A NEW APPROACH TO RESOLVING JAPAN'S REAL ESTATE CRISIS: WILL SECURITIZATION FOLLOW?

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Submitted to the Department of Urban Studies and Planning
in Partial Fulfillment of the Requirements of the Degree of
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ABSTRACT

Within the current condition of the Japanese financial markets, there exists a great problem that must be dealt with, or else run the risk of further escalation of that problem. That problem is with the Japanese real estate market. In this thesis, the impact of the implementation of securitization into the Japanese real estate markets will be examined by first taking a look at the proposed regulatory changes, and then at the impact they may have upon the market itself. Also, I try to analyze the nature of Japanese real estate investment trusts (J-REITs). The results show that the implementation of securitization into the Japanese real estate market will indeed succeed, but not immediately. Some economic and political factors that will help with securitization's success include firmer real estate prices, economic expansion, low interest rates, strengthened reserves, experience, and political resolve. However, it will be the government's actions that will ultimately decide the fate of the Japanese real estate market concerning the implementation of securitization.

Thesis Supervisor: Blake Eagle
Title: Chairman, MIT Center for Real Estate
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INTRODUCTION

In the financial and real estate industries, and even in the Japanese economy as a whole, the securitization of real estate is currently the subject that is attracting the most attention. Japanese regulators are now refocusing their attention on the real estate debt problem that turned Japan’s financial system upside down. This move comes before the approach of Prime Minister Hashimoto’s Big Bang. Recently, a new strategy was announced to try and fight the problem. The strategy includes government investment in real estate that has been taken as collateral on defaulted loans, and regulation changes that will make room for securitization of real estate and of debt collateralized by real estate.

The conversion of bad debts and mortgaged real estate into securities has been in the news as one way for financial institutions to handle bad debts. Actually, the arrival of securitization offers many economic advantages, including tax reform, stronger security perfection, and improved market liquidity for asset-backed notes. However, while the goal of this activity has been confined as a rescue remedy for financial institutions, there is currently no debate on whether this conversion of bad debts to securities is relevant or what direction it should be taking. In order to have securitization succeed in bringing a higher degree of liquidity and stability to Japan’s real estate markets, there will have to be a more realistic approach to the analysis and disclosure of Japan’s real estate assets. To develop a securities market which depends on the performance of underlying real estate assets, accurate information is necessary, especially that of cash flows.

The main players in the imminent financial Big Bang era are private investors who currently hold financial assets worth $8.6 trillion (¥1200 trillion). In comparison to the 17% cash ratio of

---

1 Refer to CHAPTER 1 C.
2 Converted by 1$ = ¥140
America's private financial assets, Japan's ratio is extremely conservative at 55%. However, it is highly likely that the structure of our assets will start to diversify in the future⁴.

Based on the principles of self regulation, the financial Big Bang will open up opportunities for entry into the finance capital market for private individuals as well as for corporations.

Investments in foreign currencies and foreign loans subject to exchange risks are already on the increase, and in the same way the movements of private investors suggest greater consideration of the balance between risks and returns.

Securitization of real estate should be discussed as financial products to provide a fitting response to current needs.

In this thesis, I would like to suggest a possible scenario for the development of available full-scale real estate securitization based on current trends in real estate securities and also deal with ways in which this may be carried out. Especially, I will focus on securitization based on the Special Purpose Corporation (SPC) Law, upon which the government is currently concentrating most of its efforts trying to make it a touchstone for the real estate securitization in Japan. I will also present an analysis of the appropriate nature of J-REITs.

A. Methodology

This thesis depends not only on literature and articles in this field but also, to some extent, on one-on-one interviews. At first, I collected and scrutinized as much information as possible. Then, I interviewed some people in charge of real estate securitization in six companies, one of which is Japanese Bank and all the others are American financial institutions. We discussed the market situation and basic problems attendant to progressing the securitization of real estate in Japan.

B. Organization

My research has four components. In CHAPTER 1, I will review Japan's real estate market focusing on after the collapse of so-called the bubble economy. CHAPTER 2 will mainly review the historical perspective of Japan's real estate securitization and also current trends. In CHAPTER 3, I will consider the U.S. REIT market. I believe this is quite significant in order to bring into relief the tasks that are prerequisite to applying REITs in Japan. CHAPTER 4 will analyze tasks and directions of the real estate securitization in Japan, especially, the impact of SPC Law that is considered to be the driving force for the securitization of real estate. Also, I will make a presentation of the possible nature of J-REITs.
CHAPTER 1
REAL ESTATE MARKET IN JAPAN

A. History of the Bubble

The Japanese economy grew throughout the 1970s and 1980s at an average of about 4 percent per year in terms of real GNP (Gross National Product) growth. The Japanese government had adopted a low-interest rate policy, and with the economy booming and prices stable, the official discount rate was a record low 2.5 percent in February 1987. Between 1987 and 1989, however, the increase in the nation's money supply was greater than the growth in GNP, creating an excess of liquidity.

As a result, significant sums were invested in securities and real estate. Stock prices reached their highest level in December 1989, and real estate prices, particularly land, increased by even more than equities. In the six largest cities, urban land prices increased nearly fourfold between 1985 and 1991. The increase in urban land prices escalated in 1986 and 1987, and spread to Japan's rural areas as well. Nationwide, urban land prices increased by about 60 percent between 1985 and 1991. This abnormal increase in asset prices was termed the "bubble economy", and Japan's economic boom continued until asset prices finally collapsed during the Summer of 1991.

B. Post Bubble Economy

The downturn in Japan's economy, more severe than any other post-war recession in terms of duration and depth, officially lasted until March 1993. However, its aftershocks can still be strongly felt today. In particular, the real estate market now has an oversupply of office space

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4 Howard C. Gelbtuch, CRE, and Tadashi Kataoka, "Real Estate Securitization Gaining Favor in France & Japan," (London, 1997), p.3-4
that was brought about by a combination of over-building during the boom years and the collapse of the bubble economy with its associated economic downturn.

1. Bad Loan Problem

Although the Japanese economy has slowly recovered since 1994, one of its most important after effects, the bad loan problem caused by overly optimistic financing for land acquisition and construction of office buildings, remains to be solved. It will continue to have a significant negative impact on the Japanese economy. According to the Ministry of Finance (MOF), the amount of bad loans at banks and other financial institutions was more than $500 billion (¥70 trillion) as of March 31, 1998. However, according to unofficial estimates, Japanese banks have about $800 billion (¥112 trillion) in non-performing real estate loans on their books.

2. Peculiarities of Japan's Real Estate Market

To solve the bad loan problem, non-performing real estate will have to be liquidated. The high proportion of value attributable to land in Japan presents some unusual problems for American investors wishing to capitalize on that country's presently depressed real estate market. For example, land and improvements are legally separable properties in Japan, and their ownership is recorded separately, even if owned by the same entity. Moreover, the land component typically accounts for such a disproportionately large percentage of property value that, during the bubble period, appraisers were frequently asked to ignore any existing improvements, and value the site as if vacant. Now, appraisers, including myself, more commonly take the existing improvements into consideration, whether the value of the improvements is positive or negative5.

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5 Howard C. Gelbtuch, CRE, and Tadashi Kataoka, "Real Estate Securitization Gaining Favor in France & Japan," (London, 1997), p.3-4
3. Bankruptcy Liabilities Set Record

Debt from Japanese bankruptcies soared to a record in 1997 as the economic slump and the seven-year slide in real estate prices sent Sanyo Securities Co., Crown Leasing Co., and other high-profile companies out of business. According to Tokyo Shoko Research which is a private institute, debt from bankruptcies rose to $100 billion (¥14 trillion) in 1997, far outstripping the previous high of $64 billion (¥9 trillion) set in 1995. Total bankruptcies were up 10.9% last year to 16,464 the most since 1986. Seven of the nation's 15 biggest postwar bankruptcies occurred last year, and Tokyo Shoko forecasts that bankruptcies in 1998 will exceed the postwar record of 20,841 set in 1984. Among the once-big corporate names that formally joined the list of failures this year are Yamaichi Securities Co., once one of the largest securities companies in Japan, and Hokkaido Takushoku Bank Ltd.

C. Big Bang

Japan's Big Bang, the country's plan to reform its financial system, is scheduled to take effect by the year 2001. The name comes from the deregulation of the London securities market on October 27, 1986, also known as the Big Bang. It is comparable to May Day in the United States when brokerage commissions were deregulated. Besides deregulating the securities transaction tax and liberalizing brokerage commissions, the Japanese Big Bang will offer substantial tax advantages to healthy banks that take control of weaker institutions. This should result in the liquidation of numerous non-performing real estate loans, either by the present balance sheets, or by the acquiring institution. Whatever form of securitization ultimately proves most prevalent, one thing appears certain; we can expect to see a large volume of securitized real estate offering based on prices far lower than these assets commanded just a few
short years ago. The key elements of the Big Bang financial liberalization from 1998 are as follows:

**Year 1998**
- Banks will be allowed to sell mutual funds.
- Stock-trade fees of $357,000 (¥50 million) or more will be deregulated.
- Foreign exchange business will be liberalized, and cross-border currency.
- System requiring only registration will replace pre-approval and licensing system for new financial products.

**Year 1999**
- Commissions on all stock trades will be freed from government control.

**Year 2000**
- Accounting standards will fall into line with international standards, including mark-to-market method and consolidated accounting.

Several trends due to Big Bang are at work that will affect the globalization of securitization. Among them are:
- the increasingly global focus of all investors, (not just those that focus on real estate), that has made investing overseas more commonplace; and
- the shift in institutional investment away from single-asset investing and into more liquid securitized offerings such as pools of loans, real estate investment trusts, and value-oriented funds.

