers and corporations can employ is the purchase of shares with funds over which they have discretionary control such as pension funds, or in the case of bank REIT's, trust accounts.

[11]Sources: Federal Home Loan Bank Board, Federal Deposit Insurance Corporation, and Federal Reserve System.

[12]Author's estimate.

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Thus, if rate competition reduces the return on real estate investments below what REIT's must obtain to attract capital, then the REIT's relatively high average cost of funds will turn out to be an important competitive disadvantage.

REIT's may also suffer from the competition of government or quasi-government institutions such as the Federal National Mortgage Association (FNMA) which have a low cost of funds or which may be subsidized.

Competition Among REIT's

REIT's might grow so rapidly that competition among them would result in a general decline in REIT earnings with some possibly showing large losses. An overpopulation of REIT's, however, is unlikely to persist for long periods since REIT's would have difficulty attracting new funds until they were again making satisfactory earnings. Nevertheless, a temporary glut may lead to a reassessment of the long-run risks in a REIT investment, and dampen investor enthusiasm.

Bad-Loan Risk

Of all of the older REIT's only one small one, a C & D REIT, has experienced substantial problems with bad loans. The two largest REIT's have made over $600 million in C & D loans from their inceptions in 1961 through 1969, and have had losses of principal amounting to less than one-tenth of one percent. Nevertheless, bad loans may prove to be more of a problem in the future.

Loss of Tax Exemption Risk

A REIT always runs the risk of failing to meet all Internal Revenue Code requirements and consequently losing its tax exemption. The penalty is high since a disqualified REIT would have to pay taxes on all income earned during the entire year in which a violation took place, no matter by what margin the Code requirements were violated. This problem is aggravated by the numerous grey areas in the wording of the Code. One requirement, for instance, is that 75 percent of a REIT's income must come from mortgages or real property, but what constitutes such income is sometimes questionable. For example, does a commitment fee on a construction loan represent income from mortgages? Many such questions remain to be clarified by the Internal Revenue Service. This study, however, has found no instances of REIT disqualification.

Interest Rate Risks

Interest rate movements may have entirely different impacts on the market price of REIT shares depending upon the type of REIT. Moreover, it is obvious that REIT's which employ borrowed funds face certain risks if their borrowing commitments are not synchronized with their lending commitments. For example, if a REIT borrows short and lends long, its earnings will be adversely affected if rates rise.[13] And, if a REIT borrows long and lends short, its earnings will be adversely affected if rates fall.

For purposes of this exposition it will be assumed that all interest rates move in the same direction, and that the differentials between rates do not change. With this simplification it can be said that a *decline* in rates is generally favorable for the shareholders of long-term mortgage REIT's and equity REIT's, but is generally unfavorable for the shareholders of C & D REIT's.

C & D REIT's. Since REIT construction loans average a year or more in duration, a decline in rates is not immediately translated into a decline in earnings.[14] Moreover, if a C & D REIT uses

[13]If it cannot arrange new financing, the REIT may not be able to repay its short-term debt.

[14]Floating (tied-to-prime) rates are sometimes employed in construction lending. However, the rate in effect at the start of the loan is often used as a floor rate.

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short-term borrowings, its earnings may improve to the extent it is able to fund old fixed-rate commitments with new, lower-rate borrowings. And REIT's may be able to increase their leverage during periods of low rates and monetary ease. However, as long as REIT's have substantial amounts of long-term debt and equity funds, a decline in rates will, with a short lag, lead to a decline in earnings per share.

Long-term Mortgage REIT's. Shareholders in these REIT's will benefit from a rate decline since the market value of fixed-return claims like mortgages and bonds will rise. A rate decline has more of a favorable impact for these REIT's than for C & D REIT's because their portfolios do not turn over as rapidly as those of C & D REIT's.[15]

Equity REIT's. Obviously, interest rate fluctuations do not affect the earnings of equity REIT's as much as mortgage REIT's. If rates decline, however, the position of equity REIT's is improved to the extent that real estate assets are valued upward due to the lower capitalization rates. Their position is further improved if they can refinance their long-term mortgage liabilities at lower rates.

Outlook

It seems likely that the rate of new REIT formations will slow markedly during the current period of monetary ease as the yields on new mortgages decline, and the competitors of REIT's find themselves with large amounts of funds to invest. However, the asset size of *existing* REIT's will be little affected since they are closed-end. In fact, the existing REIT's may be able to grow if they find that monetary ease increases their access to borrowed funds at rates which make leveraging profitable. Whether REIT's will expand rapidly again in the next tight-money period remains to be seen.

