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REITS:
BUILDING
DIVIDENDS

August 8, 2014

David G. Clunie
Executive Secretary
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, D.C. 20220

Re: TREAS-DO-2014-0005 Comment on the Development of Responsible Private Label Securities (PLS) Market

Dear Mr. Clunie,

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses which operate in all facets of the real estate economy in the U.S.

NAREIT's Mortgage REIT (MREIT) Council (Council) is comprised of both residential and commercial mortgage REITs (MREITs), and the mission of the Council is to advise NAREIT's leadership on matters of interest to mortgage REITs, in part through the input of the Council's Residential and Commercial MREIT Committees.

MREITs today provide a significant amount of capital and liquidity to the residential and commercial real estate markets. MREITs have, directly or indirectly, funded millions of residential and commercial properties, including single family homes, multifamily units, office buildings, hotels, shopping malls, and other properties. Their presence has facilitated efficient capital raising during the recent financial crisis and provided significant support to the residential and commercial mortgage markets and to the housing market as a whole. Since the beginning of 2008, MREITs have raised $65.3 billion in IPOs and secondary equity offerings.

The MREIT Council welcomes the opportunity to comment on the "appropriate role for new issue PLS in the current and future of the housing finance system." Today MREITs play a small but highly consequential role in the U.S. Agency RMBS markets, and have been an especially important source of private sector capital in the aftermath of the financial crisis, a period when many other market players withdrew. We believe that MREITs are ideally poised to play a similar role in the PLS market, which historically has served an important niche in U.S. residential finance. We feel confident the PLS market will revive and prosper, and we fully support the Department of Treasury's initiative to stimulate this important housing finance sector.

This comment letter is organized in two parts. Because MREITs present many distinctive features, which are often not well understood, in Part I we set forth some background on the MREIT sector. Part II sets forth some observations the PLS market and the current state of the overall RMBS market that we hope will be of use to the Department of Treasury as it pursues its PLS initiative.

I. Mortgage REITs

REITs were established by Congress in 1960 to enable Americans from all walks of life to gain the benefits of investment in real estate. There are two main types of REITs, generally referred to as equity REITs and MREITs. Equity REITs invest in real estate by acquiring leasing space in properties, such as shopping malls, office buildings, apartments and other properties, and collecting rents from their tenants. At least 30 countries around the world currently have enacted laws supporting equity REIT structures, which own and operate real estate assets. But the U.S. MREIT sector is distinctive in its role in supporting residential and commercial real estate debt finance.

MREITs, the focus in this comment, typically concentrate on either the residential or commercial mortgage markets, although some do both, through investments in the debt required to finance real estate. Some MREITs also originate mortgages and mortgage-related loans. Most MREITs are listed on the NYSE or NASDAQ, allowing a wide range of investors, including individual investors as well as institutions, to purchase shares of their equity securities. However, some MREITs have shares that are registered with the SEC but are not listed on any stock exchange. These public, non-listed MREITs typically are sold to investors by a broker or financial advisor. MREITs also can be privately held.[1]

Residential MREITs

Since 2009, Agency RMBS has overwhelmingly dominated U.S. single family mortgage securitization, and mirroring this development, most residential MREITs today focus on Agency RMBS. However, even today, some residential MREITs invest in PLS, securities financing residential real estate that are issued by private institutions, such as subsidiaries of investment banks, financial institutions and home builders. At the end of 2013, Agency MREITs held under five percent of Agency RMBS, with 26 percent held in banks and other depository institutions, 26 percent for the Federal Reserve, nine percent by mutual funds and the remainder held by insurance firms, pensions and other entities.

[1] For more information about MREITs, see http://www.reit.com/investing/reit-basics/guide-mortgage-reits .

<u>Commercial MREITs</u>

Commercial MREITs provide financing for many types of commercial real estate, including office buildings and office parks, apartment buildings, retail establishments, malls, restaurants, data centers and industrial facilities. They may invest in commercial mortgages and commercial real estate loans, as well as both rated and unrated CMBS, mezzanine loans, subordinated securities or construction loans, and may participate in loan securitizations. Commercial MREITs traditionally have proprietary origination platforms and provide financing solutions to various buyers and owners of commercial real estate.

<u>MREITs Have a Proven Track Record of Attracting Investors</u>

Because of their regular access to public capital markets, residential MREITs have been able to provide an important channel for private-sector capital to help sustain and finance home mortgage markets in the aftermath of the Great Financial Crisis.

As of July 31, 2014, there were 27 residential MREITs in the FTSE NAREIT All REITs index with an equity market capitalization of $48.3 billion, and 13 Commercial MREITs with an equity market capitalization of $18.1 billion. There have been 21 Mortgage REIT IPOs since the end of 2007, and listed MREITs encompassed a total of $492.4 billion in assets at the end of the first quarter of 2014.