---


D. Current Trends of Japanese Real Estate Market

1. Land Prices

As Figure 1 illustrates, the six-year fall has commercial and residential real estate prices near pre-bubble levels - off in some sectors as much as 80% from the 1990 peak. At current prices, investment yields on commercial properties (assuming they are occupied), especially office buildings, are approaching realistic levels, considerably above the less than 1% yields experienced at the bubble's peak (Figure 2). The commercial land price index reported in January 1998 actually began to rise in a certain part of the Tokyo metropolitan area for the first time since the bubble economy burst in 1991. For instance, recent auctions of prime Tokyo and Osaka commercial property have sold at slightly above-market estimates, including a much-publicized purchase by a Hong Kong conglomerate at $11,560 (¥1.6 million) per square foot.
Figure 1: Greater Tokyo Land Price Index (1990=100)

Source: Japan Real Estate Institute

Figure 2: Distribution of Investment Yields of Office and Apartment (1997)

Source: Japan Real Estate Institute
2. Rents

In Japan, like in the U.S. during the 1980's, there was a big disconnection between tenant demand for rental office space and investor demand for real estate assets. There was too much speculative real estate development backed by the abnormally increased real estate price, particularly land. A lot of Japanese institutions, especially banks, insurance companies, real estate companies and general contractors, invested significant sums so that Japan's office market was overbuilt in the bubble period. As a result, a bad loan problem was caused.

However, in 1997, after six years since the collapse of the bubble economy, rents for well located, highly functional, and large-scale office buildings have been said to have touched bottom. Furthermore, the rent of some buildings is expected to rise in the future. As Figure 3 shows, the offered rent of new large-scale buildings in the central part of Tokyo is confirmed to have bottomed out. However, on the other hand, medium to small size buildings or those in the suburbs of Tokyo are still declining, and in fact, there is little demand for many of these buildings even if the owners lower the rent.

3. Disposed Properties

If we look at the trend of real estate disposal by companies whose stocks are listed on the Tokyo Stock Exchange from 1993 to 1996, we find that the number of disposals in 1994 or later was greater than in 1993. The reason is the companies were willing to write off their debts. Since many financial firms have huge non-performing loans and mortgages and haven't finished their redemption, the amount of disposed real estate continues to increase.
**Figure 3**

**Offered Rent Index by Scale and Area (Sep. 1997)**

Index: 97/3=100

<table>
<thead>
<tr>
<th></th>
<th>All 23 wards</th>
<th>Metropolitan 3 wards*2</th>
<th>Central 6 wards*3</th>
<th>14 wards in suburbs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-scale buildings*1</td>
<td>102.9</td>
<td>102.3</td>
<td>103.3</td>
<td>101.8</td>
</tr>
<tr>
<td>Medium-to-small-scale building</td>
<td>99</td>
<td>100.4</td>
<td>99.6</td>
<td>97.9</td>
</tr>
</tbody>
</table>

*1) Large-Scale Building: More Than 550,000 sqft of Total Floor Area
*2) Metropolitan 3 wards: Chiyoda, Chuo, and Minato
*3) Central 6 wards: Shinjuku, Shibuya, Shinagawa, Toshima, Bunkyo, and Taito

Source: Japan Real Estate Institute

**Figure 4**

**Number of Companies and Properties Disposed**

Source: Ministry of Finance
4. Conclusion

The Japanese real estate market is still adjusting, and the statistical average does not reflect the actual market conditions because of bipolarized real estate markets. The problem is whether this bipolarized situation is going to be dissolved if the adjustment situation ends.

Before the bubble economy, the increase in real estate prices had been supported by the increase in population and by the high growth of the economy. However, under the prediction of a decrease in population and low economic growth, we cannot expect real estate prices to increase further. Also, the globalization of economic activity and internationalization of investment money flows press the Japanese real estate market to be more globally standardized and more clearer. In this sense, it would be impossible for the bipolarization to be dissolved. On the other hand, the difference in price between high quality properties and those of lesser quality would become wider.
CHAPTER 2
OVERVIEW OF SECURITIZATION OF REAL ESTATE IN JAPAN

A. Why the Current Focus on Securitization?

Five or six years have passed since real estate securitization began to be considered as a possible solution for the problem of non-performing loans in Japan. Securitization - whether of good debt, bad debt, or real estate - is something that should and will occur as Japan makes the transition to direct financing by which we can raise funds directly from the financial market. In an economy the size of Japan's, the traditional rigid system centered on indirect financing, which mainly means borrowing from banks, should not continue; rather, a transition to a system of direct financing would seem extremely natural. Securitization is being considered as part of the movement toward direct financing. In the process, a wide range of concerns and issues have been raised and debated, and now, finally, securitization is becoming a truly popular concept in Japan. However, several important issues, which constitute fundamental problems, have been neglected, blurring the true objectives of securitization. The reason for this is that securitization has, as I have stated above, been seen as a scheme for eliminating bad debt in order to help financial institutions which need ways to dispose of their non-performing loans, and has therefore been conceived with "impure" motives.\(^7\)

B. Historical Perspective

1. Conventional Real Estate Securitization Products

Although Japan’s securitization market has been slow to develop thus far, the country has a longer history of quasi-securitization structures of mortgage-backed securities targeting residential housing than many realize. However, unlike in the United States, these are one-time

\(^7\) Goldman Sachs (Japan) Ltd. Japan Research, (Tokyo, April 1998), p.2-3
transactions. There are no secondary markets in which these securities trade and are priced every day.

a) Three Distinct Types

- **Teito Shoken (Mortgage Securities)**
  This first quasi-securitization appeared in 1931 under the Mortgage Deeds Act, which is a negotiable instrument available for securitizing for both commercial and residential real estate mortgages, and was revised in 1987. Under this arrangement, mortgage companies provide housing loans to borrowers, and obtain approvals from the borrowers to sell the loans. As mortgage companies guarantee payment to investors, the credit risk gets associated with the mortgage companies, rather than that of the borrowers.

- **Jutaku Teito Shosho (Residential Mortgage Certificates)**
  Begun in 1974, financial institutions such as banks and housing loan companies offer a pool of common housing mortgage certificates to other financial institution investors. Further transfer of these certificates is prohibited.

- **Jutaku Loan Saiken Shintaku (Residential Mortgage Trusts)**
  Started in 1972, financial institutions and housing loan companies pool their housing loans with trust banks, which in turn issue trust certificates backed by pools of housing loans. Although the credit quality should reflect the quality of the underlying assets, most securitized offerings are supplemented with guarantees from loan originators. The issue of mortgage-backed securities targeting house mortgages and housing loans boasts a long history, however, it is only ten years since Japan has debated the question of converting commercial type real estate to securities as investment commodities.
b) Common Features$ 

We should note that in each instance above, these instruments do offer mortgage lenders an alternative funding source, however, they differ from more traditional asset-backed securities in that purchasers usually have full recourse to the mortgage originator. Credit enhancement is derived from this seller recourse, rather than subordination and/or third party guarantee. This is a function of the long-held belief in Japan that corporate credit is the most cost-effective means of financing an investment. The acquisition of most real estate has historically been arranged through corporate finance means, based on an entity's creditworthiness, rather than by valuing the underlying real estate. Non-recourse loans that ascribe value to specific assets such as real property have not been widely used in Japan. In fact, specific project financing has been particularly non-existent. More importantly, until now the necessity to liquidate specific assets or properties has rarely, if ever, arisen.

Secondly, the nature of "secured credit" is different in Japan from that in the United States. In case of default, a claim on a secured property cannot be transferred to other creditors because the security consists of all the assets owned by the debtor, not just the secured asset.

2. Recent Trends of Real Estate Securitization

Recently, Japanese financial institutions began to securitize their bad debts. However, the system that has been developed is complex and limited to corporate investors and does not offer liquidity. Also, ultimately requiring to sell real estate collateral, the risk of a price decrease, in many cases, falls at this time largely on banks and other financial institutions (Table 1).

---

Table 1: List of Recent Securities Issued by Financial Institutions

<table>
<thead>
<tr>
<th>Date Issued</th>
<th>Name of Banks</th>
<th>Sum ($ millions)</th>
<th>Converted Security</th>
<th>Risk of Price Drop for Targeted Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul-95</td>
<td>Former Mitsubishi</td>
<td>71</td>
<td>Real Estate</td>
<td>70% covered by bank trusts</td>
</tr>
<tr>
<td>Jul-96</td>
<td>Tokyo Mitsubishi</td>
<td>71</td>
<td>Real Estate</td>
<td>100% covered by banks, etc.</td>
</tr>
<tr>
<td>Aug-96</td>
<td>Fuji Bank</td>
<td>29</td>
<td>Real Estate</td>
<td>100% covered by banks, etc.</td>
</tr>
<tr>
<td>Sep-96</td>
<td>Sanwa Bank</td>
<td>214</td>
<td>Loans</td>
<td>100% covered by third party</td>
</tr>
<tr>
<td>Dec-96</td>
<td>Nippon Credit</td>
<td>23</td>
<td>Real Estate</td>
<td>100% covered by banks, etc.</td>
</tr>
<tr>
<td>Mar-97</td>
<td>Asahi</td>
<td>81</td>
<td>Loans</td>
<td>100% covered by banks, etc.</td>
</tr>
<tr>
<td>Mar-97</td>
<td>Tokyo Mitsubishi</td>
<td>36</td>
<td>Loans</td>
<td>Investors</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$525</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Kazuo Sato, Monthly Economist (April 29, 1997)

Most recently, in the middle of April, 1998, Goldman Sachs securitized the properties (land and head office building) owned by Yamato Life Insurance Company, which is the 20th largest asset holder in Japan's life insurance industry. The properties are located in one of the best areas in downtown Tokyo. In this deal, Credit Suisse First Boston Securities (Japan) Ltd. set up real estate trusts on the properties and then GS bought the whole trust beneficiary rights for $36 million (¥50 billion). The vacancy rate of the building is 0% and they expect at least 5% annual return.

3. Follow the RTC in the United States

In the search for a solution to mounting bad debt brought on by the plunging real estate prices of the 1990s, Japanese regulators followed in the footsteps of the United States by copying what the RTC did. The RTC was a United States-government-sponsored corporation created by the Financial Institutions Reform Act of 1989 in order to clean up the savings and loan (S&Ls) disasters of the late 1980s. The mechanism that the RTC used to liquidate the assets of insolvent S&Ls paved the way for large-scale securitization. The RTC has used "Good Bank, Bad Bank" strategy in order to resolve U.S. loan problems along with a number of successful U.S.-
developed private sector techniques. This process involved the sale of securities backed by pools of commercial mortgages, known as commercial mortgage backed securities (CMBSs) through investment bankers to nontraditional mortgage investors. The RTC initially set up a guarantee fund to secure CMBSs, thereby facilitating the risk rating of these debt instruments. More recently, collateralization of CMBSs has taken other forms.

