Commercial Real Estate Debt Security Market in Japan:
A Comparative Study with the U.S. CMBS Market

by

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Master of Science in Real Estate Development

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Accepted by

William C. Wheaton
Chairman, Interdepartmental Degree Program in
Real Estate Development
ABSTRACT

After the economic bubble burst, the Japanese economy has been inactive over the past ten years. Land price has dropped drastically and Japanese commercial banks have a huge amount of NPLs. Many borrowers have over-borrowed and some of them have declared bankruptcy. Banks cannot make loans actively and many companies suffer from lack of capital. In this situation, many people strongly hope for the development of the Japanese Commercial Real Estate Debt Security market, where companies and banks can get capital directly from the capital market. The value of Japanese real estate is huge, US$23 trillion, and whether the real estate market will become active again or not strongly affects whether the Japanese economy will begin to expand again.

The unique finance and real estate systems in Japan have created the specialized Japanese Commercial Real Estate Security market. This thesis analyzes this emerging market especially for the purpose of helping investors who are familiar with the U.S. Commercial Real Estate Debt Securities to invest in the Japanese Commercial Real Estate Debt Securities.

This thesis consists of three main parts. First, we explain the current conditions of the U.S. and Japanese real estate finance fields. Second, we analyze the Japanese Commercial Real
Estate Debt Security market compared to the U.S. market. In order to better understand the market, we also analyze the unique Japanese financial and real estate systems. Finally, we show several case studies, where we try to verify the arguments of the first two parts by analyzing three Japanese deals and comparing each to their matching US deals. We also try to explain reasons for features of the Japanese market and mention issues for this market to further develop.

This study would not have been possible without the support of players who work on the front lines and many of our colleagues. The players not only provided us with data and knowledge but also shared thought provoking insights. Many colleagues provided important leads to information and materials. We thank them and greatly appreciate their efforts.

Finally, we owe great thanks to Professor Timothy Riddiough who patiently advised and helped us immensely.

Thesis Supervisor: Timothy Riddiough
Title: Associate Professor of Real Estate Finance, Department of Urban Studies and Planning
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CHAPTER I - INTRODUCTION

1.1 Background

The development of the Japanese Commercial Real Estate Debt Security market resembles the initial stage of development of the U.S. Commercial Real Estate Debt Security market in the early 1990’s in some ways, as real estate value as well as traditional lending activities decline. However, different market fundamentals and financial infrastructures of the Japanese real estate and financial market affect the development of the Japanese unique Commercial Real Estate Debt Security market.

1.2 Objective

This thesis intends to analyze the emerging Japanese Commercial Real Estate Debt Security market in order to better understand the market structure and its prospects for development. Our objective is to help investors who are familiar with the U.S. Commercial Real Estate Debt Securities to invest in the Japanese Commercial Real Estate Debt Securities.

The first step is placed on studying the fundamentals that create and drive the Japanese Commercial Real Estate Debt Security market. Factors such as the financial system, the real estate system and the background of the Commercial Real Estate Debt Security market are discussed and compared with the U.S. market in Chapter 2 and Chapter 3. In addition, the current market status in both the U.S. and Japan are compared and analyzed.

In Chapter 4, we try to verify the arguments discussed on this paper by analyzing three Japanese Commercial Real Estate Debt Security deals recently completed in Japan. The major source of data was the prospecti and we compare each to their matching U.S. Commercial Real Estate Debt Security deals. In addition to explaining the similarities and differences of each matched deal, we focus on presenting arguments explaining the different factors which affect the market in Japan and mention issues for the Japanese Commercial Real Estate Debt Security market to develop further.
1.3 Definition

In this paper we compare the Japanese Commercial Real Estate Debt Security market to the U.S. Commercial Real Estate Debt Security market. The Japanese Commercial Real Estate Debt Security market consists of not only Commercial Mortgage Backed Securities ("Japanese-CMBS") but also Commercial Beneficiary Interest of Real Estate Backed Securities ("Japanese-CBIS"). The U.S. Commercial Real Estate Debt Security market consists of only Commercial Mortgage Backed Securities ("US-CMBS"). We will explain the difference between CMBS and CBIS in Chapter 3 in detail.

**Table 1.1 Commercial Real Estate Debt Security Market**

<table>
<thead>
<tr>
<th>Backed asset: Mortgage</th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Backed asset: Beneficiary interest of real estate</td>
<td>N/A</td>
<td>Japanese-CBIS</td>
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<td>N/A</td>
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</tr>
</tbody>
</table>
CHAPTER II – OVERVIEW OF THE U.S. AND JAPANESE REAL ESTATE FINANCIAL MARKET

2.1 The Current Condition of the U.S. Real Estate Financial Market

According to Professor Timothy Riddiough of M.I.T., capital intermediation in commercial real estate has changed fundamentally as a result of the late 1980’s/early 1990’s property market bust. Public market capital now tends to be more forward-looking and less susceptible to herd behavior. This should reduce volatile cycles in commercial real estate markets. However, the quick reaction time of public capital sometimes results in short-term excess volatility and illiquidity in the underlying financial asset market as well as results in increased inter-connections with the broader capital markets.

Currently, the cautious atmosphere has contributed to a slowing of transaction and lending volumes. According to a survey done by consulting firms LendLease and PriceWaterhouseCoopers, investors and lenders are concerned that recent strong rent growth and moderate new construction supply cannot continue, and are demonstrating reluctance to buy or lend on properties using standard capitalization rates and underwriting criteria. Many property sellers are reluctant to sell at prices that do not reflect the current leases and profit potential of their properties. Many other sellers are making the difficult decision to refinance and hold their properties, betting market strength is sustainable.

Mortgage supply remains strong with interest rates declining in recent months as clear signs of an economic slowdown are emerging. However, lender underwriting has grown more conservative. Originations are down significantly due to the slow-down in transactions and refinancing. Mortgage capital for specialty property types is available, but is more costly as the CMBS market continues to be hard on “non-vanilla” property types.

As with the rest of the economy, the biggest real estate investment risks are being taken with technology and Internet companies. Substantial venture capital, industry capital, and even institutional capital are pursuing investment in new real estate related Internet, data, telecommunications and services firms. Equity capital is also being raised to invest specifically in properties or locations that are tied to the “new economy.” How these investments will
influence the broader real estate capital markets is an ongoing story that will unfold in the coming years.

2.2 The Current Condition of the Japanese Real Estate Financial Market

2.2.1 Characteristics of the Japanese Real Estate Market

According to a research issued by the Japanese Government in 1998, the total value of the Japanese real estate market is about US $23 trillion. Another research report by Euroweek in 1998 indicated that commercial property value is estimated to be US $7 trillion, higher than that of the U.S. commercial real estate (US $4 trillion). Due to its gigantic value, the healthiness of Japanese real estate influences not only the Japanese economy, but also the world economy.

One of the distinctive features of Japanese real estate is its high land to total value (land value plus building value) ratio. Japan’s geographic and geological limitations result in an average land to total value ratio in Tokyo’s CBD district in the 70% to 80% range. In the U.S., on the other hand, the similar ratio is between 25% and 35% in Manhattan, New York.

In terms of ownership, most commercial real estate is owned by corporations, real estate companies and life insurance companies. Commercial banks are prohibited by law from owning real properties. To date, there are not many properties that investors own through special purpose vehicles (SPVs). As a result, it is common that the owner of the property is identified as the manager of the property: ownership and management of properties are not considered separate in Japan.

2.2.2 History

Land prices in Japan increased dramatically in the late 1980’s, leading to “the Bubble Economy” (Figure 2.1). The growth rate for residential and commercial land prices increased much more rapidly than the rate of Nominal GNP. Investors expected capital gains from holding land. Such expectations were initially met and led to the illusion that land prices would not decrease. Net income streams from properties were sometimes low or even negative. However, investors recovered normal returns by the capital gains from increases in land value. This encouraged investors to use comparative transaction prices based on land prices in valuing

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1 Property (Hard asset or building) value might decrease due to depreciation. However, the net effect of total value (building plus land) may increase.
properties, instead of the income approach commonly used in the U.S. This method combined with investors' expectations fueled the increasing trend of property prices.

