

**REAL ESTATE INVESTMENT Trusts (Reits) AND MORTGAGE BACKED SECURITIES (MBS) AS EMERGING TRENDS FOR FINANCING REAL ESTATE DEVELOPMENT IN THE NIGERIAN CAPITAL MARKET**

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**ABSTRACT:** *Before now, real estate was regarded as a very cumbersome investment media to venture into. This was largely due to the huge financial outlay required for real property projects, which were often difficult to raise and as such, only the few privileged elite invested in real estate. However, of recent, real estate investment is now securitized (that is, sold as securities in the capital market), thus making it easier for the average investor to engage in. This paper studies the Real Estate Investment Trust (REIT) and Mortgage Backed Securities (MBS) as new channels of harnessing finance for real estate development and the effectiveness of securitization in the Nigerian real estate sector.*

**KEYWORDS:** Real Estate, Investment, Finance, Real Estate Investment Trust, Mortgage Backed Securities, Capital Market, and Securitization.

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## **INTRODUCTION**

One of the remarkable achievements of the twenty-first century is the ability to link the real estate market with the capital market thereby creating proper finance machinery and resolve the liquidity problem of real estate through capital market instruments like MBS, REITs, bond and so on. It has been established that a capital market is a segment of a nation's financial system where the main article of trade is medium and long-term financial instruments. Such instruments are generally referred to as securities because of the level of confidence and assurance or guarantee it gives to the investor on the repayment of their principal. It is true that the rate of economic growth of any nation is inextricably linked to the sophistication of its financial market and specifically its capital market efficiency. According to Osaze (2009), the capital market is the only institution known to economic man that has the ability to pool vast long-term financial resources together from fund suppliers and distributing, same to continuously competing uses and users of such resources. Capital markets assist the nations of the world to muster needed financial resources and skills for growth and development of their various economies (Adewuyi and Olowookere, 2011). In Nigeria, the Nigerian Stock Exchange (NSE) is the centre-point of the capital market while the Securities and Exchange Commission (SEC) serves as the apex regulatory body. It provides a mechanism for mobilizing private and public savings and makes such funds available for productive purposes. The Exchange also provides a means for trading in existing securities. The major instruments used to raise funds in the market include equities, debentures, bonds and stocks. Capital markets are classified into

two segments, namely primary and secondary. The primary market is a market for new issues of securities. The mode of offer for the securities traded in this market includes offer for subscriptions, rights issues, offer for sale, private placement etc. while the secondary market is a market for trading in existing securities. This consists of exchanges and over the counter deals where securities are bought and sold after their issuance in the primary market. The depth of the capital market has increased with the introduction of the Unit Trust Scheme for mobilizing the financial resources of small and big savers and managing such funds to achieve relatively high returns with minimum risks through efficient portfolio diversification. Efficiently managed unit fund schemes offer the advantages of low costs, liquidity and high returns. The promulgation of the Companies and Allied Matters Decree of 1990 provided the legal framework for the establishment of unit trusts. As a result, unit trusts such as the Real Estate Investment Trusts (REITs) and Mortgage Backed Securities (MBS) emerged as new securities for real estate investment in Nigeria. Subsequent sections of this research will take a critical look at this securities and their effectiveness in real estate development in the country.

### **REAL ESTATE INVESTMENT TRUST (REIT)**

This is a Corporation or Trust that uses the pooled capital of many investors to purchase and manage income property and/or mortgage loans. Relying on the definition by the US Securities and Exchange Commission 2010, REIT is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. In Nigeria, the Investments and Securities Act, 2007 describes the real estate investment companies or trust as a body corporate incorporated for the sole purpose of acquiring intermediate or long term interests in real estate or property development. They are empowered to raise money funds from the capital market through the issuance of securities having the following characteristics: an income certificate giving the investor a right to a share of the income of any property or property development; and an ordinary share in the body corporate giving the investor voting rights in the management of that body corporate. The Act provides that a trust may be constituted for the sole purpose of acquiring a property on a "trust for sale" for the investors. The trust, in this context, is expected to have the following characteristics, the investors is empowered to acquire units in the trust through which they would be entitled to receive periodic distribution of income and participate in any capital appreciation of the property concerned; while they are also entitled to retain control over their investments by investing directly in a particular property rather than in a portfolio of investments. A real estate investment company or trust may be registered by the Securities and Exchange Commission, if it is a body incorporated under the Companies and Allied Matters Act; has a capital and reserve as prescribed by the Commission from time to time; carries on business as a collective investment scheme solely in properties; and complies with the requirement prescribed by the Commission through its rules and regulations made from time to time. There are three principal types of REITs. It may be equity REIT, mortgage REIT, or hybrid. By equity REIT, the REITs invest in and own properties and become responsible for the equity or value of their real estate assets with revenues derived principally from the rental incomes generated by the properties. On the other hand, mortgage REITs deal in investment and ownership of property mortgages and loan for mortgages to owners of real estate or purchase existing mortgages or mortgage-backed securities, and derive revenues primarily by earning on the mortgage loans; while hybrid REITs combine the investment strategies of equity REITs and mortgage REITs through investment in