Conflicts of Interest

In the typical corporation a separation of ownership and management gives rise to potential conflicts of interest. However, the coincidence of the interests of ownership and management may be furthered by management's ownership of shares, or by the employment of various devices which tie management's compensation to the profitability of the company or to the price of the company's shares. But, unless management has a very substantial ownership interest, opportunities usually exist for management to enrich itself by taking actions which are not in the shareholder's best interest. It should be noted that if management takes such actions, the company need not have a poor showing as a result. All that can be said is that the company would have had a better performance had those actions not been taken.

As mentioned earlier, the Internal Revenue Code states that in order to qualify as a REIT the five largest shareholders may control no more than 50 percent of the shares. Of all the trusts reviewed only in one case did the holdings of a shareholder approach the 50 percent figure. In general, the trustees and advisers owned none or only a token amount of their REIT's shares. It appears, then, that trusts are subject to the same conflict of interest problems that confront most corporations. Following is a discussion of potential conflicts.

Advisory fees

As a part of organizing and operating a REIT the adviser unilaterally determines its advisory fee.[16] Generally, the advisory fee is set as some

[15]Today most long-term mortgages cannot be prepaid for at least 10 years, followed by a period in which there are declining prepayment penalties.

[16]It should be noted that the advisory fees of different REIT's are not strictly comparable since different advisers absorb different proportions of their REIT's operating expenses. See the Box on page 13.

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percentage of *gross* invested assets with a provision for additional compensation depending upon how much the yield on shareholders' equity exceeds a stated amount. However, provision is usually made for a ceiling amount on the advisory fees paid.[17]

How the adviser sets his initial fee schedule is not clear; in any case, it is by no means permanent — at least three recent increases have been reported, higher operating costs being given as the reason in each case. Obviously, the more the adviser charges over the minimum rate that would induce it to form a REIT, the worse off the shareholders are.

Financing Adviser Ventures

In a number of cases REIT's have stated that the adviser or its employees have an interest in properties on which the REIT is making a mortgage loan. Still other REIT's have informed the shareholders that such transactions may arise. These transactions can benefit both the adviser and the REIT shareholders. The management can obtain needed financing for its own projects at fair market prices, and the REIT can use the management as a source of investment opportunities. (Obviously, the advantage will be of most value to the REIT shareholders when good investment opportunities are in short supply.) However, the potential for sacrificing some of the shareholders' interests is clearly present as the adviser may give itself financing terms which it could not obtain from other sources. The favorable terms may not be easy for the shareholders to detect, since they can take non-price forms — for example, a mortgage might be given for a larger amount than could be obtained elsewhere.

The Same Type of Loans

Potential conflicts may arise if the adviser or an affiliate makes the same type of loans as the REIT does. The adviser may take the better investment opportunities, leaving the REIT with the inferior ones.

Size of REIT

The adviser of the REIT can sometimes take actions which increase the size of the REIT and consequently, the size of the advisory fee, even though such actions may not be in the best interests of the REIT's shareholders. For example, by leveraging its REIT the adviser can increase its management fees (based on invested assets) even though interest rates may be such that leveraging is not profitable for the REIT shareholders. This type of conflict may also arise in connection with the sale of new shares at prices which dilute the interests of the existing shareholders.

Tie-in Business

In some cases, the adviser or its affiliates sell different types of insurance and such services as arranging financing packages to real estate developers. In order to sell these services, the adviser may offer developers unusually favorable financing terms from its REIT which would, of course, be to the detriment of the REIT's shareholders.

Bank REIT's

In addition to being subject to the conflicts cited above, banks are vulnerable to still others.[18] For example, a bank may direct its REIT to borrow from the bank when the REIT may have the less expensive option of issuing commercial paper. And the terms on which the bank extends

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[17]The Midwest Securities Commissioners Association *recommends* that its members (the securities commissioners of 24 states) require that all REIT's wishing to sell new securities in their states pay an advisory fee of no more than the greater of 1½ percent of net assets or 25 percent of the net income of the REIT before deducting advisory and servicing fees but not exceeding 1½ percent of invested assets.

[18]Cf. Representative Wright Patman's Remarks in the *Congressional Record* for July 15, 1970, pp. H6799–H6801.

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lines to (or buys paper from) its REIT may not be competitive.

If the REIT keeps its deposits at the sponsoring bank, conflicts may arise because the bank, through the adviser, manages the REIT's cash balances. Moreover, the bank may sell its REIT various banking services, such as being registrar or transfer agent, at higher prices than are available elsewhere.