In 1991, the Japanese government imposed a cap on real estate and construction lending by all financial institutions. As a result, land price decreased dramatically. Residential and commercial land prices dropped 55% and 76%, respectively, from 1991 to 1998. As a result, Japanese banks had huge amount of distressed loans. In 1998, Japanese banks had distressed loans estimated to be about $770 billion. Since the property bubble burst in 1991, real estate transactions also became inactive.

![NGNP & Land Price](image.png)

**Figure 2.1 NGNP and Land Price in Japan**

2.2.3 Current Investment Condition

Many Japanese real estate participants are still suffering from over-borrowing because of the drastic decrease in land price. For loans that originated in the "bubble era", a typical LTV today is over 400%. Many of these investors are still struggling with paying back the existing loans and therefore cannot afford to invest in new projects.

In recent years, most investors active in the real estate investment arena are foreign investors. They first entered the Japanese market in 1998 to acquire non-performing real estate loans held by banks and the Cooperative Credit Purchasing Company ("CCPC"). The CCPC reportedly sold about $9 billion in non-performing loans in the 1999 fourth quarter, or two-thirds
of its total loan sales since it was created in the early 1990s. Among foreign investors, the early entrants into the market remain the most active. These players include Cargill, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. These foreign investors also tried to invest in real estate assets but many of them did not succeed in acquiring properties, as many real estate companies could not sell assets due to over-borrowing. On the other hand, Japanese real estate owners who did not suffer from over-borrowing held on to their investments, speculating for better sale prices.

The condition has drastically changed from several years ago because of the market to market pricing amendment to the accounting system enacted in April 2000. Companies are now required to mark up the market price of their properties frequently. Many properties owned by companies now have face values a lot lower than their market values. As a result, many companies must sell these undervalued properties because of decreasing ROA. In addition, many real estate companies, which have been struggling with paying back their debt service, have decided to file for bankruptcy. After filing bankruptcy, the bankruptcy courts sell the properties directly to buyers.

Currently, individuals are considered potential investors in real estate in Japan, which has a very high savings rate. The total saving amount by individuals in Japan is about US$ 12 trillion. Individual investors are now looking for new investment opportunities because of the extremely low saving rates offered by banks. The Japanese real estate market is expected to become more active once these individuals enter the market.

2.2.4 The Emergence of the Public Real Estate Capital Market in Japan

In 1999, Morgan Stanley Dean Witter sold the first securities backed by Japanese non-performing loan portfolios collateralized by office, retail, and apartment buildings. One of the major drivers of the securitization market is the demand of companies to off-balance the real estate they own. The other major driver is increasing acceptance of non-recourse loans in Japan. As of June 2001, there were 38 deals in the Japanese commercial real estate security market, according to available reports.

As for the equity investment market, J-REIT, which was made as US-style real estate investment trust, debuted in March 2001. However, there are not many participants now because the system is not user friendly. For example, the UP-REIT structure is not allowed in Japan.
Additional modifications are needed to develop the J-REIT further. As real estate capital market continues to develop in Japan, more liquidity should be available to investors. This will facilitate the financing of property transactions and increase the participation of individual investors.
CHAPTER III - COMPARISON OF COMMERCIAL REAL ESTATE DEBT SECURITY MARKET IN U.S. AND JAPAN

3.1 Market Overview
3.1.1 U.S. CMBS market and its recent trends

Prior to 1990 there had been several efforts to pool seasoned commercial loans and then securitize cash flows for sale to outside investors. The issuance volume took off when barriers were overcome as a result of the severe commercial real estate recession of the late 1980's and early 1990's. Due to numerous failures of commercial banks and Saving & Loan Institutes, the Resolution Trust Corporation (RTC) was created by the U.S. government to liquidate financially distressed commercial real estate loans by packaging them into bonds. A bulk sales approach was ultimately favored by the RTC and it provided market participants the incentive to develop the conduit market.

The CMBS market continued to experience tremendous growth until the Russian Crisis of 1998. Russia’s default on its bonds sent a shock wave towards U.S. fixed income markets. Investors avoided high credit risk products such as CMBS and caused a dramatic halt to issuance. The CMBS market has entered into a slower phase since the Russian crisis, and products have become relatively less complex in order to suit the decreasing appetite for risk of investors. A combination of higher interest rates and a cyclical low in refinancing activity reduced the new issuance market. Currently, fixed income investors have become more comfortable with understanding risks and returns of CMBS and the market is expected to reach a stable stage of development.

According to a recent survey to CMBS professionals conducted by Han and Cuffee in 2001, current CMBS transactions have adequate subordination levels and still represent good investments to investors. The delinquency rate may edge up, but the spread is expected to tighten. The survey predicts the year 2001 CMBS issuance in the U.S. will reach $44 billion, similar to issuance volume of 2000.

Tad Philipp from Moody’s Investors Service noted that transactions nowadays are smaller in size and more generic. There is also an increase of interest in floating rate transactions as the current volatility of interest rates rises. Seasoned loan transactions are also emerging as a
new product as life insurance companies and banks try to securitize some of the real estate loans on their books. As the transactions in the U.S. have become increasingly concentrated, and selected markets and asset classes are peaking, investors need to exercise greater caution. Supported by the current favorable interest rates, CMBS volume is expected to increase in 2001.

3.1.2 Japanese Commercial Real Estate Debt Security market and its recent trends

The Japanese Commercial Real Estate Debt Security market officially started in 1999. Seven commercial real estate pools were securitized in 1999, with a total volume of ¥151 billion. The market underwent rapid expansion in 2000 and issuance reached ¥550 billion ($5.5 to $6.5 billion), a four-fold increase from 1999’s issuance. Sizes of transactions have ranged from ¥7 billion to ¥63 billion, with average transaction size of approximately ¥23 billion. Market issuance is expected to increase by 35% in 2001.

In the U.S., the only kind of backed asset for commercial real estate securities is commercial mortgages. But in Japan, there are three types of securitized assets that are

(1) Commercial mortgages,
(2) Non-performing loans (“NPL”)
(3) A beneficiary interest of real estate.

We call securities whose backed assets are commercial mortgages, including NPL, as Japanese commercial mortgage backed securities (“Japanese-CMBS”) and securities whose backed assets are beneficiary interest of real estate as Japanese commercial beneficiary interest of real estate backed securities (“Japanese CBIS”).

According to the available reports, there have been two deals of commercial mortgage backed securities in Japan so far, in August 2000 6 non-recourse loans, ¥27,200 million by Orix, and August 2000 ¥10,300 million by JP Morgan. Initially Orix and JP Morgan originated loans for themselves and securitized them.

There have been two deals of NPL backed securities, ¥21,000 million on December 1999, and ¥31,000 million on August 2000. Both the deals are issued by MSDW. MSDW began to buy NPL from 1998 and they securitized them twice while they asked their subsidiary special servicer to resolve the NPLs.
The distinctive characteristic of the Japanese Commercial Real Estate Debt Security market is that CBIS dominate the market. Among 38 Japanese Commercial Real Estate Debt Security deals, 34 deals are Japanese-CBIS.

A beneficiary interest is a right to get the income from entrusted properties. To entrust properties means that the original owner of properties entrusts properties to a trust company ("asset trustee"), which manages them, enhances their value and finally disposes them at the order of original owner. As a beneficiary interest holder, the original owner gets the income from the entrusted properties. Only trust banks can enter the entrusting business.

The following chart shows the difference between Japanese-CMBS and Japanese-CBIS.

**Securities 1:** Commercial Mortgage backed Securities (Japanese-CMBS)

**Securities 2:** NPL backed Securities (Japanese-CMBS)

**Securities 3:** Beneficiary Interest backed Securities (Japanese-CBIS)

In CBIS, securitization is not for lenders but for real estate owners and CBIS are issued at the owners’ demand. This is because the backed assets of CBIS are real estate (beneficiary
interest) and securities are issued for real estate owners to get capital from the capital market and to put the assets out from their accounts (off-balance), while backed assets of CMBS are loans and securities are issued for banks to get capital from the capital market and to off-balance the assets (loans).