4. CCPC

The Japanese regulators also worked together with Japanese financial institutions to establish several vehicles to house and service non-performing debt and loans originated by bankrupt financial institutions. One of these vehicles is the Cooperative Credit Purchasing Company (CCPC), which provides financial institutions that transfer loans with a reduction in their non-performing loan balances and tax write-offs for the difference between book and market value of property used as loan collateral.

To date, however, the CCPC has not produced a significant restructuring of underlying assets and obligations. Asset risk and reward remain with the financial institutions that originated the loans, and property liquidations have been minimal. As of March 31, 1997, the CCPC had purchased - at a discount- $39 billion (¥5.44 trillion) of debt collateralized by real estate, primarily from major Japanese banks and insurance companies. Only $5.5 billion (¥812.8 billion: approximately 15%) has been repaid with the proceeds of real estate collateral sales.

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9 In addition to the Cooperative Credit Purchasing Company, primarily established for non-performing bank loans, regulators set up the Housing Loan Administration Corp. for servicing non-performing loans originated by Jusen (housing finance) companies and the Resolution & Collection Bank to service operations of bankrupt credit unions.
C. Mistaken Objectives of Asset Securitization in Japan

As I stated previously, the most dangerous problem with the ongoing securitization debate is that the objectives of securitization currently resemble an extension of the bad debt problem; they show a strong leaning toward helping financial institutions, which are complaining that they need ways to dispose of their non-performing loans. Comprehensive debate of how securitization regulations can best be designed to invigorate the market and therefore contribute to the overall economy has undeniably been absent.

In the United States, during the financial crisis in which S&Ls failed in large numbers in the latter half of the 1980s, products based on securitized assets (such as public mortgaged-backed securities) were able to spark a rapid pickup in the stagnant funding environment.

In Japan, however, the pressing matter of non-performing loans already exist, and as officials for the first time attempt to formulate rules for a securitized product market, we are repeatedly hearing the argument that securitization is necessary to solve the bad debt problem. I believe this is a confusion of priorities. In this era of the Big Bang, to consider creating new rules to help specific market players is a problem that has the potential to alienate investors, who are also, after all, market players. This has given rise to concern about potential negative impacts on the market's development.

In particular, it goes without saying that securitization is a means of creating added value and appropriately distributing risk. Appropriate risk distribution leads to proper levels of risk and return on investments, creating added value for the overall economy. In the securitization debate, it is dangerous to forget the pursuit of such societal efficiency, which should be a major underlying principle behind whichever scheme is adopted.

D. System of Securitization of Real Estate

The securitization of real estate involves the certification of earning rights and deed titles of properties as negotiable securities or other products by the realtor (financial procurement body)
via a conduit (special security issuing body), which are then purchased by investors (Figure 5). This system is identical to that in which investors purchase regular shares and bonds with an aim to procuring dividends and interest. These conduits are made up of trust companies or consortia, who are not subject to taxation under current laws, and have a duty to provide payments and redemption to investors, as is the case with regular negotiable securities.

Figure 5: Basic System of Securitization of Real Estate in Japan

Source: NLI
E. Market Impact
The MOF and other agencies have already begun work on all proposed initiatives; however, it may be at the end of fiscal-year 1998 or later before many of them become law. The long-term potential impact of those initiatives on the market include the following:

1. Special Purpose Vehicles (SPVs)
The U.S. tax code contains specific provisions, such as real estate mortgage investment conduits (REMICs) and real estate investment trusts (REITs), which facilitate securitization by eliminating SPV level taxes. The Japanese tax and commercial codes, however, are not designed for SPVs and trusts to act solely as asset financing or selling vehicles between issuers and investors. The proposed regulatory changes are designed to support that concept by eliminating vehicle level taxation, capital requirements, and other restrictions. As a result, future securitizations can be accomplished using domestic SPVs, which will eliminate certain cross-border risks and complications. Moreover, establishing a legal framework for SPVs and trusts to act as single-purpose vehicles in Japan will help promote bankruptcy-remoteness by decreasing potential SPV obligations unrelated to the securitization. The next chapter presents a detailed analysis of SPC Law.

2. Liquidity
By defining trust certificates as securities and by establishing a secondary market for private placements, as proposed, liquidity for real estate backed instruments will have to be improved. Unfortunately, measures to reduce the cost (e.g., taxes) and the time required to foreclose and sell real estate collateral in Japan have exhibited less progress. The liquidity of underlying real estate and the defining of lien holder and of owner's rights continue to be a very serious problems.
3. Security
The introduction of a Uniformed Commercial Code-like system is the most significant regulatory initiative being offered and could greatly facilitate asset-backed securitizations in Japan. The difficulty in establishing a secured interest in financial obligations has been a major deterrent to Japanese securitization. The Specified Credit Law (Tokusai-ho) for perfecting a security interest in monetary obligations did help certain asset types (e.g., auto loans and leases). However, for such assets as real estate loans, which do not come under the law, the perfection process can be a deal breaker because each debtor must be notified or must consent to the sale of identified existing receivables. If expanded to include other forms of corporate debt (trade receivables and unsecured bank loans), efficient filing of security interests could stimulate a large potential asset pool and help refocus Japanese securitization on asset strength and not on seller guarantees.

4. Credit Enhancement
By opening up credit enhancement to property and casualty insurers, more innovative support structures will be made available. In the short term, however, the danger is that insurers will be an additional crutch to wrap poorly disclosed real estate assets into corporate guarantees, again hampering the development of securities based on real estate performance.

5. Information
It is information that will drive more accurate market valuations and help prevent unrealistic run-ups in real estate prices. The proposed initiatives stress disclosure rules and a market valuation system, however, concrete measures have yet to be announced, except for the

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10 The Uniformed Commercial Code (UCC) in the United States provides the purchaser of (or lender against) financial assets with the ability to secure its claim to the specified assets by filing a financing statement with the secretary of state or other designated public official.
development of data bases on real estate rents. Establishing and enforcing disclosure requirements is a critical government role.

E. Securitization Focus

1. Residential or Commercial?

Despite the securitization-friendly nature of residential mortgages (uniform collateral/loan pools and a large number of diverse obligors), securitization efforts in Japan have centered on commercial (not residential) real estate finance. The reason commercial real estate has taken the lead is because it is at the heart of Japan's bad debt crisis, and both the Japanese government and the business want action.

As the world's largest credit nation, Japanese households hold financial assets of approximately $8.6 trillion (¥1,200 trillion). Of this total, 55% is held in deposit accounts, which provides financial institutions with a dependable, low-cost funding source. Therefore, contrary to the United States experience, Japanese financial institutions (both private and public) have generally been content to retain and fund residential mortgage pools on their balance sheets. The same, however, cannot be said for commercial mortgage debt. The issue here is not one of funding, but of asset risk and liquidity. Commercial real estate – traditionally a high price volatile asset – has been on an uncontrollable roller coaster ride in Japan over the past 10 years. This is the problem regulators appear most anxious to confront. As a result, Japan's initial forays into securitization have been backed by relatively undiversified commercial real estate holdings or large loans collateralized with commercial real estate – a trend that is likely to continue.

Will large-scale residential MBS ever take hold in Japan? To date, most analysts have considered it to be unlikely; however, deregulation and Japan's Housing Loan Corporation (HLC), a government-owned home mortgage lender, may soon change that.

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The U.S. model for stimulating home ownership is to provide private mortgage originators with a low-cost funding source through guaranteed home mortgage backed securities issued by Fannie Mae, the Government National Mortgage Association (Ginnie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac). The model and the market that followed are credited with establishing asset securitization in the United States.

On the other hand, the Japanese government also intervenes to promote real estate development and home ownership; however, it takes a far different approach. With deposits of $1.6 trillion (¥225 trillion) from the postal savings system, the Japanese government directly competes as a residential mortgage lender through Japan's Housing Loan Corporation (HLC), which in recent years have held a massive 41% share of the residential mortgage credit outstanding in Japan. Stimulating residential mortgage lending through funded loans, in contrast to indirect support for loan securitization, has been a key structural factor in preventing residential MBS development in Japan.

The situation, however, may soon change. Government officials recently announced their intentions to securitize part of the HLC’s huge residential mortgage portfolio to reduce its dependence on postal savings for funding. Depending on the scale, that would not only provide an excellent foundation for an MBS market in Japan, but it could also stimulate investor interest in other securitized products.

A move by non-government mortgage lenders to incorporate mortgage backed securities as a funding alternative in Japan will likely depend on the degree to which deregulation (i.e., increased investment opportunities) and the disintermediation, which will result, will cut into the banks’ deep deposit base. The shrinking deposit base of mortgage originators (banks and savings and loans) brought on by deregulation and by the corresponding competition for investment funds was a driving force in U.S. residential mortgage securitization.
2. Debt or Equity?

The U.S. market – with equity REITs and mortgage (i.e., debt) REITs, REMICs (offering both debt and residual equity investments), MBS and CMBS – offers a wide array of securitization alternatives. Japanese regulators indicate that they also are seeking to establish markets for securities backed by both real estate equity and debt collateralized by real estate. The exact form these structures will assume has yet to be fleshed out. In past securitization initiatives, the tendency has been toward limiting transactions to pre-approved structures. Issuer and investor needs, however, would be better met if clear legal guidelines were established and structuring within those guidelines was left to creative market forces.¹¹

G. Summary

The traditional method of approaching real estate financing in Japan was of indirect borrowing, and although there were several instruments concerning securitization, none of them functioned well. In response to the plunging real estate prices and resulting bad debt problems, Japan used the RTC as a helping model. They hoped that what the RTC did for the United States would also work for them. One of the resulting vehicles was the Cooperative Credit Purchasing Company (CCPC). However, to date, it has not produced a significant restructuring of underlying assets and obligations. Currently in Japan, the MOF and other agencies have begun work upon constructing a real estate securitization model that is more in line with the objectives of healing the Japanese economy. These initiatives may have various impacts upon the real estate market, such as the elimination of cross-border risks and complications due to the use of domestic SPVs, and the increase of liquidity for real estate backed instruments. Nevertheless, the bottom line is that there must exist a real estate securitization model that is designed around the economy in order to have the proper effects.