Over time, investors have been well served by publicly traded REITs, typically earning total returns built on dividends and the potential for capital appreciation. Moreover, investor returns on MREITs generally, as measured by the FTSE NAREIT Mortgage REIT Index, have been competitive with investor returns in broad stock indexes.

<u>MREITs Have Deep Expertise in Mortgage Debt Markets</u>

The success of MREITs today reflects years of developed expertise in the fundamentals of real estate debt markets, expertise combining rigorous research, valuation, data collection and technical analytics, together with a deep understanding of the fiscal, legal and regulatory frameworks within which RMBS and CMBS markets operate. MREITs make use of proprietary models to assess loan characteristics and likely performance, factoring in prepayment risk, structural risks, servicing risks, and other risks under a variety of scenarios. MREITs employ both quantitative and qualitative tools to further test performance projections against multiple scenarios of changing regulation, interest rate shifts and changing real estate market conditions.

Moreover, MREITs deploy quantitative and qualitative risk management techniques, continuously assessing relevant risk parameters, including changes in market, macro-economic and policy conditions. Today MREIT risk-management practices incorporate a range of proven strategies and tools to address interest rate fluctuations, currency fluctuations, counterparty credit risk, prepayment risk and liquidity risks. These include continuous balance sheet stress-testing, active and disciplined liability management, and well-tested hedging strategies, such as the use of interest rate swaps; swaptions; interest rate collars, caps or floors; and other financial derivatives contracts.

MREITs Have the Potential to Play a Larger Role in PLS Markets

MREITs have the potential to play an expanded role in PLS markets. They can and do attract capital successfully; they have deep experience in RMBS research, acquisition and valuation; and, they have developed and successfully made use of sophisticated models and protocols to evaluate real estate, mortgage and mortgage securities' fundamentals and to manage the risks presented by RMBS acquisition and management.

Today MREITs play a small but highly consequential role in the U.S. Agency RMBS markets. They have been important source of private sector capital in the aftermath of the financial crisis, a period when many other market players withdrew. MREITs are ideally poised to participate in PLS markets now and in the future.

II. Growing the PLS Market

The MREIT Council applauds the Department of Treasury's initiative to assess ways to support private sector development of an equitable and responsible PLS market serving borrowers, lenders and investors alike. The Council believes that, ultimately, however, it will be investors who drive the course and scale of the PLS market. The MREIT Council respectfully suggests that future investors in PLS would benefit from greater clarity and definition in a number areas, discussed below.

The MREIT Council also notes that the full potential of the PLS market is not likely to be realized until the future status of the GSE conservatorships is either resolved or on a certain path towards resolution. Only then will private capital that has been "sitting on the sidelines," feel fully comfortable committing to the PLS sector.

We group our comments around five observations:

- Transparency and Standardization are Critical to PLS Investors
- PLS Investors Deserve Confidence in their Remedies
- PLS Investors Must Have Confidence in Ratings
- Political and Regulatory Uncertainties are an Obstacle to PLS Market Growth
- Public Sector Coordination, Accountability and Transparency are Key to Transitioning the U.S. Housing Finance Sector

Transparency and Standardization are Critical to Investors

Publicly traded MREITs today are able to attract investors because their holdings and operations are transparent and their disclosure practices are elaborate and thorough. Similar transparency principles, applied more uniformly across the PLS market, would likewise serve to attract additional investment. There is considerable room to standardize documentation practices associated with aggregation and securitization practices.

In this regard, several bills pending before the 113th Congress, including the *Protecting American Taxpayers and Homeowners Act* (HR 2767 the *PATH* Act)[2] and the *Housing Finance Reform and Taxpayer Protection Act of 2013* (S. 1217, the *Johnson-Crapo* bill)[3], include provisions intended to encourage standardized agreements, standardized representations and warranties and pool level disclosures for PLS. The Department of Treasury's assistance and encouragement of these and other similar efforts to standardize practices and documentation across the PLS market could provide beneficial momentum.

PLS Investors Deserve Confidence in their Remedies

Investors are not likely to return to the PLS market if they are uncertain about how liability will be apportioned if their investments go sour. Litigation that followed RMBS defaults in the Financial Crisis have suggested to market participants and experts that the roles and responsibilities of mortgage pool trustees, largely understood to be exempt from the 1939 Trust Indenture Act, should be better defined and possibly expanded. Some academics[4] and investor groups[5] have recently urged Congress to enact legislation to impose a clear fiduciary duty on mortgage pool trustees, or to otherwise set forth a clear delineation of duties of trustees, servicers and investors. The *Path Act* stipulates that the securitization utility would specify the duties of mortgage pool trustees.[6] Amendments to the *Crapo-Johnson* bill pending in the 113th Congress would have gone further and imposed a fiduciary duty on PLS mortgage pool trustees.[7] Moreover, both the *Crapo-Johnson* bill and the House *Path Act* included provisions to address successor liability and indemnification, both important to attracting new investors.