3.2 Factors that affect the development of the Japanese Commercial Real Estate Debt Security market

The Japanese financial system, real estate system and the background of the Commercial Real Estate Debt Security market are unique and in many ways different from their U.S. counterparts. Understanding the difference between the two systems is important to good understanding of the Japanese Commercial Real Estate Debt Security market.

3.2.1 Japanese Financial System

*Loan characteristics*

Most of the loans in the U.S. are non-recourse based. The standardized nature of non-recourse loan makes it easy for securitization. This, in turn, enhances the development of CMBS market.

In Japan, loans with real estate collateral are not usually classified as real estate loans. Since real estate companies borrow with companies’ credits, almost all loans to real estate companies are classified as corporate loans. Therefore, when a real estate company develops a land or purchases a building, the financial strength of the company is critical in paying interest or retiring the loans. Because the debt service is not directly pegged to the rental incomes of the properties, real estate companies can pay debt services by income from other projects or even other methods. In some way, this works like cross-collateralization in the U.S. Thus, many Japanese developers own buildings, collect rents from these buildings and allocate the total income to pay each loan’s debt service.

Another confusing fact is when a real estate company becomes a borrower, it is common to collateralize the same property for different loans. Although creditors are recognized by their seniority to the claim of debt, (Senior lien, junior lien, the third lien, etc.), it makes it hard for investors to analyze the actual legal claims on the property should a default occur.
Due to the inadequacy of securitizing recourse corporate loans, the Japanese-CMBS market has to be preceded by the development of a non-recourse loan market. Both Japanese and U.S. banks have started lending non-recourse loans to Japanese real estate borrowers because of increasing demand from investors. To date the non-recourse loans market is growing at very high rate. The continuation of this trend is essential to develop the Japanese-CMBS market into a mature one.

**Cross Industry Knowledge**

One of the major competitive edges of the United States is its human capital. The ability of U.S. to attract and train professionals in both the real estate and financial fields have helped accelerate the development of the U.S. CMBS market.

In Japan, since commercial banks are prohibited from conducting (brokering, developing, investing and managing) real estate business, their only real estate exposure is through making loans to real estate companies. This regulation inhibits cross-industry training of professionals in different fields. This slows down the development of the Commercial Real Estate Debt Security market. Because of the complicated nature of Commercial Real Estate Debt Securities, developing a mature market requires expertise in both financial and real estate fields. There are many experts in either finance or real estate but very few experts in both fields.

On the other hand, commercial banks hold much lease and sale transaction data not available to the general investors. This limitation makes an inefficient use of important information, which further slows down real estate investment activities. Commercial banks are eager to use their edge in real estate market information, and thus are very interested in Commercial Real Estate Debt Security investment, which is allowed by the law since Commercial Real Estate Debt Securities are classified as securities.

**Yield on government paper remains low**

Since 1995, the Japanese government has instituted a “zero interest rate” policy to try to stimulate the economy. This leads to a decrease in yields in the government bond markets. Japanese investors now have a “ravenous appetite for structured paper as yields on JGBs have shrunk.”
Increasing NPL Transactions Expected

Due to the large amount of non-performing loans (NPLs) present on the balance sheets of Japanese conglomerates, there is a large market to securitize NPLs. NPLs resemble the early RTC days, when unstable loans were securitized in order to provide liquidity to the real estate capital markets. To date, two NPL pools have been securitized. This trend is expected to continue and help develop a more liquid public real estate financing market.

Table 3.1 Macro Market Issues (capital related issues)

<table>
<thead>
<tr>
<th>Comparison</th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Characteristics</td>
<td><strong>- Recourse vs. Non-recourse</strong></td>
<td><strong>- Most loans (including corporate and real estate loans) in Japan are recourse.</strong></td>
</tr>
</tbody>
</table>
|                               | • Most of the loans in the U.S. are non recourse. The standardized nature of non-recourse loan makes it easy for securitization | • Non recourse loans started to gain popularity in late 1990s.  
• The non-standardized nature of recourse makes it harder for securitization. |
| Cross-industry knowledge       | **- One of the U.S.’s biggest competitive advantages is its ability to attract professionals with many talents.**  
• The abundance of experts and professionals in both real estate and financial fields helped accelerate the development of the CMBS market. | **- The regulation that commercial banks cannot deal with real estate business inhibits cross industry training in both finance and real estate.**  
• This inhibits the development of commercial real estate debt securities as the product requires expertise in both financial and real estate fields |

3.2.2 Japanese Real Estate System (Property related)

Tenant's Bargaining Power

Tenants in the U.S. basically have protection via the court system. However, the landlord-tenant relationship mostly depends on the real estate market dynamics and also the overall performance of the market.

In general, Japanese tenants have more bargaining power than landlord in Japan. Typically tenants can terminate lease at anytime with a six-month notice without paying a prepayment penalty. As a result it is harder to estimate cash flow because of increased volatility in occupancy rates. On the other hand, landlords cannot evict the tenants even at the expiration
date. Typically, landlords are forced to roll over the lease if a tenant chooses to renew. This applies not only to the residential sector but also to the office and retails sectors. Exceptions are applied when either the tenant breaks the lease or when there are rationales to evict tenants, for example when the buildings need to be demolished or rebuilt.

The tenant protection laws also depress the rent level because the landlord is forced to rollover existing lease regardless of the level of market rent. However, if market rents decline, tenants can easily sign another lease at the prevailing market rents. For leases that were signed at substantially below market rent a long time ago, it is difficult to value the true economic value of the property because of the uncertainty of rollover risks. In March 2000, a new law was passed and gives landlords some power to evict tenants when a lease expires. However, this law only applies to new leases but does not affect existing leases. As a result, the current situation is expected to remain for the time being.

**Lease Term**

In the U.S., most lease terms are standardized as 5-15 years, which makes it easy to be securitized. On the other hand, Japanese real estate leases are typically two to three years in length, including office properties that usually have longer lease terms. Short lease terms make it difficult to predict cash flow because increased rollover risks increase the volatility of cash flow, which makes securitizing the leases harder. Since future market consumption needs are uncertain, longer lease terms can reduce fundamental asset risk due to the more stable and predictable cash flow streams.

**Distressed Real Estate Market as Catalyst for Development**

In the United States, the Savings & Loan crisis in the late 1980’s ultimately led to a bailout from the government. Resolution Trust Corporations packaged the delinquent loans and sold them in securitized bonds, which helped the later expansion of the CMBS conduit market.

The real estate transaction volume in Japan is relatively light due to the following reasons:

a) Real estate values are too high to make frequent transactions.

b) The real estate tax rate is very high: When an investor buys a property, he or she must pay approximately 5% of the transaction price. However, there have been
governmental efforts to mitigate the high transaction tax, such as temporary decrease in property tax rate.

c) Ownership structure is complicated: Lands and buildings are legally and economically separated and are registered accordingly. In addition, there may be division of land ownership within one building. The number of the properties that have simple ownership structure is small.

As a result, the volume of sales transactions has remained low for years. This lack of sales transactions reduces the accuracy of market prices. This could hinder the growth of the Commercial Real Estate Debt Security market.

_Lack of Real Estate Information Disclosure_

In the U.S., although lease information is confidential, a lot of brokerage companies, real estate consulting firms and appraisers have access to anonymous lease sales information, which provide efficient real estate market information to investors and underwriters. As a result, real estate market information is efficiently disseminated to the public.

In Japan, information on all leases and sales is kept in strict secret. Landlords are skeptic that once they release lease information, their bargaining powers relative to the tenants will further decrease. Only some appraisers can understand and accurately appraise real estate transactions. The government has published land value data for decades, but the methodology is based on sales approach instead of the income approach that is commonly used in the U.S. In addition, the prices determined by the sales approach are different from that of income approach. Without efficient market information, the development of the Japanese Commercial Real Estate Debt Security market will be hindered, as investors encounter difficulties evaluating the economic value of a collateral. This is also one of the major reasons why the B-piece market is not as popular in Japan. Investors are more willing to take credit risks by buying investment grade bonds than taking too much real estate risks in the below investment-grade classes.

_Real Estate Capital Market (J-REIT Market)_

In the U.S., mortgage REIT became a key link in a production change that allowed CMBS conduits to offer attractively low rates on originating new loans. Mortgage REITs were
therefore a key to CMBS market growth. Their subsequent troubles let to a steep decline in CMBS market’s competitiveness.