CHAPTER 3

THE DEVELOPMENT AND ROLE OF REITS IN THE UNITED STATES

A. U.S. REIT Market

1. History of REITs in the United States

In the United States, REITs were first introduced after the federal government passed the so-called REIT Law in 1960. Then, REITs were considered to be revolutionary. They were security-type products that offered ownership in large-scale commercial real estate properties to many different types of investors. However, a true REIT market did not develop until the late 1980s, for the following two reasons.

   a) Initially, REITs were only permitted to own real estate, not to manage or administrate properties, and management had to be entrusted to third parties. Third parties often charged large fees. This created a conflict of interest. Thus, REITs were unable to meet the expectations of investors wishing to maximize the cash flow generated by their equity.

   b) Another method of acquiring equity in real estate, the Master Limited Partnership (MLP), offered preferential tax treatment in that it allowed investors to offset other income with interest payments and depreciation costs associated with real estate investment (as is the case for physical real estate investment in Japan). Thus, because MLPs constituted a tax shelter, they became more popular than REITs. Incidentally, because the REIT scheme generated regular, taxable income for investors, REITs were seen as less tax favorable than MLPs.
2. The Tax Reform Act of 1986

In 1986, the Tax Reform Act changed the nature of REITs and also tightened the regulation of MLPs, on which real estate investment had centered until that time. The changes are as follows:

a) The previous trend of using real estate investment as a tax shelter was, in a sense, unhealthy, and leverage was sometimes pointlessly used in speculative investments. For this reason, the Tax Reform Act strictly limited the tax deductions permitted on depreciation, and other costs related to real estate investment. As a result, there were no incentives to invest in real estate unless a greater amount of income could be generated. Considering Japan for a moment, it is better to keep in mind that the avoidance of taxes is still one of the objectives of real estate investment. The policies that will determine how losses are taxed regarding J-REITs have not yet been made clear. Since Japan's land prices are high, it is still difficult to earn profits without tax benefits, and careful legislation will most likely be necessary on this point.

b) The Tax Reform Act decreased the limitations on REITs, allowing them not only to own real estate but also to perform almost any service related to the management and administration of real estate. As a result, the interests of both the investors in the REIT and the REIT management were aligned. No more conflicts of interest. This change encouraged the establishment of more attractive REIT products.

Figure 6 provides information on the issuance of new REITs. As a result of the Tax Reform Act, the pace of new issuance rose to approximately $2 billion per year in the late 1980s. However, the main growth did not start until around 1993 because there was a variety of factors that blocked the growth of the REIT market. Throughout the 1980s, banks, life insurance companies, and other organizations invested heavily in real estate (most notably, excessive
investment in mortgage products on the part of rapidly growing S&Ls). This was also the period in which Japanese financial institutions, heavy with cash from the bubble economy, moved to purchase large quantities of U.S. real estate. This is important because the flow of funds into the real estate market was so great that there was only a small need to rely on REITs to bring in funds.

However, this situation came to an end - and REITs for the first time began to attract a great deal of attention - when financial institutions were weakened by many banks failures, inflows of funds from overseas fell drastically with the collapse of Japan's bubble economy, and the real estate market fell into a slump as a result of oversupply created by excessive development throughout the 1980s. 1992 was the year where REITs began to re-develop.

**Figure 6: REIT Debt and Equity Capital Rising ($ billions)**

![Chart showing REIT debt and equity capital rising from 1982 to 1996](source: NAREIT)
B. Developments since 1992 - Explosive Growth in U.S. REIT Market since 1992 Is a Function of Several Events

1. Substantial Amount of Overbuilding Across the United States During the Late 1980s

Vacancy rates reached 20%-25% for many suburban office markets and 15%-20% in many downtown areas, and rent rates dropped. As a result, the financial system (including commercial banks, savings and loan organizations, and insurance companies) was weakened; new mortgage credit was not extended to borrowers (commercial real estate developers and owners); and the rate of commercial mortgage delinquencies and defaults increased, reaching an all-time high in 1992. With all these trends happening at the same time, property values dropped dramatically (50% in many cases), from the peak in 1988 to 1992-1993 levels. Yields on commercial properties increased from the 5%-7% range to 10%-12%. However, interest rates in the United States during 1993 were extremely low, and investors seeking higher income from their portfolios. REITs offered an attractive high-yield equity security that traded in the public market which in turn brought liquidity to a real estate investment.

2. Umbrella Partnership REIT (UPREIT) Structure Encouraged High-Quality Asset Portfolios to Enter Public Market

Real estate developers who owned major commercial property assets with a low-tax basis due to years of accumulated depreciation were able to swap, on a tax-free basis, their ownership positions in individual property partnerships for units in an operating partnership that was set up to own the REIT in the first place. The operating partnership shares are economically equivalent to common shares in the REIT. The public market's acceptance of the UPREIT corporate structure encouraged many over leveraged developers to take their companies public. Today, majority of equity REITs use UPREIT structure.
3. Consolidation a Reason for Recent Growth in REIT Industry

In the United States, the commercial real estate market is estimated to be valued at least $3 trillion, of which less than 7% is publicly traded. This allows REIT companies good opportunities to acquire properties and manage assets more efficiently, which leads to improved margins and earnings. This has contributed to the sector's strong stock market performance since 1991.

C. The Structure of REITs in the United States

A REIT is an organization - with real estate as its principal asset - which issues securities meeting strict requirements. More specifically, although the REIT Law exists, it is the tax system that basically regulates REITs, and this essentially constitutes regulation of finance through the tax system. Whether publicly traded or private, REITs must derive most of their revenue from income-producing real estate or real estate mortgages. It distributes to its shareholders substantially all of its earnings in addition to any capital gains generated from the sale of disposition of assets.

As far as the interpretation of laws governing financial administration is concerned, the biggest difference between the United States and Japan is the concept of activities as "allowed in principle" versus "prohibited in principle." In the United States, while detailed regulations applicable to REITs exist, a scope of activities that is established by expressly stating specific activities that would violate regulations. Generally, the law is interpreted as in principle not prohibiting activities not set out in such way. In Japan, on the other hand, regulations are usually of a format specifying which parties can engage in specified actions, and the law is generally interpreted as in principle prohibiting activities not expressly allowed. This type of interpretation has been partly responsible for delays in reforming financial administration and creates a problem that complicates the question of whether REITs will really take root in Japan.
1. Structure of REITs

Figure 7 is a simple illustration of the structure of a REIT as an organization that issues securities.

Looking at the figure, one can notice that the balance sheet structure of a REIT is actually simpler than that of an ordinary business. The most obvious characteristics of a REIT is that its assets are mostly real estate. In order to maintain the passive nature of REITs, there are some restrictions put upon the management activity. Management can actively engage in property managerial and related services. It cannot engage in any other businesses to any significant degree. Trustees or directors are permitted to make decisions that involve the conduct of the affairs of the REIT itself. Shareholders' equity is raised by the REIT selling shares and, provided strict requirements are met, the REIT shares are then registered with the Securities and Exchange Commission as securities. The financial institutions that are also the REIT’s creditors sometimes securitize REITs liabilities and sell them as commercial real estate collateral loans\(^\text{12}\).

\(^{12}\) Goldman Sachs (Japan) Ltd., *Japan Research*, (Tokyo, April 1998), p.17-21
Figure 7: Typical REIT Balance Sheet Structure

Board of Directors or Trustee

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>(Nonrecourse Type)</td>
</tr>
<tr>
<td>or</td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
</tr>
<tr>
<td>Mortgage</td>
<td></td>
</tr>
<tr>
<td>Shareholders</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>(REIT)</td>
</tr>
</tbody>
</table>

Registered on the Market (SEC)
- Investors Can Buy and Sell Freely
- Equity Prices Fluctuate with Supply and Demand

<Main Points>
A REIT is registered or listed on capital markets, and therefore offers liquidity. Investors have rights of claim to cash flow generated by a REIT's assets. The market reacts sensitively to change in the projected cash flow of the REIT, and the market value of the REIT security itself fluctuates accordingly.

Source: Goldman Sachs (Japan) Ltd.

1. Regulation of REITs
A REIT is basically a creation of the Internal Revenue Code, and is a real estate company or trust that has elected to qualify under certain tax provisions to become a pass-through entity that distributes its shareholders substantially all of its earnings in addition to any capital gains generated from the sale of disposition of its assets. The real estate investment trust does not pay taxes on its earnings. In accordance with the tax provisions, however, the distributed earnings do represent dividend income to its shareholders and are taxed accordingly. In addition, any distributed capital gains are taxed at the shareholder's applicable tax rate.

Effective January 1, 1961, special income tax benefits were accorded a new type of investment institution by an amendment to the Internal Revenue Code (Sections 856 through 860). Under this amendment, a real estate investment trust meeting pre-set requirements during the taxable year may be treated simply as a conduit with respect to the income distributed to beneficiaries.
of the trust. Thus, the unincorporated trust or association ordinarily taxed as a corporation is not
taxed on distributed taxable income when it qualifies for the special tax benefits. Only the
beneficiaries pay the tax on the distributed income. To qualify as a REIT for tax purposes, the
trust must satisfy the following requirements.

a) Asset requirement

- At least 75% of the value of a REIT's assets must be made up of real estate assets, cash,
  and government securities.
- No more than 5% of the value of the assets may consist of the securities of any one issuer
  if the securities can not be included under the 75% test.
- A REIT may not hold more than 10% of the outstanding voting securities of any one
  issuer if those securities can not be included under the 75% test.

b) Income requirement

- At least 95% of the entity's gross income must be from dividends, interest, rents, or gains
  from the sale of certain assets.
- At least 75% of gross income must be from rents, interest on obligations secured by
  mortgages, gains from the sale of certain assets, or income attributable to investments in
  other REITs.
- Not more than 30% of the entity's gross income can be from sale or disposition of stock
  or securities held for less than six months, or real property held for less than four years
  other than property involuntarily converted or foreclosed.

c) Distribution requirement

- REITs must disburse at least 95% of their profits, or income (revenues minus expenses),
  to their shareholders. Because REITs are intended to be conduits or throughways for
shareholders, they cannot pursue profits for themselves. Cash flow obtained from managing properties is ultimately passed on to shareholders.

d) Tax treatment

One area of importance in accounting for REITs is the treatment of depreciation for financial reporting and the determination of taxable income. For example, a REIT may use an accelerated method of depreciation in its determination of taxable income, however, when determining income available for dividends it is required to use 40-year asset life. The use of inconsistent methods of income calculation sometimes results in shareholders receiving dividends in excess of the REIT's calculated taxable income. However, these dividends will be taxed as normal income. Any additional amounts distributed, such as those representing depreciation, will be considered a return of original capital and thus will simply reduce the shareholder's tax basis

Although many other regulations also apply to REITs, consideration of these points alone is sufficient to gain an understanding of the strict conditions under which REITs operate. To be granted tax exemptions, REITs require extremely capable management, skilled not only in managing real estate properties but also in continuously increasing the profits they generate and in structuring assets.