The MREIT Council understands that expanding the role and responsibilities of PLS mortgage pool trustees is not costless, but also notes that these costs may be outweighed by the benefits accrued by attracting new investors who would feel confident that trustees are acting in their best interests. We believe the Department of Treasury could play a constructive role in evaluating the cost-benefit trade-offs presented by these proposals.

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[2] HR 2767, § 322(b).
[3] S.1217, § 223.
[4] See, e.g., *Testimony before the Senate Banking Committee, Adam J. Levitin, Professor of Law, Georgetown Law Centre* (October 1, 2013) (the *Trust Indenture Act* of 1939 should be updated to provide clear basic minimum standards for the duties of trustees and servicers in PLS and investors rights).
[5] *Testimony before the Senate Banking Committee, John Gidman on Behalf of the Association of Institutional Investors* (October 1, 2013); and Douglas M Hodge, *How to Make Housing Safe for Private Capital*, Barron's April 11, 2014.
[6] HR 2767, § 322(b).
[7] Amendment numbers 19 and 20 to S. 1217 would have created a fiduciary duty for trustees of PLS issued both off and on the common securitization platform to investors. Similar provisions were included in the *Foreclosure Fraud and Homeowner Abuse Prevention Act of 2011* (S. 824) in the 112th Congress.

Confidence in Ratings is Essential to Attracting PLS Investors

Investor trust in ratings is a critical element to entice investors back into PLS. Counter-party trust in these ratings is equally important to ensure that rated PLS are accepted as collateral in repo and securities lending markets. The *Dodd-Frank Act*, and subsequent SEC regulations, has required credit rating agencies (NRSROs) to disclose their methodologies, a positive step. But it is clear that some potential PLS investors still do not feel entirely confident of the ratings of PLS securities.

While the ultimate development and adoption of a PLS ratings methodology will fall on the private sector, the MREIT Council believes that this is an area that could benefit from guidance and leadership from government regulatory experts. Several promising proposals have been advanced recently, including the implementation of a *single, numerical, public structured credit scale* for certain structured credit instruments, such as PLS.[8] These, together with others, should be evaluated.

Political and Regulatory Uncertainties are an Obstacle to PLS Market Growth

Since they were placed into conservatorship in 2008, the two U.S. housing government sponsored entities (GSEs), Fannie Mae and Freddie Mac, have continued to play a key role in the U.S. housing market recovery, which has deterred private capital from entering the market. There is additional uncertainty surrounding the future direction, if any, of congressional action to address the GSE conservatorships, further deterring PLS market development. Recently some investors have filed lawsuits challenging the terms of the GSE conservatorships, contributing another level of complexity to the outlook.

This uncertainty has practical consequences that are impossible to overstate. Current and future market participants do not know whether the federal government will continue to play a role in housing finance, and if so, what the size and scope of the federal role will be, how it might be structured, regulated and supervised. Will the concept of the conforming loan survive? If so, will the loan limit be lower, higher or the same? Will securitization markets be dominated by a few large players? If so, on what terms? Who will regulate this market? How?

Compounding this unsettled state of affairs, even today, the post- Dodd-Frank Act regulatory environment is also far from fixed. The ultimate, cumulative effect of the implementation of the final risk retention rules, the multiple consumer protection regulations and the Basel III bank capital and liquidity rules is still unknown.

Recognizing that no single governmental or market player can unilaterally transform this situation, the MREIT Council wishes to encourage the Treasury Department to continue its leadership in seeking a resolution of the status of the conservatorship of the GSEs.

[8] Ann Rutledge and Robert E. Litan, A Real Fix for Credit Ratings (Brookings, July 9, 2014).

Coordination and Accountability are Critical to Transitioning the Housing Finance Market

Understanding that the transition from the conservatorships of Fannie Mae and Freddie Mac is likely to take time, the MREIT Council respectfully suggests that the Department of Treasury could play a constructive role in coordinating transitional activity—including transitional activity already underway—and in ensuring that key players from both the public and private sectors execute on the various regulatory, supervisory and market infrastructure initiatives that will be required to move U.S. housing finance onto appropriate footing for the 21st Century.

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NAREIT and its Mortgage REIT Council look forward working with the Department of Treasury and other governmental and private sector stakeholders on issues related to the development of the PLS marketplace and other important issues related to reform of the U.S. housing finance sector. Please feel free to contact me at swechsler@nareit.com or at (202) 739-9406 or Victoria Rostow, NAREIT's Senior Vice President of Regulation and Policy at vrostow@nareit.com or 202) 739-9431 if you would like to discuss this letter in greater detail.

Respectfully submitted on behalf of the MREIT Council,

Steven A. Wechsler
NAREIT President & CEO