Japanese real estate players (both developers and investors) obtain most of their capital and financing from financial institutions, including banks and insurance companies. Because these financial institutions are still holding a lot of non-performing loans, there is a shortage in the lending market. The creation of J-REITs will act as an alternative source of real estate capital to developers. J-REITs will offer the opportunity for investors, including individuals, to learn how to value real estates. In the future, mortgage J-REITs will also helps increase the number of investors that choose to incur more real estate risk. In the long run J-REITs are expected to actively participate in Commercial Real Estate Debt Security market, especially in the below investment-grade market.

**Real Estate Underwriting Approach**

In U.S., appraisers use three methods to calculate the value of property: sales comparison, income approach and cost approach. Appraisers will use their judgment in determining the final value of the property.

In Japan, the sales approach is the most common method of appraising a property. However, in recent years, many appraisers have begun to use the income approach due to increase demand from investors. This migration facilitates the development of the Commercial Real Estate Debt Security market.

**Table 3.2 Real Estate System**

<table>
<thead>
<tr>
<th>Comparison</th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenant protection</td>
<td>• US laws and courts are usually pro-tenant.</td>
<td>• Due to Tenant Protection Laws, tenants usually have more bargaining power than landlords in Japan.</td>
</tr>
<tr>
<td></td>
<td>• However, the landlord-tenant relationship mostly depends on the real estate market dynamics and also the overall performance of the market.</td>
<td>• With more bargaining power, tenants can cancel leases easily, which make it harder to analyze rollover risk as well as underlying cashflows that support commercial real estate debt security valuations.</td>
</tr>
<tr>
<td>Distressed Real Estate Market</td>
<td>The S&amp;L crisis ultimately led to bailout by the RTC to sell the delinquent loans in packages.</td>
<td>Real Estate Bubble in the 90’s resulted in a lot of non-performing loans, which increases the need for securitization.</td>
</tr>
</tbody>
</table>
3.2.3 Background of the Japanese Commercial Real Estate Debt Security market

Investors’ characteristics

In the U.S., there are a lot of investors who participate in the CMBS market. There is also abundant capital to digest issuances with various risks (Investment grade and non-investment grade classes). Investors are sophisticated and are able to understand the underlying risks. Commercial banks, life insurance companies, Pension funds, and REITs are the major capital sources in U.S. market. Below investment-grade tranche buyers usually come from a handful of investors nowadays, which include specialized real estate opportunity funds.

There are many Japanese institutional investors, including life insurance companies and agricultural cooperative associations. They are familiar with investment in real estate equity and are now starting to buy Commercial Real Estate Debt Securities. However, they are risk adverse investors and eagerly invest in tranches from AAA to A. The problem is that there are few investors who actively choose to expose the real estate risks. There are still few investors of BBB tranche and very few investors of below investment grade, including equity investors.

In April 2001 the amendment of the accounting system was enacted, where off-balance of the property was not permitted when the originators had more than a 5% piece of equity or bonds of the sold property value. This means below investment-grade investors are essential for Commercial Real Estate Debt Security market because originators have to sell at least 95% of property value to a third party to put the property out of their balance. In the future, mortgage Disclosure

<table>
<thead>
<tr>
<th>Disclosure of sales and lease information</th>
<th>A lot of brokerage companies, real estate consulting firms and appraisers have access to anonymous lease and sales information, which provide efficient real estate market information to investors and underwriters</th>
<th>Information on sales transactions and leases is kept strictly confidential. Only some appraisers can correctly estimate a portion of the transactions, which make it hard for investors to analyze the true value of the underlying collaterals.</th>
</tr>
</thead>
<tbody>
<tr>
<td>REIT as capital source</td>
<td>In the U.S., mortgage REIT became a key link in a production change that allowed CMBS conduits to offer attractively low rates on originating new loans. Mortgage REITs were therefore a key to CMBS market growth.</td>
<td>The J-REIT is expected to help increase the number of investors who are interested in taking more real estate risks. In the long run they will be able to invest in commercial real estate debt securities and increase the capital source base.</td>
</tr>
</tbody>
</table>
REITs, real estate investment companies and foreign real estate opportunity funds are expected to actively participate in the below investment-grade market.

Foreign capital is expected to provide extra liquidity to the market. Currently about $20 billion of international opportunity capital has poured into Japan in search of distressed assets. The bargain-hunting trend is expected to continue and some of the capital will undoubtedly move into commercial real estate security investment and provide additional demand for the growing market.

**Availability of Real Estate Indicies & commercial real estate debt security Research**

There are many researchers in the United States who analyze CMBS and publish their findings to the public. They have helped the industry to better analyze and understand commercial default risks. Academic institutions also play a very important role in training students and professionals to better understand the complex CMBS market. Furthermore, real estate indices in the U.S. such as NACREIF help distribute real estate market information quarterly to interested investors. In addition, CMBS indices such as the Lehman CMBS index help disseminate CMBS market information in a fast and efficient manner.

The study of real estate is not common in Japan. There is only one real estate department among all Japanese universities, Meikai University. In addition, real estate indices using the income approach were not created until 1996. The lack of real estate research and real estate indices will definitely hinder the development of Commercial Real Estate Debt Security market, as investors have less available market information to rely on. This is especially important for foreign investors, who are usually not familiar with the Japanese real estate market. As a result, the lack of real estate studies and indices may decrease the depth and liquidity of the Japanese Commercial Real Estate Debt Security market.

**Special servicer**

In the U.S., the main responsibility for a special servicer is to resolve the situation at times of default. They are also responsible for collecting payments and distributing the payments to investors. This structure is necessary for the securitization process because investors do not need real estate expertise in these kinds of situations. This broadens the investor base because non-real estate investors can also participate in the CMBS market.
In Japan, the Minister of Justice approves the establishment of special servicers. There are over thirty companies who have this license. In addition, many special servicers come from the United States, which bring along the real estate know-how in default situations. Special servicers are often established as the subordinate of NPL investors and are professionals at negotiation with borrowers. This facilitates the development of the Japanese-CMBS market.

**Master servicer**

The major role of Master servicers includes acting as registrars or paying agents. In the U.S., master servicer is usually carried out by commercial banks or trusts. Master servicing is also necessary to the Commercial Real Estate Debt Security market as the division of labor helps attract investors with no real estate knowledge. As the Commercial Real Estate Debt Security market expands and the amount of the issues goes up, underwriters require the role of the master servicer. In Japan, special servicers are now studying the master servicer business and they are adding this function right now.

**Information/Technology**

In the U.S., a lot of information is available about commercial mortgages, which facilitates the secondary trading market. It also helps monitoring and lowering the information risk of CMBS. Information such as standard appraisal information, engineering reports and environmental risks help investors to be better informed.

To further the development of the Japanese Commercial Real Estate Debt Security market, certain information deliverables such as standardized engineering reports, environmental reports and earthquake reports are needed for comprehensive credit analysis of loans. If this situation is getting better, more investors will be able to better understand the underlying risks of the bond. Improving the serving industry will also help provide liquidity by advancing interest and principal.

**Earthquake Risk**

In U.S., PML reports are available at a reasonable cost, which help to supply adequate information to underwriters, rating agencies and investors. However, since not all parts of the U.S. are affected by earthquakes, the need for PML reports is smaller than in Japan.
For Japan, only a limited number of qualified engineering firms are available to certify buildings in terms of earthquake risks. Many investors in Japan prefer to invest in buildings built after the construction guideline change in 1981, which imposed more stringent rules for earthquake preventions. To further develop the market in Japan, it is necessary to increase in numbers of engineering firms that can service the increasing demand of earthquake certificates.

