The REIT Modernization Act of 1999

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Abstract

This article examines two effects of the passage of the REIT Modernization Act (RMA) of 1999: its impacts on REIT shareholder wealth and changes in REIT systematic risk in the period following its passage. The results indicate a modest positive wealth effect associated with the legislative events leading to its enactment. Our estimates of the wealth gain probably underestimate the true wealth gain because of the partially anticipated nature of the legislative process. We also document a significant decline in the systematic risk of REITs subsequent to the passage of the RMA. The evidence suggests that this decline is not attributable to a provision of the RMA that allows REITs to establish taxable subsidiaries.

Key Words: REITs, shareholder wealth, regulatory change, risk change

On December 17, 1999, the NAREIT Composite Index and the Morgan Stanley REIT Index each rose almost 4 percent, the largest increase ever for these indexes in a single day. The rise was attributed to a tip from Warren Buffett, the guru of investments. Buffett auctioned his 20-year-old wallet as part of a fundraiser in Omaha, Nebraska and left a stock tip in it: First Industrial Reality Trust, a REIT (Wall Street Journal, 1999a). But the Buffett tip was not the only important thing to happen on that day. On the same day, President Clinton signed the REIT Modernization Act (RMA) as a part of a larger bill.1

The enactment of the RMA was expected to have a significant impact on the future growth, profitability and risk of the REIT industry. At the time of its passage, it was widely believed that the most important provision of the RMA was the provision to allow REITs to own up to 100 percent of a Taxable REIT Subsidiary (TRS). A REIT could now set up a TRS to provide additional services to its tenants and others. Other provisions of the RMA included a reduction in the mandatory payout requirement from 95 percent of earnings to 90 percent, and other relaxation of regulatory requirements.

Industry and media reports hailed the RMA as the most significant legislation affecting REITs since President Dwight Eisenhower signed the initial REIT legislation in 1960.2

Steven A. Wechsler, President and CEO of NAREIT, summarized the reaction of the REIT

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industry: “Among other things, the changes will enable REITs to remain competitive and flexible. REITs will continue to be fully grounded in the ownership, operation and finance of rental real estate, yet now will be empowered to offer the same range of services provided by competitors in the fast changing real estate marketplace” (Newswire, 1999a). Moody’s Investors Service and Standard & Poor’s reported that the RMA ‘‘will generally be a credit positive for the sector” (NAREIT, 2000).

Because the RMA came into effect on January 1, 2001, it is too early to examine its long-run impact on REIT growth and profitability. Instead, the purpose of this study is to use the stock market reaction to the passage of the RMA as a measure of its effect on REITs. The stock market reaction is informative because it captures the market’s perception of the net effect of the RMA. We use an event study methodology to examine the effect on the entire REIT industry, and then do a cross-sectional analysis to identify which type of REIT was expected to gain or lose more from the passage of the RMA. We also examine changes in the systematic risk of REITs in the two years after the passage of the RMA.

We examine two primary hypotheses. The first hypothesis states that the RMA will have a positive impact on REIT shareholder wealth. The logic is straightforward: the RMA relaxed a number of constraint facing REITs; thus, they can be no worse off than before its passage and are likely to be better off. The second hypothesis states that the RMA will change the systematic risk of REITs. However, the alternative hypothesis in this case is two-sided. Depending on the types of new investments undertaken by REITs as a result of RMA, a REIT’s covariance with the market (and hence systematic risk) could either increase or decrease.

We document that the market price reaction to the passage of the RMA was positive. The three-day cumulative abnormal return (CAR) for REITs was 1.17 percent around April 29, 1999 when the RMA was introduced in the House of Representatives. The initial market reaction was more positive for mortgage REITs and retail REITs. The evidence also suggests that the systematic risk of REITs declined after the passage of the RMA. We find that the systematic risk (market beta) for our sample declined in the two years subsequent to the passage of the RMA. There was no difference in the change between the TRS group (a sub-sample of 67 REITs that had a TRS at the end of 2001) and the non-TRS group. We conclude that the TRS provision of the RMA did not incrementally influence the systematic risk of REITs.

This research is important as it provides estimates of the impacts of the RMA, important legislation affecting the regulation of the REIT industry. This study also extends the work done in the area involving the use of event study methodology to study important regulatory changes.4 Event study methodology has been used to evaluate the effect of regulatory changes in two ways. The first approach measures the wealth effects of legislation affecting a specific industry.5 The second approach evaluates a regulatory change that has a less focused impact, such as changes in the scope of shareholder lawsuits, changes in the laws affecting the trade relationship between countries, and major court decisions.6 We contribute to the REIT literature by estimating the impact of an important regulatory change for REITs. We also contribute to the important stream of literature that studies the economic impact of regulatory legislation.