2. Categories of REITs

a) Classification by Asset Structure

In accordance with the structure of their assets, REITs can be classified into the three categories shown in Figure 8. Individual REITs in all three categories are not different from one another; instead, a REIT naturally moved into a category as it developed its own areas of expertise.
b) Classification by Owned Properties

A REIT can also be classified by the type of property in which it invests, because REITs mostly acquire areas of expertise as they accumulate properties in specific regions as well as specialized knowledge. Figure 9 shows these categories. In actuality, the REIT market grew almost 50% and that the share of the overall market held by office REITs rose from 6% to 17% between December 1996 through November 1997.

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13 Brueggman, and Jeffery D. Fisher, Real Estate Finance and Investment, (Chicago, Irwin, 1997), p.661-663
Figure 9: REIT Industry Capitalization and Comparison, Dec. 31, 1996 vs. Nov. 30, 1997

Source: Goldman Sachs (Japan) Ltd.
3. Merit and Demerits of REITs

a) Merits

- Direct real estate is characterized by a lack of liquidity. In the past, investing in real estate involved tying up large amounts of funds for long periods of time as well as the risk of not being able to find a buyer when ready to sell. The market was structured such that, as funds circulated at ever-faster speeds, perceived liquidity risk often prevented even healthy funds contribute to economic development by efficiently distributing surplus funds and adding value to real estate.

- The equity-oriented REIT provides investors with opportunity (1) to invest funds in a diversified portfolio of real estate under professional management and (2) to own equity shares that trade on organized exchanges, thus providing more liquidity than if a property were acquired outright.

- Previously, investors could not invest in real estate unless they had large amount of funds. With the introduction of REITs, investors could acquire real estate equity in small lots, assuming less liquidity risk in light of the ability to sell that equity at any time. Suddenly, investors had a new way to seek a higher return on their assets that provided acceptable distribution of risk. Although certainly not an instrument like ordinary stocks with which to aggressively pursue capital gains, REITs constituted an opportunity to invest readily in real estate and earn stable dividend income. Also, investors could obtain proper information for investing in real estate properties that has traditionally been enclosed.

- Even in likely profitable developments, developers are sometimes unable to assume all the risk associated with large-scale projects. In such cases, large amounts of funds can be raised simultaneously from a wide range of investors by establishing a REIT. Moreover, given
REIT's foundation in non-recourse financing, their responsibilities are different from those of ordinary businesses.

b) Demerits

- Recently, moving at ever-faster speeds, funds have come to flow relatively briskly into and out of a variety of markets. As a result, volatility in world markets has tended to increase. On the one hand, this helps to adjust real estate market prices - which had tended to fluctuate wildly because of the immovability or illiquidity of real estate - to appropriate levels in shorter periods of time. However, doubts remain as to whether changes in real estate prices will really be able to keep pace with hypersensitive stock and bond prices, which can fluctuate drastically, and as to whether real estate, supposedly a long-term investment, should be exposed to such short-term fluctuations.

- In the United States, as in Japan, investment in real estate is an important tactic used to reduce taxes. At the direct property level, investors can take advantage of tax exemptions by borrowing money to purchase real estate, and through deduction of interest and depreciation shelter some or all of the cash flow. However, although REITs also invest in real estate, and are not taxable at the entity level, dividend income paid to REIT investors at the shareholders level is taxable. Therefore, investments in REITs do not offer as much tax efficiency as do MLPs\(^\text{14}\).

\(^{14}\) Goldman Sachs (Japan) Ltd., *Japan Research*, (Tokyo, April 1998), p.22-23
CHAPTER 4

TASKS AND DIRECTIONS OF SECURITIZATION IN JAPAN

A. New Rules: The Assets Liquidation Law (Special Purpose Corporation Law)

The Special Purpose Corporation (SPC) Law has been promoted by the Commission on the Securitization of Credits and other assets within the General Affair Department of the MOF's Banking Bureau. The SPC Law is currently being approved by the Diet, and is expected to take effect as early as September 1, 1998. Although the general framework of the law has taken shape, many details remain to be finalized before the bill is approved and enacted as law. The upcoming developments should be watched carefully because they will determine whether the plan that will be adopted will be useful or not.

I will now analyze the relationship between the SPC Law and other legislation, as well as the contents of MOF's preliminary draft of the law - which is what we currently know as the SPC Law.

1. Positioning of the SPC Law and the Circumstances of Its Proposal

The SPC Law started as an effort to expand securitization permitted under the Specified Credit Law, particularly to include accounts receivable and other assets. Only very recently has it been expanded to include the concept of real estate securitization.

As is clearly shown in Figure 10, the SPC Law is the result of demands to combine and expand two existing laws, the Real Estate Syndication Law and the Special Credit Law. The Real Estate Syndication Law, established in 1994, resulted from the desire to somehow make possible real estate investment in small lots. It was based on investment in real estate itself and its main purpose was not to make standards in the market for securitized real estate products, but just to save taxes and to give the conversion of real estate into small lots a legal basis. As a result, the
products were not positioned as financial products and lacked liquidity. On the other hand, the Special Credit Law resulted from demands to add liquidity and create new added value for a limited range of certain financial products; however, it was limited to lease credits and installment credits.

However, it became clear that such vertically divided administration was out of date, and attention began to focus on hopes for a single law that would allow for investment securities in a wide range of categories. Thus, in one sense, formulating the SPC Law has been difficult because of the many demands being made simultaneously. Unlike in the case of accounts receivable, handling taxes associated with real estate is extremely complex. Thus, the largest bottleneck has been determining whether the securitized products ultimately offered will attract investors or not.

2. **Current Framework of the SPC Law**

Table 2 shows the framework of the draft of the SPC Law submitted to the Liberal Democratic Party (LDP) by the MOF on March 3, 1998.

Table 3 compares taxation related to SPCs under the SPC Law with the current taxation of real estate properties.

Although repeated in part in Table 2, the following are important points regarding SPC Law and functions and rules governing SPCs.

a) **Establishment**

The proposer prepares the articles of association, underwrites specified funds, appoints managing directors and auditors, and registers the SPC. The proposer can be an employee of the parent company and does not have to be a director.
Figure 10: Positioning of the SPC Law

Securitization of Specific Products
- Specified Credit Law
  - Limited to Lease Credits and Installment Credits
  - SPC Method, Trust Method
  - License System

Criticized for "Limiting" the Products
- A Combination of Both?
  - Securitization of Accounts Receivable, Etc.
  - Securitization of Real Estate
  - J-REITs

Criticism Stating that "Securitization" is Necessary
- Real Estate Syndication Law
  - Not Securitization
  - Conversion of Real Estate into Small Lots
  - Based on Investment in Real Estate Itself
  - Aim is Tax Savings Advantage
  - License System

Source: Goldman Sachs (Japan) Ltd.
Table 2: Current Disposed Framework of SPC Law

- **Spirit and Functions**
  - Tentative name in special commercial code cases is the Bill of Law Pertaining to the Liquifying of Specified Assets by Means of the Issuance of Securities by Special Purpose Corporations (SPCs)
  - The activities of SPCs are restricted solely to issuance of securities using assets as collateral

- **Description of SPCs**
  - *Kabushiki Kaisha* (joint stock companies with capital of approximately $21,400 (¥30 million)) established by financial institutions or general corporations.
  - Must have one or more managing directors' and one or more auditors (three are normally required under the commercial code).
  - The company can use the SPC indefinitely, in multiple projects.

- **Securitization Scheme**
  - Assets subjects to securitization include loan credits, accounts receivable, real estate, etc.
  - Issued securities include stocks, bonds, commercial paper, and other marketable securities as defined by the Securities Exchange Law.
  - In addition to information disclosures required by the Securities Exchange Law, assets & business plans, etc. must be disclosed.

- **Related Tax System**
  - License tax on the registration of SPC establishment is $214 (¥30,000).
  - Exempt from corporation tax provided at least 90% of profits are disbursed as dividends.
  - License tax on the registration of real estate transfer is 2.5% and acquisition tax is 2% (half of the usual rate); exempt from special land ownership tax and effectively exempt from tax on transfer profits are disbursed as dividends.
# Table 3: SPC Taxation

<table>
<thead>
<tr>
<th>Name of Tax</th>
<th>Current System for Real Estate</th>
<th>SPC Law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Acquisition Taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Registration License Tax (registration of transfer of ownership title)</td>
<td>5% of tax-appraised value of fixed assets</td>
<td>2.5% of tax-appraised value of fixed assets</td>
</tr>
<tr>
<td>Real Estate Acquisition Tax</td>
<td>4% of tax-appraised value of fixed assets</td>
<td>4% of 1/2 tax-appraised value of fixed assets (special case for two years)</td>
</tr>
<tr>
<td>Special Land Ownership Tax</td>
<td>3% of value of land acquired during past year</td>
<td>Not taxed (special case for two years)</td>
</tr>
<tr>
<td><strong>Ownership Taxes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate Tax</td>
<td>1.4% of tax-appraised value of fixed assets</td>
<td>No change</td>
</tr>
<tr>
<td>City Planning Tax</td>
<td>0.3% of tax-appraised value of fixed assets</td>
<td>No change</td>
</tr>
<tr>
<td>Special Land Ownership Tax</td>
<td>1.4% of land value</td>
<td>Not taxed (special case for two years)</td>
</tr>
<tr>
<td><strong>Corporation Tax</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>37.5% of taxable income</td>
<td>If specific conditions* are met, the profits an SPC disburses as dividends are counted as Losses for the purpose of calculating income.</td>
</tr>
<tr>
<td><strong>Registration License Tax (registration of Establishment of company)</strong></td>
<td>In the case of a Kabushiki kaisha, 7/1000 of capital or $1,071 ($150,000), whichever is greater</td>
<td>$214 ($30,000) per registration</td>
</tr>
</tbody>
</table>

* The specific conditions are met if any of the following are true:

- The SPC issues $714,000 ($100 million) or more in special bonds for the public.
- The SPC issues special bonds limited to "eligible institutional investors" (banks and other financial institutions).
- The priority investment securities issued by the SPC are underwritten by 50 or more people.
- The SPC issues priority investment securities limited to "eligible institutional investors" (banks and other financial institutions).

and if both of the following are also true:

- The SPC is conducting business activities in accordance with its asset liquification plan and no other than business activities.
- The SPC is disbursing as dividends 90% or more of its income available for dividends to parties not constituting its family companies under the Corporation Tax Law (excluding cases in which the SPC issues at least $714,000 ($100 million) in public special bonds or special bonds limited to eligible financial institutions).