**Table 3.3 Backgrounds of Commercial Real Estate Debt Security market**

<table>
<thead>
<tr>
<th>Comparison</th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors Risk Appetite</td>
<td>A lot of investors participate in the CMBS market, and there is abundant capital to digest issuances with various risks. Investors are sophisticated and are able to understand the underlying risks. Commercial banks, life insurance companies, Pension funds, and REITs are the major capital sources in U.S. market.</td>
<td>Although there are many Japanese institutional investors, including life insurance companies and agricultural cooperative associations, they are mostly risk adverse and have eagerly invested in till A tranche. There are few investors who are willing to expose themselves to the real estate risk. The emergence of risk loving investors is necessary to develop the Japanese commercial real estate security market.</td>
</tr>
</tbody>
</table>
| Availability of Real Estate & CMBS Research | • The ACLI data and the Synderman credit default studies help the industry to better analyze CMBS credit risks.  
• Research institutions such as MIT/CRE provides research on real estate | • The study of real estate finance and the research of real estate are not common in Japan. There is only one real estate department among all Japanese universities, Meikai University. |
| Availability of Real Estate & CMBS Index | • Real Estate indices such as NAREIF help distribute real estate market information quarterly.  
• CMBS indices such as the Lehman CMBS indices help distribute market information in a fast and efficient manner. | • There were no real estate indices that utilized the income approach until 1996. As a result, there is no historical data available for investors.  
• The lack of data may inhibit development of the commercial real estate debt security market as investors find it hard to correctly value collaterals. |
| Servicing                       | • Master servicers are important in terms of collection of payments. A healthy master servicing system is important in servicing a large CMBS market. | • As the commercial real estate debt security market expands and the amount of the issues goes up, underwriters will require master servicers to help manage the payments.  
• Special servicers in Japan are now exploring the master servicer business and will probably add this function in the near future. |
3.3 The current market status in the U.S. and Japan

As discussed above, the Commercial Real Estate Debt Security market in Japan is constantly evolving, and is expected to grow into a more mature market in the next few years. Here is a list of qualitative comparisons between the status of the Japanese and U.S. markets.

**Market Size**

The U.S. Commercial Mortgage Backed Securities market has been around for about 10 years. To date, approximately $US280 billion of commercial mortgages in the U.S. has been securitized. The securitized amount is about 15% of the total real estate debt in the U.S.. Issuance has been down since the market’s peak ($78 billion) in 1998: it decreased to 60 billion in 1999 and $50 billion in 2000.

In Japan, Commercial Real Estate Debt Security market started in 1999. Issuance was about ¥151 billion in 1999, and has expanded to ¥550 billion in 2000. Thus, the current total market capitalization is about ¥700 billion.

<table>
<thead>
<tr>
<th>Information/Technology</th>
<th>A lot of information is available about commercial mortgages, which facilitates the secondary trading market. It also helps to monitor and lower information risk of CMBS. Information such as standard appraisal information, engineering and environmental risks help investors to be better informed.</th>
<th>To further develop the Japanese commercial real estate debt security market, standardized engineering environmental and earthquake reports are needed for investors to better analyze the underlying risks of bonds.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earthquake</td>
<td>PML reports are available at a reasonable cost, which help to supply adequate information to underwriters, rating agencies and investors. However, since not all parts of U.S. are affected by earthquakes, the need for PML reports is smaller than in Japan.</td>
<td>Only a limited number of qualified engineering firms are available to certify buildings in terms of earthquake risks. Increasing the number of engineering firms is necessary for development of the commercial real estate debt security market.</td>
</tr>
</tbody>
</table>
Commercial Real Estate Debt Security
Market in Japan, Market Growth,
1998–2000

Figure 3.2 Japanese Commercial Real Estate Debt Security Market Growth

**Originators**

In the U.S., there is a wide range of CMBS originators. Issuers range from small regional banks such as Key Corp. to international securities giants such as Morgan Stanley. Originators in the U.S. can be broadly categorized into three tiers: Investment banks, Commercial banks and Finance companies. Investment banks usually seek loans from regional brokerage firms and securitize the loans. Commercial banks such as Wells Fargo or Nationsbank usually securitize commercial mortgages on their own books. Finance companies such as GMAC or GE Capital also seek loans from regional brokers or may have loan origination functions themselves. After the Russian crisis, many originators began to team up with partners from different tiers in order to get a better balance and diversification of securities. This may be partly due to rating agencies’ requirement for more geographical and economic diversifications within a CMBS issuance.

In Japan, all originators of Japanese CBIS are the real estate owners because backed assets are real estate. Originators include real estate companies, life insurance companies, retail companies, and manufacturers. It is a distinctive characteristic that Japanese manufactures would like to own and manage their properties but because of the April 2000 amendment of the accounting system which requires the market to market pricing, they cannot avoid selling their properties. This is main reason why they want to securitize their own assets. However because they do not have enough knowledge to securitize these assets, investment banks and Japanese
commercial banks play an arrangement roll as a so called “arranger”. Initially, investment banks started this business, but soon after the Japanese banks and their subsidiary security companies caught up with them and now dominate the market because these commercial banks have strong business relationships with corporations.

Now Japanese commercial banks also eagerly originating non-recourse loans at a very low fee for their clients because keeping long-term business relationships is far more important than earning a spread from securitization. Therefore, Japanese commercial banks are also expected to dominate Japanese CMBS market in the near future. Foreign investment banks are expected to have a hard time competing with local financial intuitions due to the differences in fees and their lack of Japanese business relationships.

**Transaction Type**

Most of the U.S. CMBS are conduit style transactions. These transactions have collaterals of about 50 to 300 properties. There are some single-pool transactions, which securitize groups of larger whole loans (>US 50 million). Single asset securitization is also common in the U.S., especially for well-known buildings such as the Mall of America.

Most of the Japanese-CBIS transactions to date are single-asset originated. One of the reasons may be because single asset transactions are easier for investors to understand and to correctly estimate their cash flows. The Seibu Ikebukuro transaction underwritten by Merrill Lynch is the largest Asian commercial real estate security transaction to date. The first multi-class, multi-owner deals are JPM-JC1 and Shiba Asset Finance issued in spring 2001.

U.S. CMBS are one of the most advanced financial engineering products ever created. After 10 years of improvement, current CMBS transactions can better tailor different risks by separating cash flows into additional tranches. For example, the creation of different classes of IO, the addition of different maturity classes and the existence of credit default swaps help investors to pick and choose the credit, interest rate, real estate and duration risks in conduit style transactions which they prefer. In a typical current U.S. CMBS issuance, one will find usually 15-20 different tranches, ranging from AAA-classes to below investment grade classes in the C ratings.
The Commercial Real Estate Debt Security market in Japan is still at its infancy; its product design is much simpler. Among the Commercial Real Estate Debt Security transactions issued in the last two years, almost all have only investment grade classes, and the number of classes is few (usually less than 4 classes).

**Bond Type**

In the U.S., the majority of the CMBS issuances are fixed rate oriented, with a small percentage of floating rate issuance. Historically, floating rate bonds are viewed as more risky and are associated with complex structures such as FASIT, SASCO or RE-REMIC. As investors grow more sophisticated, they welcome floating rate issuances as one way to hedge interest rate risks. The trend has grown in recent months as the Federal Reserve has frequently changed its interest rate policy. Currently, about 20% of CMBS issuances are floating rate with some other individual floating rate classes appearing in conduit issues.

In Japan, almost all Commercial Real Estate Security issuances are fixed rate. One reason is because of the Ministry of Finance’s “0% interest policy”. Since the interest rate environment has been relatively stable, underwriters prefer fixed rate issuances rather than floating rate issuances. In addition, investors seem to prefer a “plain vanilla” structure before becoming more comfortable with analyzing Commercial Real Estate Debt Securities issued in Japan.

**Underlying Collateral/ Property**

Commercial mortgages securitized in U.S. conduit transactions are mostly from five broad categories: Office, Retail (anchored & unanchored), Multifamily, Lodging and Industrial. In a typical conduit transaction, one will find approximately the same amount of office, retail and multifamily loans, with the balance being other property types.

In Japan, most of the underlying properties are offices (~65%). Due to the dominance of single asset transactions (which are typically trophy office buildings), offices represent the majority of property securitized. However, the market is expecting conduit fashion transactions, which include multi-sector properties, to become more popular in the near future.
Rating Agency Influence

Moody’s Investors Service dominated both the U.S. and the Japanese markets by rating the most number of transactions as well as the largest amount of transactions in both markets. International rating agencies such as Moody’s play a critical role in helping to transport securitization skills overseas, by adopting fundamentally similar credit rating approach to different countries, after adjustment for country specific issues. By providing a comparable benchmark that most investors understand and use, rating agencies’ credit ratings help increase the acceptance and liquidity of the new Commercial Real Estate Debt Security products in different countries such as Japan.