both properties and mortgages with individuals either by purchasing their shares directly on an open exchange or by investing in a mutual fund that specializes in public real estate. REITs are traded on The Nigerian Stock Exchange just like stocks. They are also granted special tax considerations. A number of studies (notably, Kolbe, *et al* 2008; Chandra, 2008; Kolbe and Greer, 2009) have focused on the importance of real estate investment trust (REIT) as a vehicle for real estate development finance. According to Kolbe *et al* (2008), Chandra (2008), Kolbe and Greer (2009), REIT has been identified as a vehicle for real estate finance, especially in developed nations. REITs operate like closed-end mutual funds and raise funds by issuing shares, bonds, commercial paper, and by borrowing from other financial institutions while also investing in real estate debt and equity. REIT offers several benefits over actually owning properties. First, they are highly liquid, unlike traditional real estate. Second, REIT enables sharing in non-residential properties as well, such as hotels, malls, and other commercial or industrial properties. Third, there's no minimum investment with REIT. REIT does not necessarily increase and decrease in value along with the broader market. However, they pay yields in the form of dividends no matter how the shares perform. REIT can be valued based upon fundamental measures, similar to the valuation of stocks, but different numbers tend to be important for REIT than for stocks. Other benefits include:

- REITs offer diversification and a level of stability, without sacrificing growth potential.
- REITs provide exposure to real estate – real assets with tangible value and reliable income streams – in a highly liquid, marketable security.
- REITs are distinct in their combination of relatively steady income, capital gains potential, tax benefits and professional, active management.
- Typically, REITs provide more attractive yields than other income investments
- It provides a hedge against inflation.
- As a Trust, REITs are subject to more stringent regulations in areas such as leverage and financial reporting, providing investors with an added layer of security.
- REITs also offer capital gains potential as the portfolio grows and individual properties benefit from synergies and professional management.
- With the critical mass to diversify over a number of real estate properties, a REIT can expose its investors to the entire real estate market, reducing the risks that come with owning just one property in one location and/or sector.
- The metric used REITs referred to as the Funds From Operations (FFO). This measures the value of the properties owned by the REIT is based on income generated.

## **MORTGAGE - BACKED SECURITIES**

Mortgage-backed securities (MBS) can be described as securities that are based on mortgages which are conventional corporate debentures floated by corporate entities to raise funds. These securities are obtained from mortgaged assets and serve as debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then

assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization. Securitization is the process of converting real estate into tradable instrument with the underlying asset as security. It is the creation of tradable paper interests in real estate as alternative to direct ownership of the assets, and involves the collection of large number of illiquid loans or receivables into pools that are used to collateralize securities for eventual sales to the investors (Oni et al, 2012). According to Osaze (2009), Mortgage-Backed Securities (MBS) are created when mortgages are pooled together and undivided interest or participation in the pool is sold. The initiator of the MBS continues to service the original mortgages in the pool, collecting payments and sending across (passing-through) the principal and interest, less the servicing, guarantee and other fees to the security holders who share these cash flows on a pro-rata basis. Part of the outstanding principal is paid monthly according to the amortization schedule of the individual mortgages. However, the principal can be prepaid without cost wholly or partially at any time before the maturity date of the security. The usual initiators or originators of MBS are commercial banks, savings and loans companies, finance houses and primary mortgaged institutions. The principal and interest payments from the underlying mortgage loans provide the cash flow on the instrument to investors. Payment may be flexible-with allowance for prepayments or restricted-without allowance for prepayments and interest rates can also be fixed or variable. MBS is characterized by attractive yields, credit quality and pool of funds, tradable capital market instrument, and aids diversification of financing sources. (Walmsley, 2007; Adereti, 2007).