And in many areas, customers of the bank-affiliated REIT may be offered a tied product. One example, which is unique to banks, is the requirement possibly at the expense of the REIT, that the parties that do business with the REIT must maintain deposits with the bank.[19]

Regulation of REIT's

Other than having to meet strict requirements to qualify for tax exemption, REIT's are subject to very limited government regulation. They must satisfy the disclosure requirements of the SEC, both in their initial offerings and in their regular financial reports to their shareholders. And, like corporations, REIT's have to meet the requirements of state securities laws ("blue sky" laws), if they wish to sell new securities in those states.

Given the various conflicts of interest to which REIT's are subject and given that some REIT's may have an "unfair" competitive advantage over others (e.g., the access to credit of bank-sponsored REIT's), the question arises as to whether the regulation of REIT's and their advisers should be increased. The answers to this question should, of course, be set within the context of a consistent regulatory philosophy which could be applied to other organizations as well as REIT's.

The Case for More Regulation

Adviser Compensation. Among factors suggesting the need for greater regulation is the very poor disclosure of adviser earnings, both direct and indirect, which can be attributed to its REIT. For example, the stated advisory fee is not a good measure of how much direct compensation the adviser gets from its REIT because the adviser always absorbs some of its REIT's operating expenses.

Moreover, the shareholders of REIT's can do little if the adviser decides to increase its advisory fee without justification. Coordinated opposition would be difficult because share ownership is usually very widely scattered (in compliance with the Internal Revenue Code requirements). And in at least two recent cases, shareholders were not given the opportunity to vote on increases in the advisory fee.

As pointed out earlier, the REIT tax legislation intended REIT's to be mutual funds for real estate investments. Thus, one can argue that to be consistent Congress ought to pass legislation on REIT advisory fees for the same reasons it passed legislation on mutual fund advisory fees in 1970 allowing the SEC or shareholders in a mutual fund to bring a court suit to test whether the adviser's management fee is appropriate for a fiduciary.

Other Conflicts of Interest. A case may be made for regulating REIT's in order to eliminate other *possible* conflicts of interest. For example, REIT advisers might be barred from making REIT loans to themselves or to any party with which they have financial ties. Moreover, the adviser might be barred from offering the same type of real estate financing as is offered by its REIT.

There are also possible courses of action which would limit the adviser's ability to take advantage of its economic power (to their

[19]At the time of writing Morgan Guaranty Trust Co. was being sued for damages stemming in part from the allegation that the stock transactions of the Bank's trust accounts were executed with brokers who kept relatively large balances at the Bank (which were of benefit to the Bank, but not the Bank's trust accounts).

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Financial Data on C & D REIT's

Of the different types of REIT's only C & D REIT's had financial data which were amenable to analysis. The data were limited for mixed maturity and long-term REIT's because these types were formed recently, while for equity REIT's the data were of limited use because the true value of the real property they owned was not accurately reflected in their financial statements.

To provide some indication of C & D REIT earnings, advisory fees, expenses, and short-term indebtedness, recent data were compiled for 28 of the 45 C & D REIT's identified in this study. The 17 remaining REIT's were excluded because data could not be obtained or because the only data available were for the first quarter of operations.

The aggregated statistics from four financial ratios are shown in Table I. Although the results are not presented here, the ratios were also analyzed by type of adviser. This factor undoubtedly affected the ratios of individual REIT's; however, it did not show up in any overall pattern, i.e., there was little correlation between the type of adviser and each of the four ratios.

Gross Earnings

The gross earnings that REIT's are able to obtain are the product of many different factors. For example, the risk-taking policies of the REIT are important since higher risk loans and investments will pay higher returns than the lower risk ones. Higher earnings may also represent an active pursuit of non-rate income, such as the collection of various commitment fees or the extra income generated by selling loan participations. Moreover, new trusts have often shown relatively low gross earnings because much of their initial funding was invested in relatively low-yield participations.

Table I

Latest Ratios for 28 C & D REIT's*

	Mean for 28 REIT's	*Range*	*Standard Deviation*
Gross Earnings to Average Assets (annual rate)	11.9%	9.9 — 14.2%	1.2%
Total Expenses to Average Assets (annual rate)	1.8	1.0 — 2.5	0.4
Advisory Fee to Total Expenses	73.5	25.0 — 97.6	16.4
Short-term Debt to Average Assets	23.8	0.0 — 63.4	17.4

*Figures are taken from the most recent REIT financial statements available (July-October, 1970). "Total Expenses" are defined to be total expenses less interest expense and provision for possible loan losses. The means and standard deviations were computed with each REIT receiving the same weight.