Table 3.3 Comparative Analysis between U.S. and Japanese Markets

<table>
<thead>
<tr>
<th>Comparison</th>
<th>U.S.</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Size</td>
<td>• Up to $US 280 billion of commercial real estate mortgages securitized.</td>
<td>• Current market capitalization is Yen 700 billion</td>
</tr>
<tr>
<td></td>
<td>• Year 2000 issuance was approximately $US 50 billion.</td>
<td>• Year 2000 issuance was Yen 550 billion.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Year 2001 predicted volume ~ Yen 740 billion.</td>
</tr>
<tr>
<td>Originators</td>
<td>• Commercial Banks (Wells Fargo, Bank of America)</td>
<td>• Real estate companies, life insurance companies, retail companies, and manufacturers are main originators in Japanese-CBIS market.</td>
</tr>
<tr>
<td></td>
<td>• Investment Banks (Lehman, Merrill Lynch)</td>
<td>• Domestic Japanese commercial banks and their subsidiary security companies are the originators in the Japanese-CMBS market.</td>
</tr>
<tr>
<td></td>
<td>• Finance Companies (GMAC, GE Financial)</td>
<td></td>
</tr>
<tr>
<td>Transaction Type</td>
<td>• Dominated by Conduit Style (Multi-class style) transactions</td>
<td>• Dominated by Single Asset transactions.</td>
</tr>
<tr>
<td></td>
<td>• Some Single Asset (Large Loan).</td>
<td>• No conduits.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Multi-borrower, multi-class transactions emerging.</td>
</tr>
<tr>
<td>Transaction Design</td>
<td>• From Aaa tranche all the way to C tranche</td>
<td>• Mostly from Aaa tranche to Baa tranche.</td>
</tr>
<tr>
<td>Bond Type</td>
<td>• Mostly Fixed Rated Bonds (77%). (ML presentation)</td>
<td>• Mostly Fixed Rate Bonds</td>
</tr>
<tr>
<td></td>
<td>• Some Floating Rate Bonds (23%).</td>
<td></td>
</tr>
<tr>
<td>Underlying Collateral/</td>
<td>• Equally distributed among office, retail and multifamily.</td>
<td>• Mainly office (~67%), and some retail.</td>
</tr>
<tr>
<td>Property</td>
<td>• Currently no distressed real estate securitization transactions.</td>
<td>• About 6% is NPLs.</td>
</tr>
<tr>
<td>Rating Agencies Influence (Market share)</td>
<td>• Moody’s (~80%), S&amp;P (~60%) and Fitch (~50%)</td>
<td>• Moody’s (85%), Japan Credit Rating Agency (25%), S&amp;P (25%)</td>
</tr>
</tbody>
</table>
CHAPTER IV - CASE STUDY

In this chapter, we explain the common and major features of overall Japanese Commercial Real Estate Debt Security deals, that is, structure, vehicle, player, payback method and the role of a trust bank and a servicer. Next, we analyze three Japanese-CBIS deals from their prospecti compared with their matched US-CMBS deals. We show the similarities and differences between each matched deal and explain the underlying reasons. The deals we have chosen are multiple offices, single office, and multiple retails CBIS deals.

4.1 The features of Japanese Commercial Real Estate Debt Security deals

4.1.1 Structure

The structure of Japanese-CMBS is similar to US-CMBS but there are presently no conduit loans in Japan. The structure of Japanese NPL backed securities are similar to RTC or other early 90’s US NPL CMBS. The structure of Japanese-CBIS, which is peculiar and unique, is explained in the following chart.
1. An originator entrusts its property to a trust company (trust bank).
2. An originator gets a beneficiary interest.
3. An originator sells a beneficiary interest to a SPC.
4. The SPC issues securities to investors.
5. The SPC gets the sales proceeds.
6. An originator gets the sales proceeds from the SPC.

The main reasons why CBIS are dominant in Japan are because real estate owners suffered from lack of capital and because the April 2000 amendment in accounting system, which requires market to market pricing to real estate owners, was enacted. We explain it in Chapter V in detail.

The main reason for using trust of properties in this structure is due to a tax issue. If an originator sells the properties to a vehicle, the vehicle must pay property registration and the acquisition tax. But if the originator sells beneficiary interests to a vehicle, the vehicle doesn’t have to pay these kinds of taxes at all, although the originator must pay the trust registration tax. In addition, when a trust company declares bankruptcy, creditors of the trust company cannot get trust property because the entrusted property is totally independent from all other assets of the trust company.

4.1.2 Vehicle

Another distinctive feature of Japanese Commercial Real Estate Debt Securities is a vehicle which issues securities. There are two types of vehicles. One is an offshore SPC, the other is a Japanese SPC (TMK). Offshore SPCs are used because they are a bankruptcy remote entity. Offshore SPCs, especially Cayman SPCs, issue the stock to a charitable trust. Charitable trusts have voting rights but because the charitable trust is irrelevant to an originator, offshore SPCs are totally independent from the originator and even if an originator declares bankruptcy, the creditors cannot get the SPC assets.

Japanese SPCs (TMK) are established based on the September 1998 SPC Law for the government to enhance the securitization of assets. The features of the Japanese SPC (TMK) are the followings:

- The minimum required capital of a SPC is ¥3 million.
- SPCs can be established with a single director.
- A SPC must file an “asset securitization plan” with the Japanese authorities before it can commence a securitization program.
- A SPC is prohibited from engaging in any business activities other than those specified in its filed asset securitization plan.
- SPCs can acquire a wide spectrum of assets, including receivables, loans, real estate interests and trust beneficial interests.
- SPCs can issue debt securities, commercial paper and preferred equity securities.
- SPCs can obtain substantial relief from corporate level taxation, and thus achieve “pass through” treatment, by disbursing at least 90% of their distributable income in each fiscal year and complying with certain other specified conditions.

The SPC Law constitutes an important development. The tax changes relating to corporate level taxation may make SPCs established under the SPC Law viable vehicles for securitization transactions. But it is widely suspected that they will not have the flexibility offered by special purpose vehicles used in other jurisdictions such as companies established in the Cayman Island and REMICs and FASITs in the US. Some problems cited include the following:

- The need to file an asset securitization plan will prevent changes to a deal structure in a timely fashion if market conditions change.
- The SPCs cannot issue multiple series of asset-backed securities.
- An absence of bankruptcy remoteness.
- Taxes on transfer profits (capital gain taxes) are imposed on sellers when assets are transferred to the SPC.

In terms of the capital gain tax, tax on transfer profits could be deferred in the REMIC in US CMBS. That is, a sponsor of mortgage loans is treated as receiving the REMIC regular and residual interests in exchange for the assets contributed. The sponsor allocates its basis in the assets contributed to the regular and residual interests in proportion to the fair market value of those interests as of the pricing date. At this time the sponsor does not have to pay tax. If the
interests are sold, gain or loss is computed by comparing the sale price to the allocated basis in the interest disposed. If the sponsor retains an interest in the REMIC, any difference between the fair market value of the interest and its allocated basis is deferred and recognized over the life of the REMIC for residual interests.

By virtue of these problems, deals which use the Japanese SPCs are about only half of all deals. According to a J.P. Morgan report, 13 of 26 deals employed the Japanese SPC while 11 deals employed the offshore SPC structure as of March 2000. In addition, many deals utilizing the Japanese SPC structure also employed an offshore SPC to further improve the bankruptcy remoteness. The typical structure utilizing not only a Japanese SPC but also an offshore SPC was shown in the former chart.

4.1.3 Player

Typical players of Japanese CMBS share many traits with those of US CMBS. On the other hand, players of Japanese CBIS have many differences compared to US CMBS. The following table compares the two.