## **BENEFITS OF SECURITIZATION**

Securitization has been defined by Godwin (1995) as the trade-able paper interest in underlying assets like property as an alternative to direct ownership of the asset. Nubi (2000) in Emoh (2004) asserts that securitization entails the conversion of assets (illiquid assets i.e. bank loans) into readily trade-able financial assets, i.e. securities. The introduction of securitization to real estate finance has in no small measure boosted real estate development all over the world. In the United States for instance, MBS have become the main vehicles for securitizing all the different types of mortgage instruments which are available to home buyers. The federally guaranteed loans are guaranteed by the Government National Mortgage Association (GNMA) established in 1970. The mortgage pools deriving from the GNMA consist of Federal Housing Authority – insured loans and bear the full faith and credit of the US government. In other words, whether the mortgage payment is made or not, the security holder is guaranteed full and timely payment of principal and interest. The second major issuer of MBS is the Federal National Mortgage Association (FNMA) which was established in 1981 as a quasi-private corporation without government subsidy or subventions. Apart from holding loans which were purchased from the originations in its portfolio, it also securitises and sells mortgages. It pools mortgages from its purchases and issues MBS to initiators in exchange for pooled mortgages. Both the GNMA and FNMA guarantee the timely payment of principal and interest on all the securities that they issue. With GNMA and FNMA, the US government has succeeded in expanding the volume of funds available for housing and urban development in America. This has resulted from its very active involvement and participation in the secondary market for mortgages.

However, although REIT and MBS have found useful applications in developed countries, it is yet to gain wide acceptance in Nigeria according to Nubi (2002) for the following reasons:

- Absence of favourable tax regime
- Administrative bottleneck
- Inadequate or absence of legal infrastructure
- Vaguely defined operating strategy for succeeding in competitive market
- High cost of land transfer

Research observations show that most property investors and financiers prefer commercial property investments compared to other forms of property investments while developers on the other hand prefer to invest in REITs and MBS. This is evident in that developers who utilize securitization in financing real estate will have more funds made available outside the traditional channels; enjoy lower interest rate charges, long term finance and spread of housing development round the nation. Other benefits of MBS introduction are delivery of affordable housing, wealth creation for investors; expansion of the capital market with a multiplier effect of reinvigorating economic growth and stability; and will reduce employment problem by creating more jobs. Given these benefits, there is hence the need to encourage this investment medium to meet low-cost housing finance as a significant proportion of the population cannot afford high profile properties. REITs have been in place in Nigeria since January 2007 and were introduced as a tax efficient vehicle which allows property investment companies to offer shares to the public. In 2005, the Nigerian Government announced plans to improve the efficiency of both commercial and residential property investment markets. Adetunmbi (2006) suggests that the use of REIT in Nigeria will transform the mortgage business and real estate development, will facilitate long term instrument vehicle for real estate equities and deepen the capital market, provide access to good and affordable housing and provide long term stable income for investors. However there are only about two REIT companies operational in Nigeria.

## CONCLUSION

Given the limited pool of funds available for housing finance and urban development in Nigeria, can MBS and REITS as financing vehicles come to the rescue? What role can the government, housing finance associations and professional real estate associations play in expanding the pool of loan able funds for housing development in Nigeria? Mortgage-backed securities and Real Estate Investment Trusts as alternative housing finance options have proved to be very effective vehicles for expanding housing funding in other countries, especially in the US. They can and will work here in Nigeria. It would appear that too many Nigerians believe in acquiring property rather than creating assets. A property is not as useful as an asset in the sense that the latter is securitize-able and expandable while the former is not. What needs to be done is to change the attitude of Nigerians to the value of assets through securitization. To benefit fully from investing in MBS, estate developers should have strong corporate governance, reasonable share capital base, effective internal control mechanism, audited financial statements, tax clearance certificate and good track record. Also, the Federal



Mortgage Bank of Nigeria (FMBN) can begin to actualize its new mandate of linking the housing sector to the capital market by taking the next step in creating government-backed or in its case, government agency-sponsored GNMA mortgage-backed securities. It can also facilitate the efforts of the Real Estate Development of Nigeria or similar, private sector organizations in originating FNMA-type mortgage-backed securities. All these are easily registrable with the regulatory authorities, including SEC if well organized and promoted (Osaze, 2009). The Nigerian Institution of Estate Surveyors and Valuers also has a great role to play in birthing the investment vehicle by sponsoring a bill in the National Assembly for requisite legal framework to be provided for its implementation in Nigeria. The role also includes organizing enlightenment programmes through Mandatory Continuous Professional Development (MCPD) workshops to educate the real estate practitioners and the populace. This will remove the Federal and State Governments from direct provision of finance for real estate while serving as alternative to the Housing Policy that has not effectively met real estate investment expectations in Nigeria. The REITs will encourage the private sector to be encouraged through credit facilities as the sector holds the ace to turn the financing of the real estate sector of the economy alive (Oni et al, 2012). For REITs and MBS to be viable instruments of housing finance, the Nigerian Capital market ought to create an enabling environment for: securitization of real estate assets, increase in number quoted property companies and release of in-depth information to stakeholders in the property industry. There is also need for a proper legislative framework on foreclosure, securitization and conduct of due diligence.

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