Source: Goldman Sachs (Japan) Ltd.
b) Registration
The registration of an asset liquification plan with the Prime Minister is required.

c) Capital
An SPC's capital comprises priority capital and specified capital. As indicated later, priority capital is capital stock issued when the issuance of priority investment (securities) is approved in the asset liquification plan. Specified capital is the SPC's capital at the time of establishment and must be ¥3 million.

d) Contents of Asset Liquidation Plan
The plan must clearly present goals related to the acquisition, management, and disposal of the specified assets. Specifically, they include the total amount, type, and conditions associated with the securities to be issued in correspondence to the assets.

e) Securities to Be Issued
SPCs can issue the following three types of securities, referred together to as securities issued in correspondence to assets:

- **Priority Investment Securities (Equities)**
The holders of priority investment securities, like those of preferred stocks, have the right to receive, ahead of specified investors, income dividends and residual property disbursements.

- **Specified Bonds**
The term specified funds refers to funding other-than-priority funds received by the SPC. Also, specified bonds are bonds issued in accordance with the SPC Law.

- **Specified Promissory Notes (Commercial Paper)**
f) **Scope of SPC Business Activities**

The scope of an SPC’s business activities is limited to activities associated with the liquification of specified assets that is in accordance with its asset liquification plan. In other words, the purpose of an SPC is to liquify assets and to issue and redeem securities, and SPCs are not permitted to engage in other business activities.

g) **Limit on Borrowed Funds**

An SPC must not borrow funds other than those of necessary to maintain liquidity.

3. **The Destination of The SPC Law: Points to Be Resolved and Anticipated Tasks**

I have explained the main points of the SPC Law that have already taken shape. Other points will now be announced in the form of ministry or government ordinances. Without a doubt, the details to be decided will determine whether the law is ultimately useful or worthless. Therefore, the details must be pushed forward cautiously but firmly.

The following are some important points that remain unclear regarding the aspects of the bill that have already been announced, as well as those relating to tasks and details that remain to be finalized.

a) **SPC Borrowing Limitations**

In principal, as previously mentioned, SPCs cannot borrow money. Therefore, in cases in which unplanned costs might be generated, SPCs will likely issue commercial paper. However, it remains unclear how such commercial paper would be underwritten and how it would be rated. One realistic method might be to require a letter of guarantee with the credit of the originator. However, in general, Japan real estate owners are always expected to bear larger risk, generating unexpected costs (repairs and construction work associated with changing tenants). It is highly doubtful that commercial paper alone would be sufficient.
b) Contents of Asset Liquification Plan

It is particularly difficult to clearly specify such details as the time of sale and the other party in the sales transaction - and even more so in the case of non-performing loans.

c) Inability to Increase or Decrease Priority Investment Securities (Equities)

Increasing or decreasing the amount of priority investment securities is not permitted. Thus, as mentioned previously, in the event of a shortage of funds, the only way to obtain financing is through the issuance of commercial paper. In my view, this point is in need of rethinking.

d) Disclosure Obligations

The degree of disclosure required in asset liquification plans remain unclear. Since specified bonds and priority investment securities are considered marketable securities, the disclosure associated with the Securities Exchange Law is obligatory. However, the amount of disclosure necessary is unclear? Can tenant information, in particular, be disclosed? In Japanese commercial buildings and housing rental businesses, the rents of existing tenants vary widely depending on when the properties were occupied, and rents have traditionally not been disclosed regarding specific building occupancies and rents. Large real estate companies are likely to balk if rent information about individual buildings and tenants is required, because rental information, if disclosed, could be used as a tool for luring tenants away from competitors.

e) Will Joint Funding Be Allowed for Establishing SPCs?

For example, would ABC Securities and XYZ Real Estate Corporation be able to establish an SPC jointly? I guess this will likely be possible; however, a final decision has not been made.
f) Will SPCs Themselves Be Allowed to List?

In principal, SPCs cannot be listed. However, the advent of the J-REIT, the Japanese version of the REIT, was heralded with the fourth round of economic stimulus measures, with the statement, "In our country as well, securities based on real estate, securitized in accordance with the SPC Law, will be positioned as J-REITs. We will promote investment from both domestic and overseas investors. We will consider listing the securities on stock exchanges or otherwise preparing trading markets for them. We will thus seek to reinvigorate the real estate market." I discuss J-REITs, or corporate investment trusts, in detail later in this chapter. At present, the characteristics of J-REITs have not been clearly defined; it seems that only their name or title has been established. Currently, one possible technique that I envision for listing an SPC is to first "package" the SPC with a corporate investment trust (the investment trust would be listed after it purchased securities issued by the SPC). It is likely, in my view, that such a scheme will be adopted for J-REITs. It would be simpler if SPCs themselves could be listed, however, it is unclear at present whether SPCs will be allowed that function.

g) Taxation on SPCs

Table 3 shows the situation regarding SPC taxation. One concern is that the exemption from acquisition taxes is currently considered an exceptional measure to be implemented for two years. This would seem to point to the fact that the SPC Law is intended as an act of legislation of limited duration, and raises doubts about its ability to foster a Japanese securitized product market over the long term. Also, while SPCs are, in principle, exempt from corporation taxes, this exemption is subject to certain conditions, as shown in the note to Table 3. I am concerned that these conditions may be somewhat strict.

Among these tasks, I would be particularly worried about the ultimate usefulness of the
securitization permitted by the SPC Law if strict rules were adopted in relation to the first four significant points that I have mentioned.

B. The Way to J-REITs

1. What Are J-REITs?

The concept of the J-REITs was first put forward in the previously quoted statement regarding securitization made in conjunction with the February 20th announcement of the LDP's fourth round of economic stimulus measures.

The plan is believed to be aimed at attracting not only institutional investors but also many individual investors, to expand the use of SPCs (or, in other words, to increase liquidity through the listing of securities).

However, in reality, the government does not yet know what J-REITs will be or how they will work. For the moment, the REIT seems to be presented as a possibility or goal.

2. The Concept of The J-REITs: SPC + Corporate Investment Trust = Greater Liquidity by Means of Securities Listing

It goes without saying that the creation of a J-REIT market is eagerly awaited. The aim of the J-REIT is to increase investor participation by maximizing the liquidity of real estate asset-backed securities (issued in accordance with the SPC Law). Needless to say, there is a possibility that maximum liquidity could be achieved by listing the securities.

Of course, as I have already mentioned, allowing the listing of SPCs themselves would greatly simplify matters, however, that function has not yet been assigned to SPCs. Assuming that the listing of SPCs themselves is not permitted, it would be appropriate for corporate investment trusts to purchase the securities issued by SPCs and then be listed themselves.

It is also theoretically possible to establish a corporate investment trust and incorporate actual real estate into it. An investment trust reform bill, which will be submitted in the current fiscal
year's ordinary session of the Diet, seeks to ease the regulation of investment trusts, shifting investment trust companies to an approval system from the current licensing system and moving products to a notification system from the current approval system. As a result, XYZ Real Estate corporation would be permitted to establish an XYZ Real Estate Investment Trust and transfer its stock of buildings to the new company. However, real estate is currently not a permitted product for investment trusts, and, as shown in Table 3, the current system of tax benefits would not apply in the case of normal real estate. Ultimately, it would be advantageous from a tax standpoint to invest in real estate by purchasing it in the form of an investment trust product after it has been securitized by SPC.

In addition, from the standpoint of sales ability, rather than real estate companies creating investment trust companies and selling investment trusts, it would be more efficient for a securities company to purchase securities issued by an SPC formed by a real estate company or a general business or financial institution and to create, list, and sell investment trusts. Real estate investment advisory companies would be able to earn fees from advisory business for creating such products and by evaluating and appraising target products and properties. In addition, such third-party institutions will be necessary for the creation of a J-REIT market.

The liquidity risk associated with real estate can be reduced by listing real estate as an investment trust, thus raising liquidity. This can be expected to result in a considerable increase in investment incentive, provided that, as I have already mentioned, SPCs are first given enough functionality to make them worthwhile.
C. Need for a Standard Method of Securitization and Special Legislation

Of course, real estate securitization in Japan will probably not be limited to the previously mentioned SPC-type products or SPC products packaged by corporate investment trusts for greater liquidity. The Real Estate Syndication Law that already exists will probably continue to be used. It is conceivable that the Commodity Fund Law could also be applied. There will also probably be ways of combining the SPC Law with the Real Estate Syndication Law as well. However, having a wide array of different schemes is actually undesirable; without a method of securitization that is to some degree standard, there will be a small amount of liquidity, and there would be no point to securitization without enough liquidity. The enactment of special legislation (a securitization law) combining such things as the SPC Law and corporate investment trusts is essential to producing some standard for securitized products.

D. Fundamental Tasks and Problems Associated with Securitization and Evaluation of Progress

Even when supporting that a standard method of securitization could be established, there are still fundamental issues to consider regarding whether it is truly possible to create securitized products in Japan. As I stated before, many factors present obstacles to real estate securitization. Now I am going to try to consider what types of changes needed that would improve the outlook for securitization.