<table>
<thead>
<tr>
<th></th>
<th>US CMBS Player</th>
<th>Japanese CBIS Player</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originator</td>
<td>Regional banks, non-bank (lender)</td>
<td>Real estate owner</td>
</tr>
<tr>
<td>Underwriter</td>
<td>Lead manager (Investment bank)</td>
<td>Lead manager (mainly Japanese securities companies)</td>
</tr>
<tr>
<td>Asset Servicing Agency (Asset: loan /property)</td>
<td>Servicer (loan agent)</td>
<td>Trust bank (property agent)</td>
</tr>
<tr>
<td>Bond Trustee</td>
<td>Bank</td>
<td>Typically main bank of originator</td>
</tr>
<tr>
<td>Issuer of bonds</td>
<td>Trust Fund</td>
<td>Subsidiary or branch of offshore SPC or Japanese SPC in Law</td>
</tr>
<tr>
<td>Owner of real estate</td>
<td>Borrower</td>
<td>Originator</td>
</tr>
</tbody>
</table>
4.1.4 Principal payback method

Because backed assets are a beneficiary interest of properties in Japanese CBIS, the principal is paid back mainly by selling properties by the security maturity date. Because it takes long time to sell properties, typically there is a tail period, usually two years, before the maturity date in CBIS. In this period prepayment is allowed at each time the property is sold. And there are many cases where the originator has a right to buy the property back before a tail period. (An originator has a first refusal right to buy the properties.)

In the U.S. the principal is typically paid back by refinancing mortgage loans. Recently almost all balloon dates are established before the maturity date of securities (external tail), which decreases the risk of refinancing and of principal payback default risk.

4.1.5 The role of a trust bank (Japanese property agent) and a servicer (US loan agent)

A trust bank has a right to sell the property at the market price if the price is greater than the outstanding balance of securities in the tail period. If the sales price is expected to be less than the outstanding balance of securities, the issuer must get the approval of investors to dispose the properties and after that a trust bank starts to sell the properties.

A servicer usually has a right to determine how to sell the collateral or how to work out distressed loans when the borrower is default pursuant to the contract which was made when the securities were issued.

A trust bank has no obligation to make a Monthly Payment Advance. On the other hand, a servicer might be obligated to make a Monthly Payment Advance in an amount equal to the monthly payment on the mortgage loan that was delinquent as of the close of business.

4.2 Case study of Multiple Offices

4.2.1 Deal Description

(1) Japanese Deal

Sumquest Co., Ltd. (Sumquest), a Japanese KK whose shares are solely owned by a bankruptcy-remote Cayman Island SPC, issued unsecured, domestic notes with limited recourse.
Sumitomo Realty entrusted five office buildings located in central Tokyo and Kawasaki to a trust under the terms of a trust agreement with The Sumitomo Trust & Banking (Sumitomo T/B). Sumitomo T/B issued senior and junior beneficiary interests to Sumitomo Realty, who sold all the senior certificates to Sumquest. The notes are backed by the senior beneficiary interest. The subject properties will be liquidated upon the default of the notes, or in a situation where the senior trust certificates are not prepaid on July 14, 2004. The final rated maturity of the notes is two years after July 14, 2004. Hence, there is a two-year liquidation period. The subordinate levels (Series B and C notes) as well as the junior beneficiary interest are owned by Sumitomo Realty.

If the actual debt service coverage ratio (ADSCR) falls below 2.75, all the free cash flow after debt service will not be distributed to junior trust certificates holders but will be reserved in an account under the name of Sumitomo Trust (“trapping mechanism”).

Sumitomo Realty has a right to prepay the notes on July 14, 2004 in exchange for getting the ownership interest of the portfolio. If Sumitomo Realty does not prepay the notes, the property trustee will begin the liquidation of the portfolio. The notes are prepaid each time when a property in the portfolio is sold in the prepayment period, for two years, and the trustee will sell all of the properties by July 14, 2006.

**Japanese Multi-Office Deal “Sumquest Co. Limited”**

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating</th>
<th>Amount (□)</th>
<th>LTV (x)</th>
<th>DSCR</th>
<th>Interest Rate</th>
<th>Issue Price</th>
<th>Expected Maturity</th>
<th>Rated Final Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Aa2</td>
<td>16,300</td>
<td>43.2</td>
<td>2.18</td>
<td>2.09%</td>
<td>100%</td>
<td>7/14/04</td>
<td>7/14/06</td>
</tr>
<tr>
<td>B</td>
<td>A2</td>
<td>3,400</td>
<td>52.2</td>
<td>1.81</td>
<td>2.59%</td>
<td>100%</td>
<td>7/14/04</td>
<td>7/14/06</td>
</tr>
<tr>
<td>C</td>
<td>Baa3</td>
<td>4,800</td>
<td>65.0</td>
<td>1.45</td>
<td>3.54%</td>
<td>100%</td>
<td>7/14/04</td>
<td>7/14/06</td>
</tr>
</tbody>
</table>

(*) LTV of CBIS means the ration of security amount, instead of loan amount, to the property value.

**Structure Summary**

<table>
<thead>
<tr>
<th>Issuer:</th>
<th>Sumquest Co., Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structure Type:</td>
<td>Direct issuance</td>
</tr>
<tr>
<td>Interest Payment:</td>
<td>Semi-annually</td>
</tr>
</tbody>
</table>
Redemption: No
Property Trustee: Sumitomo Trust & Banking
Property Manager: Sumitomo Realty & Development Co. Ltd.
Note Trustee: Sumitomo Bank
Principal Paying Agent: Daiwa Securities SBCM Co. Ltd. / IBJ Securities Co. Ltd.
Launch Date: June 17, 1999

<table>
<thead>
<tr>
<th>Portfolio Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying assets: Five office buildings located in central Tokyo and Kawasaki</td>
</tr>
<tr>
<td>Ownership Interest: Fee Simple</td>
</tr>
<tr>
<td>Property Type: 35,146 sqm net rentable area in total (one building has a small portion reserved for residential use)</td>
</tr>
<tr>
<td>Valuation: □45,926 million by Real Estate Appraisal (REAC) as of Feb.1999)</td>
</tr>
<tr>
<td>Loan-to-Value: 53.3%(REAC), 65.0%(Moody’s)</td>
</tr>
<tr>
<td>DSCR(Moody’s): 1.45x based on Moody’s hurdle rate of 6.5%</td>
</tr>
</tbody>
</table>

2) US deal

TrizecHahn Office Properties Trust CMBS, which was issued on August 1999 by Goldman Sachs & Co., is a typical example of Commercial Mortgage Pass-through Certificates in the U.S.. TrizecHahn Office Co. is a subsidiary of TrizecHahn Office Properties, which is one of the largest and most broadly based real estate companies in North America with a market capitalization in excess of $7.1 billion. With 11 Class A and B office properties backed, it has $295 million in loans and $160 million of Aaa tranche. The trust fund consists primarily of a single, newly originated, floating rate mortgage loan made by the originator (Secore Financial Co.,) and the initial interest rate is LIBOR plus 95 bps. The transaction has 50.1% of overall LTV and the DSCR of the portfolio, based on NCF and a spread of 95 bps current 1 month LIBOR, is 2.35x.
US Multi-Office Deal “TrizecHahn Office Properties Trust”

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating (Moody's)</th>
<th>Amount ($,000)</th>
<th>LTV</th>
<th>DSCR</th>
<th>Interest Rate</th>
<th>Issue Price</th>
<th>Expected Maturity</th>
<th>Rated Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Aaa</td>
<td>160,200</td>
<td>27.2</td>
<td>4.32x</td>
<td>LIBOR+.5%</td>
<td>100%</td>
<td>08/15/05</td>
<td>08/15/07</td>
</tr>
<tr>
<td>B</td>
<td>Aa1</td>
<td>21,800</td>
<td>30.9</td>
<td>3.81</td>
<td>LIBOR+.6%</td>
<td>100%</td>
<td>08/15/05</td>
<td>08/15/07</td>
</tr>
<tr>
<td>C</td>
<td>Aa2</td>
<td>23,350</td>
<td>34.9</td>
<td>3.37</td>
<td>LIBOR+.7%</td>
<td>100%</td>
<td>08/15/05</td>
<td>08/15/07</td>
</tr>
<tr>
<td>D</td>
<td>A2</td>
<td>36,250</td>
<td>41.0</td>
<td>2.87</td>
<td>LIBOR+1.2%</td>
<td>100%</td>
<td>08/15/05</td>
<td>08/15/07</td>
</tr>
<tr>
<td>E</td>
<td>Baa2</td>
<td>25,350</td>
<td>45.3</td>
<td>2.59</td>
<td>LIBOR+2.0%</td>
<td>100%</td>
<td>08/15/05</td>
<td>08/15/07</td>
</tr>
<tr>
<td>F</td>
<td>Baa3</td>
<td>28,050</td>
<td>50.1</td>
<td>2.35</td>
<td>LIBOR+2.6%</td>
<td>100%</td>
<td>08/15/05</td>
<td>08/15/07</td>
</tr>
</tbody>
</table>