Advisory Fees and Total Expenses

A problem in the interpretation of advisory fee data is that different REIT managers render different services for their advisory fee. When a REIT requires services not covered by the advisory fee, it must pay for them in addition to the advisory fee. Consequently, the best indication of a REIT's cost of operation is not the ratio of the adviser's fee to average assets, but rather the ratio of total expenses (excluding interest expense and provision for possible loan losses) to average assets.

The length of time a REIT has been operating must also be taken into account when evaluating advisory fees. The reason is that most REIT's have an incentive clause in their advisory agreement which makes the advisory fee rate dependent upon the rate of return on shareholders' equity. And the return on shareholders' equity usually increases substantially as a REIT becomes more seasoned. However, the ceiling on adviser compensation may limit the incentive payments after the REIT has been in operation for a year or two.

Still another factor that is sometimes important in evaluating advisory fees and management compensation is the amount of non-advisory fee compensation that accrues to the adviser (and affiliates of the adviser). Such compensation may take the form of profits made on non-advisory services sold to the REIT or the REIT's customers, or it may take the form of the acquisition of its REIT's shares at an attractive price (possibly before the shares were sold to the public). If the non-advisory fee compensation is considerable, the adviser may charge a lower advisory fee than it otherwise would.

Short-term Debt

As pointed out earlier, REIT borrowings can make an important contribution to REIT earnings. Consequently, access to credit markets is important for a REIT's profitability. Unfortunately, while the figures in Table I provide an indication of the extent to which C & D REIT's *utilize* short-term borrowings, they give only a vague indication of actual borrowing capacity.

In this analysis only short-term debt was considered because no REIT's have sold straight long-term debt. All long-term debt issues of REIT's have been sold in a package which also offered the buyer a chance to buy shares of the REIT in question. The REIT would either offer the shares directly, make the long-term debt convertible, or attach warrants.

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REIT's advantage and to the disadvantage of less fortunate REIT's) as well as eliminate some possible conflicts of interest. For example, the adviser (and affiliates of the adviser) might be barred from using discretionary funds to purchase its REIT's shares. Similarly, an argument might be made for barring all business dealings between the adviser (and its affiliates) and the REIT (and its customers) other than the normal advisory services. In the case of a bank REIT, for instance, a bank would not be permitted to lend funds to its REIT or to accept deposits of its REIT or its REIT's customers.

The Case Against More Regulation

Despite the arguments in favor of more regulation, it is possible to make a case to the contrary based on such factors as REIT competition and the similarity of REIT's to ordinary corporations.

Competition. Judging by the usual corporate standards, REIT's are highly competitive. Moreover, most large REIT's operate on a national basis — there are no restrictions on where they may do business. And, in addition to competing among themselves, REIT's also compete with a formidable array of other financial intermediaries. The high degree of competition might suggest that no additional regulation is needed.

Competition is also furthered by the relative ease with which a new REIT may be organized. As noted earlier, the SEC and the state securities commissioners must approve the REIT's share offerings, but that amounts to little more than a check to insure honest disclosure. And, as in the case of mutual funds, very little capital is needed to start a REIT. In sum, the major obstacle to REIT formation is the selling of the shares to prospective shareholders.

Similarity to Ordinary Corporations. As pointed out earlier, taxable corporations are subject to the same conflicts of interest as REIT's are. If one makes a case for regulating the income and activities of REIT advisers, one may apply the same arguments to regulating the compensation and activities of corporate executives.

It should also be noted that in the case of both corporations and REIT's, the principals involved are liable for those decisions which they know are not in the shareholders' best interests.

Coincidence of Adviser and Shareholder Interests. The incentive for advisers to have their REIT's show the best possible earnings per share is similar to the desire of mutual fund managers to have their fund outperform the others. In short, the advisory fee of both is largely based on some measure of the dollars of assets that they are managing. And the better the performance, the easier it will be for the adviser to increase the asset base through the sale of new shares. In addition, REIT advisory contracts often contain incentive compensation for good performance. Adviser penalties for poor performance, however, are limited by the REIT's closed-end nature, in sharp contrast to open-end mutual funds where investors, by selling their shares, reduce the total assets of the fund.

Summary

Real estate investment trusts have grown very rapidly in numbers and assets during the past 3 years. Acting as a financial intermediary, REIT's have increased the flow of funds into different types of mortgages, and to a lesser extent into real estate ownership positions. The REIT's growth was largely the result of the recent prolonged period of monetary restraint which handicapped their competitors and pushed interest rates to record levels. However, as monetary policy eases, it seems likely that the rate of new REIT formations will slow markedly. In addition, the possibilities for conflicts of interest between REIT advisers and shareholders may lead to pressure for increased government regulation.

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