1. Factors That Block the Creation of Securitized Products

The first major problem that will be encountered when attempting to create a securitized product is the difficulty in securing the cash flow that is a prerequisite to the product. This is due to the following reasons.
a) **Leasing Code**

A lease can be canceled, without penalty, simply by providing six months’ notice. In the Japanese Leasing Code, in general, protections and compensation for tenants can be considered excessive. As a result, it is often the case that owners will shoulder nearly all unforeseen costs. Under a new Fixed-Term leasing Code, which is in the process of being passed in the ordinary session of the Diet, new types of leases – for example, long-term leases and leases that rule out excessive compensation – will become possible. The new code will be applicable only in the case of new contracts; leases concluded under existing laws will remain in effect under those laws. Persistent efforts to shift to the new code will likely be required, and, realistically speaking, a complete switch to the new system will take considerable time. It should be noted that as long as these problems exist, it will be extremely difficult to create securitized products with a redemption term of more than five years.

b) **Large Number of Real Estate Regulations**

In addition to tough regulations pertaining to floor area ratios, a strict Building Standards Law, unduly harsh environmental assessments, and a counterproductive law requiring the attachment of residential dwellings to commercial developments means that an unusually large number of local and prefectural regulations apply to real estate. As a result, it is difficult to expect commercial properties to yield profits. Construction is often halted for up to a year so as to allow excavation in search of objects of possible historical importance, completely stopping cash flow. Other countries may look on certain Japanese systems, such as the deposit system (*kyotaku seido*), under which rent payments to owners can easily be halted, though this may seen unbelievable.
c) **Bankruptcy Law and Corporate Reorganization Law**

It is feared that when owners or rental service companies file for protection under bankruptcy or reorganization laws, the payment of interest or the repayment of original capital to investors could be affected. A securitization law would need to be enacted as special legislation that includes the establishment of countervailing conditions.

2. **Factors That Block Distribution**

a) **Lack of Information about Rents**

In other countries, tenants pay taxes that correspond to Japan's ownership tax, a type of fixed asset tax based on rent revenues. Thus, information on rent is essential for the collection of taxes. In Japan, however, asking rents and agreed-upon rent amounts in new leases are not announced publicly, and trends in rent are, therefore, impossible to ascertain. Efforts toward a system of disclosure on the part of specialists and corporations are desirable.

b) **Does A Trading Market Exist?**

As mentioned previously, there is no standardization in the market for securitized real estate products, and existing liquidity (rent paid to owners by existing - not new - tenants) is therefore limited. Obviously, efforts are needed to enact new legislation specially designed to create standardized products.

c) **Tax System**

Japan's real estate taxation system also needs to be reviewed. Whereas in the US and Europe, where real estate sales profits (transfer profits) are normally included in corporate income and taxed at operating corporate tax rates, in Japan, these are calculated at corporate tax rates of long-term at 5% (5 years or more), short-term at 10% (over 2 years and under 5), or ultra-short-term (under 2 years), lowering the rate of return after tax. Moreover, frequent
revisions in accordance with the economic climate make it hard to evaluate risks and returns. Another important issue is Japan's higher transaction taxes (Real Estate Acquisition Tax and Registration and License Tax) in comparison with the U.S. and Europe, and there is a need to look at reducing real estate taxation costs related to real estate transactions in this country.

d) Separation of Real Estate and Finance
In the United States, with the REIT Law enacted in 1960. Also, real estate has long been treated as a financial product in the United States. In Japan, on the other hand, a policy deliberately separating real estate and finance has been in place since the first oil crisis. The two are even overseen by separate government bodies - MOF and MOC (Ministry of Construction). Banks, in particular, have been prohibited from having real estate operations, and have not even been allowed to set up holding companies to run real estate companies. Given such an environment, it is doubtful that Japan will instantly move harmoniously toward the creation of liquidity through securitization.

e) Differences in Financing Loans
Even if prime properties (actual real estate) are securitized, and if multiple rights of pledge (collateral) are set up in a recourse financing scheme, it would be difficult in practice to transfer a property to an SPC because of cases such as the following: a bank has loaned money to ABC Real Estate, and (part of) the collateral for the loan to ABC Real Estate is set up as a right of pledge on the XYZ Building. It would be difficult for ABC Real Estate to transfer ownership of the XYZ Building to another company of its own accord. In other countries, non-recourse financing - under which separate loans are obtained for each product - is popular, and ownership transfer is simple. In a country without non-recourse financing, a sudden implementation of securitization is not impossible, but it is extremely difficult.
f) Guarantee of Principal, Investors, and Investment Advisory Services

Last fiscal year 1997, a few collateralized real estate loans were actually securitized; however, the risk of secondary loss (the loss that might ultimately be realized on the disposal of the collateral property at the time of redemption) was in each case compensated by a bank subsidiary or an investment bank whose credit was used to back the securities. A proper shift of responsibility to investors did not take place. In the United States, hedge funds and investors known as "grave dancers" boldly assumed such risk, however, doubt remains as to whether Japan's institutional investors are likely to do so. However, it is also true that even if they wanted to assume the risk, there is no way to measure such risk if proper disclosure regarding the real estate in question does not take place. Also, professionals (investment advisors and others) able to appraise the property in a fair setting hardly exist to begin with. Unless a system is established whereby large numbers of such important supporting actors materialize and carry out their roles, it is unlikely that investors willing to take on the risk will emerge. Last year, the establishment of Mitsui Realty, the largest real estate company in Japan, of Mitsui Fudosan Investment Advisory attracted much attention, and other large real estate companies are showing signs of following Mitsui's lead. An accelerated trend in which the plentiful real estate professionals employed by financial institutions - trust banks in particular - set up independent businesses or join forces with foreign companies to create real estate investment advisory companies would be desirable.

g) Servicers (Collection Agents)

Particularly in the case of collateralized real estate lending, nothing will begin without a servicer, special collection agents responsible for collecting loans. In the United States, there are as many as 26 major servicer companies that have obtained ratings, and these servicers contributed to the disposal of the bad debts of S&L in the early 1990s. Under the Attorneys
Law, only lawyers have been permitted to perform collection work; however, a Servicer Law expected to be enacted in the near future (in the fall of 1998) will probably allow private institutions to perform this work as well. It is important that this change be implemented as soon as possible. In addition, the need to obtain the consent of debtor was eased recently. This has reduced the complexity of procedures associated with transfer of credits (for example, from a bank to a foreign financial institution).

h) Appraisal Method

Until the collapse of the bubble economy, the Japanese people generally believed that land prices always increase and never decline ("Land Myth"). Therefore, real estate appraisers mainly considered how much in capital gains they could receive in the near future. Therefore, the real estate prices haven’t reflected the benefit from utilizing that real estate. This completely contradicts the real estate appraisal method in the United States.

i) The Government’s Attitude

With the movement to pass the Fixed-Term Leasing Code and Servicers Law, the government appears to have made reasonable efforts over the past year regarding the previously mentioned revision to the civil code, and efforts to implement securitization. At the same time, however, it made announcements to the effort of, "Even if we create securitized products, investors probably will not buy them, so we will purchase them with public funds (including the funds of agencies under the supervision of MOC). If the government’s objective is to foster the development of a securitized product market, this stance would seem to be unhelpful.
E. Does Securitization Hold Any Incentives for Real Estate Companies?

I have already discussed what is known about the securitization scheme and some of the problems associated with it. Of course, the fiscal contents of the SPC Law will determine to what extent securitization is possible; however, even if securitization creates liquidity, will real estate and construction companies have any incentive to promote it? As far as now, I have to say, at least with interest rate levels as low as they currently are, there is little incentive for securitization. I judge little economic value particularly for parent companies in securitizing an existing, physical property.

To consider an exception, I expect that companies with high liability ratios and heavy interest expense burdens will use securitization as a means of financing new developments. Also, assuming that real estate acquisitions eventually become brisk, after a few years we may see a trend of selling existing properties and purchasing new ones, to take advantage of the exemption of replacement purchases from the tax on transfer profits. In such cases, a scheme in which properties are initially sold to SPCs is a distinct possibility. However, under the current circumstances, more would be lost than gained by securitizing an existing property and using the funds to repay interest-bearing debt.

Below, I am going to consider the merits and demerits of securitization from the point of view of real estate companies, as well as the reason why I think securitizing existing properties holds little meaning for these companies.

1. Parent Company’s Profit or Loss on Sale

When a parent company sells a property to an SPC, the sale generates a profit or loss, as in normal transactions. Although the SPC is exempt from most taxes, normal taxes are imposed on the sellers (i.e., real estate parent companies). When transferring a property to the SPC, the parent company is obligated to do so at the property’s full appraisal price. Assuming that real
estate originally costing $10 billion has a current appraisal value of $200 million, the parent company would have to transfer the property at a price on the same level as the appraisal value and recognize $800 million in losses. Selling the property at a higher price compared with the market price - to delay the realization of the loss until the redemption of the securities - is not permitted under the SPC Law in its present draft form.

2. Interest Rate Levels

To give an example, Mitsui Realty's average cost of borrowing is about 2.6% at May 1998. The company is able to raise funds, on credit, at this low interest rate. If it were to use securitization as a method of financing new development, it would have to attach a coupon of at least 4% - 5%. At least as long as interest rates remain at their current low levels, raising funds through securitization makes no sense for companies with good credit. The same is true even in the case of existing properties.

Table 4 shows a simulation of the impact of the securitization of Kasumigaseki Building (a prime property located at central Tokyo) and of the World Business Garden (WBG) Building (a property of good quality but not enjoying a high operating rate because of its location) on Mitsui Realty's profit and loss statement. This was prepared by Goldman Sachs Japan Ltd. (GS). According to GS's estimates, the Kasumigaseki Building provides an annual cash flow of $67 million (¥9.4 billion). If the property were securitized at a yield of 4%, $1.7 billion (¥234.5 billion) in funds would be recovered, and interest-bearing debt could be reduced by that amount. Comparing this with the resulting $44 million (¥6.1 billion) reduction in interest expense and the parent company's loss of $67 million (¥9.4 billion) in cash flow on transferring the good property to an SPC, we can see that securitization is not in the company's best interest. On the other hand, there would be a larger reduction in interest costs for buildings such as the WBG, which was built during the so-called bubble period. For real estate companies, securitizing groups of less profitable properties would probably hold greater incentive than securitizing prime buildings. The crucial point is that at current low interest-rate levels, the better a company's credit, the less it gains through securitization. From the opposite angle, if interest
rates rise, the strategic significance of reducing liabilities by raising funds and unloading properties through securitization will increase.

3. Probable Main Players: Semi-Majors and Smaller Companies?
However, there is a strong chance that companies that lack the credit of Mitsui Realty (and therefore pay higher interest rates) and are burdened with large borrowing will rely on securitization. Considering this, I guess it is quite possible that the semi-majors and smaller companies, or unlisted companies with limited means of raising funds, will become the main players in securitization in the real estate industry.¹⁵

¹⁵ Goldman Sachs (Japan) Ltd., Japan Research, (Tokyo, April 1998), p.5-15
   Goldman Sachs (Japan) Ltd., Japan Research, (Tokyo, May 1998), p.2-7
Table 4: Pro-Forma Assumption for Mitsui Fudosan: If Two Existing Building Are Converted to an SPC

<table>
<thead>
<tr>
<th>(a) Floor space (sqft)</th>
<th>Assumption A Kasumigaseki Building (built in 1968)</th>
<th>Assumption B WBG Building (built in 1991)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,627,867</td>
<td>1,397,789</td>
</tr>
<tr>
<td>(b) Rentable rate (%)</td>
<td>75.0%</td>
<td>65.0%</td>
</tr>
<tr>
<td>(c) Operating rate (%)</td>
<td>99.5%</td>
<td>90.0%</td>
</tr>
<tr>
<td>(d) Estimated rent per square foot ($ per year, gross)</td>
<td>67.7</td>
<td>30.4</td>
</tr>
<tr>
<td>(e) Estimated revenue ((a)×(b)×(c)×(d): $ millions)</td>
<td>82.2</td>
<td>24.9</td>
</tr>
<tr>
<td>(f) Estimated land price/sqft ($'))</td>
<td>2,314</td>
<td>514</td>
</tr>
<tr>
<td>(g) Land/area (sqft)</td>
<td>46,667</td>
<td>314,967</td>
</tr>
<tr>
<td>(h) Estimated value for land ((f)×(g): $ millions)</td>
<td>108</td>
<td>22,678</td>
</tr>
<tr>
<td>(i) Book value for building ($ millions)</td>
<td>122</td>
<td>293</td>
</tr>
<tr>
<td>(j) Book value for land ($ millions)</td>
<td>28</td>
<td>54</td>
</tr>
<tr>
<td>Costs for leasing ($ millions)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real estate tax and city planning tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k) For building</td>
<td>2.1</td>
<td>5.0</td>
</tr>
<tr>
<td>(l) For land</td>
<td>0.9</td>
<td>1.4</td>
</tr>
<tr>
<td>(m) Depreciation</td>
<td>0.5</td>
<td>10.5</td>
</tr>
<tr>
<td>(n) Cost for lease (estimated by (e)×15%)</td>
<td>12.3</td>
<td>3.7</td>
</tr>
<tr>
<td>(o) Cash flow from the building ((h)-(k)-(l): $ millions)</td>
<td>67</td>
<td>15</td>
</tr>
<tr>
<td>(p) Estimated % of return (coupon)</td>
<td>4.0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>(q) Estimated face value of securitized products ((o)+(p))</td>
<td>1,673</td>
<td>269</td>
</tr>
<tr>
<td>(r) Opportunity loss from shifting the building (including interest costs for construction)</td>
<td>67</td>
<td>15</td>
</tr>
<tr>
<td>(s) Estimated face value of securitized products ($ millions)</td>
<td>1,673</td>
<td>269</td>
</tr>
<tr>
<td>(t) Opportunity gain from saving interest costs (cons. Base*)</td>
<td>43.5</td>
<td>2</td>
</tr>
</tbody>
</table>

*1) Estimated by Official Land Price Survey
*2) Average cost of borrowing (3/97 parent): 2.6%

Source: Mitsui Realty Co., estimated by Goldman Sachs (Japan) Ltd.
4. Outlook for Securitization as a Means of Financing Real Estate Development Projects

I have been discussing the possibility of using securitization as a means of financing new real estate development for some time; however, securitization based on a combination of the SPC Law and corporate investment trusts will actually have little suitability for financing new development. The reason for this is that, as mentioned before, SPCs formed in accordance with the SPC Law will not be permitted to borrow money. New development is often dogged by unforeseen financial needs, and involves a high degree of uncertainty. In such development, a method that incorporates the options available under the Real Estate Syndication Law, which allows SPCs to borrow as business enterprises, could conceivably be employed. First, in the development stage, an SPC (funded by an anonymous association) in accordance with the commercial code would be established as an approval company under the Real Estate Syndication Law. This business enterprise would be able to borrow funds. Next, after completion, when cash flow is being generated, the property would be sold to an SPC and securitized in accordance with the SPC Law.

A more realistic possibility might be for the parent company to handle the development, without employing the Real Estate Syndication Law. When cash flow is generated, the parent could transfer the property to an SPC and securitize it. In the United States, partnerships often handle development and then "REIT out" properties when development work is completed. In any case, investors should be aware that securitization under the current draft of the SPC Law incorporates a restriction on borrowing funds, and is therefore likely to be inappropriate on its own as a method of financing new development.
CHAPTER 5

CONCLUSION

A. Facing a Mature and an Aging Society

Half of the office buildings in the Tokyo's 23 wards district don’t meet with the standards of earthquake-resistant structures and there has been minimal rebuilding or repairs to enhance their resistance to earthquakes. While we are being told that economically, our society is maturing, all we can talk about is the annual doubling of housing prices while we ignore the quality aspects of our existing housing such as spaciousness and structure. On the other hand, as the number of elderly householders who own a home but do not have the means to improve it, increases, interest in more fluid housing assets is on the rise.

While in its bubble economy stage, when it was said that the amount of real estate money spent in Japan would buy four Americas, land was the predominant target for investment, leaving little remainder to invest in buildings and, as a result, we have not created a stockpile of high-quality urban structures for following generations.

B. Benefits of Securitization of Real Estate

Despite the fact that after World War II, Japan continued to rebuild and reorganize office buildings, housing, transport infrastructures, and other structures, factors such as the increased aged component of our population make-up, a fall in population, and stunted economic growth have led to a fall in investment margins for real estate stock.

The securitization of real estate provides greater benefits than simply those related to people in the real estate investment market. It also means the potential to procure new capital and employ assets that can build a superior urban landscape (Table 5). This is because investors will provide the capital to restructure urban stock by forming their own assets.
Table 5: Benefits of Securitization of Real Estate

<table>
<thead>
<tr>
<th>Capital Procurement Firms</th>
<th>Investors</th>
<th>Real Estate Investment Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Diversification of capital procurement methods</td>
<td>- Increased investment opportunities</td>
<td>- Restructured, revitalized market</td>
</tr>
<tr>
<td>- Diverse development enterprises, and methods</td>
<td>- Diversified investment objects</td>
<td>- Lineup of diverse products linked to other financial products</td>
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<td></td>
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<td>- Incentive for new domestic and foreign investors to enter the market</td>
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<td>- Increased market scale thanks to formation of converted securities market</td>
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<td>- Greater emphasis placed on real estate profitability and use value</td>
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<td>- Greater progress in disposal of bad debts and mortgaged real estate</td>
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C. Factors That Will Improve Future Securitization in Japan

Will a meaningful real estate securitization develop in Japan as a result of recent government initiatives? Immediate results are unlikely; however, over the next one or three years, they will come slowly but surely.

There have been many structural and legal changes in the Japanese real estate and financial markets, and the real estate market hit the bottom and began rising after a long period of downward trends. Also, the government realized the importance of this real estate problem and is now seriously trying to change and support the new funding market. As we have seen, large financial institutions started to liquidate their assets, mainly non-performing loans with major foreign investment banks, although most of the deals are not profitable to the Japanese banks.
Economic and political factors that have improved real estate and securitization's future include the following:

1. **Firmer Prices**

As we saw before, after increasing by fourfold from 1985 to 1990, the commercial land price in Japan's six largest cities has declined since then by nearly 80 percent (see Figure 1). However, if the government carries out its planned infusion of capital into long-term real estate property purchases and continues to loosen zoning requirements, and, most important, if it implements a restructuring of real estate tax laws, further support could be achieved.

2. **Economic Expansion**

Japan's GDP expanded 3.6% in 1996, faster than any other major industrialized country. A strong economy equals improved cash flows, which equals stronger collateral value.

3. **Low Interest Rates**

Historically low interest rates (Japan's discount rate is currently 0.30%) reduce carrying costs and lower required returns.

4. **Strengthened Reserves**

Banks have built up loss reserves to better withstand write-downs.

5. **Experience**

Japanese security houses and money center banks have developed valuable experience by securitizing assets in the United States, Europe, and Japan. In fact, Nomura Securities and Daiwa Securities are on the cutting edge of commercial mortgage real estate securitization in both the United States and the United Kingdom.

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6. Political Resolve

Prime Minister Hashimoto and the Liberal Democratic Party have a strong political stake in following through with the financial deregulation.

D. Conclusion

Securitization has been an often-misinterpreted concept; however, it will not eliminate losses from a real estate price bubble, nor will it suddenly make bad assets perform better. In fact, in most cases, because of high seller recourse or third-party support requirements, securitization may not be particularly effective in handling non-performing assets – a primary role for which it has been touted in Japan.

Over the long run, however, securitization can play a helpful role in Japan’s efforts to improve financial market efficiency by:

- Establishing a market that will allow a wide range of investors to freely buy and sell real estate debt and equity exposure, which will thereby improve liquidity and stimulate new demand.
- Providing a vehicle for financial institutions to trim their heavy concentration in real estate risk born from a financial system long overdependent on real estate as loan collateral.
- Requiring realistic, regular cash flow and market valuation reporting.
- Hedging interest rate exposure on long-term mortgage assets.
- Supplying a low-cost alternative funding source\(^\text{17}\).
- Promoting disintermediation in a bank-loan-dominated debt market, which would assist lenders to shift from interest to fee income generation.

\(^{17}\) Securitization may appear more costly than consumer bank deposits; however, when the cost of maintaining the branch network required to generate deposits is factored in, securitization can be very cost-competitive, even in Japan.
• Offering a wider array of investment opportunities to Japanese investors.

The key to securitization's success lies in the will and the motivation of the government and of the key market participants to realistically deal with real estate. Real estate's qualities of permanency and tangibility are accentuated by Japan's geographical limits and social values, however, in the end, real estate is a cash generating asset. Efficient markets must accurately reflect this fact.

In establishing an effective real estate securitization market in Japan, it is important for regulators to look beyond the immediate bad debt dilemma. Securitization is not a miracle cure for current real estate woes; however, it can help provide additional liquidity and stability that will prevent future market failures.
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