Structure Summary

Issuer: TrizecHahn Office Properties Trust
Structure Type: Mortgage Pass-through
Interest Payment: Monthly
Property Trustee: State Street Bank and Trust Company
Principal Paying Agent: AMRESKO Services, L.P.
Launch Date: August 18, 1999

Portfolio Summary

Underlying assets: Eleven office properties located in seven states in the U.S.
Ownership Interest: Fee Simple
Property Type: 4,886,442 sqm net rentable area in total
Loan-to-Value: 50.1%
DSCR: 2.35x based on NCF and a spread of 95 bps current 1-month LIBOR
4.2.2 Comparative analysis of the Japanese deal

Although many factors of these two deals have similar features, we found that there are also some critical differences between the two deals.

(1) Similarities

Water-fall distribution process

The distribution of principal in the Japanese-CBIS and US CMBS pool is allocated to class A1 through the lowest tranche. Losses in the pool are allocated in the reverse sequential order from the lowest tranche to the highest tranche.

Cross-collateralized asset characteristics

There is no cross collateralized clauses in Japanese deal. However, a beneficiary interest is the interest of all properties. That is, a beneficiary interest holder can get income from all properties at once and distribute the income to securities investors. This means that beneficiary interest works practically cross collateral.

(2) Differences

Assets

In the Japanese deal assets are five office buildings located in Tokyo and Kawasaki. In the U.S. deal the assets are 11 commercial mortgage loans secured by 11 office buildings.

LTV and DSCR

From the tables above, we found that the overall LTV and DSCR level in the same tranche of Japanese deal is higher than those of US deal. It indicates the Japanese deal is considered comparatively stable by the rating agency. We argue some points as follows.

- Asset substitution is allowed in the US deal. The borrowers may replace in the aggregate up to four of the mortgaged properties with comparable properties, provided that the percentage of the aggregate principal amount outstanding on the mortgage loan allocated to such replaced properties does not exceed 25%. This allowance can be a negative factor when
rating the securities. On the contrary, any kind of asset substitution is prohibited in the Japanese deal.

- The Japanese deal has a trapping mechanism. This is a kind of cash reserve and the holder of the tranche can get the income from this reserve even when tenants default. The Japanese deal is more stable because the tranche holder is protected from default in some sense.
- All properties in the Japanese deal are class A office buildings located in the Tokyo area unlike the US deal in which all properties are either class A or class B office buildings. The number of tenants is much higher in the Japanese deal and well diversified. So is the quality of the tenants in Japan.
- In the U.S. deal, the mortgage loan is freely prepayable by the borrowers without any obligation to pay a premium, fee or other charges. This may be a big concern to investors. On the contrary, there is no prepayment clause in Japanese deal. Generally, prepayments on the mortgage loan will tend to shorten the weighted average lives of the certificates whereas extension of the scheduled maturity date of the loan will tend to lengthen the average lives of the certificates. Any changes in such weighted average lives may negatively affect the yield to the investors, thus having a negative impact on the rating process.
- The Japanese economic situation as well as the cycle of the real estate market in 2000 is near the bottom and most investors expect the market to move upward. This trend can be a positive factor for the security rating.

However, there are also some factors that might contradict our argument, as listed below:

- In Japan, a lease term is typically two years and tenants have a right to terminate the contract even before the expiration date as discussed before. This means the cash flow from property is more volatile and means more risky.
- Because CBIS are not loans backed securities but beneficiary interest securities, cash flow is more volatile than that of CMBS. In CBIS interest and principal payment of securities come from not debt service of loans but rents of properties directly. Security interest is directly affected by rent paid by tenants. There are many types of tenants and landlords might typically exanimate tenants less than lenders do borrowers. We think CBIS have more volatile cash flow and should be more conservative DSCR.
In Japan, principal is paid back by sales of the properties while in the U.S. principal is paid back by refinancing mortgage loans. It is clear that refinancing is easier than selling properties and principal payback is more risky in CBIS than in CMBS.

In the U.S. deal, mortgaged properties are located in seven states. The highest state concentration is in California representing 36% of the pool allocated loan balance, followed by Georgia representing 31.8%. Almost all mortgaged properties in the Japanese deal are concentrated around Tokyo. In terms of earthquake risk, because all of the mortgaged properties are located at a region with relatively high risk and frequency of earthquakes, the majority of the mortgaged properties can be damaged for losses caused directly or indirectly by earthquakes.

Despite these negative factors in assessing securities, we think that the Japanese deal has a good reason to be less conservative based on the factors mentioned above.

The number of tranche

The number of tranche in the Japanese deal is fewer than that in the U.S. deals. Furthermore, in view of the tranche structure of the Japanese deal, although it has three different tranches – Aa2, A2 and Baa3 - investors can invest only in the Aa2 grade security. The other two are owned by the originator.

The key reason is that the Commercial Real Estate Debt Security market in Japan is in its very early stages and there have been few risk loving investors. Most investors would not prefer complicated and diversified tranches until they have come to be familiar with the market. That’s why there is only one tranche open to investors and the originator buys the other lower classes – Aa2 and Baa3. The amendment of the accounting system enacted in April 2000, where an originator cannot hold greater than 5% piece of the whole value of the property for the purpose of off-balance, discourages these types of transactions because the originator cannot off-balance his assets.

No AAA tranche in Japanese deal

In the Japanese deal there is no AAA tranche. That is because, we think, the Japanese Commercial Real Estate Debt Security market is in the early stage of development and the
number of investors is small. At the result the originator makes the bonds to the demands of the specific investor and there are many cases where an originator does not have to make a AAA tranche. In addition, current investors are usually willing to take a risk for not only AAA but also AA tranche, thus they must little perceive the actual difference between AAA and AA tranche.

4.3 Case study of Single Office

4.3.1 Deal Description

(1) Japanese Deal

MM Property Funding Co., Ltd. (MM Property), a Japanese KK whose shares are solely owned by a bankruptcy-remote Cayman Island SPC, issued unsecured, domestic bonds with limited recourse.

Morinaga Seika Co. Ltd. (Morinaga Seika) entrusted its head office building located in central Tokyo to a trust under the terms of a trust agreement with The Mitsubishi Trust & Banking (Property Trustee). Property Trustee issued a beneficiary interest to Morinaga Seika, who sold it to MM Property. The notes, total amount ¥13,500M, are backed by the beneficiary interest. MM Property makes a Tokumei-Kumiai contract, where Morinaga Nyugyo, a group company of Morinaga Seika, is a Kumiai-in (investor) and MM Property is Eigyosya (operator), and MM Property gets equity, ¥11,500M, from Morinaga Nyugyo. Takumei-kumiai is a Japanese partnership consisting of Eigyosya and one or more Kumiai-ins. In Tokumei-kumiai, it is an Eigyosya who does the business as the representative of the Kumiai-in and the Kumiai-in doesn’t participate in the business and there are no cases where he has a right and obligation connection with the third party of the business. The Kumiai-in has a limited liability within the amount of their equity invested. In this case Tokumei-kumiai works for a credit support because its dividends are inferior to the interest and principal payback of bonds.

Property Trustee asks Morinaga Nyugyo to manage the property. Morinaga Nyugyo has a master lease contract with Mitsubishi T/B, who has a sublease contract with the existing tenants.
The difference, ¥1,400M, between sales proceeds of bonds and equity of Tokumei-kumiai (¥25,000M) and the purchase price of beneficiary interest (¥23,600M) is saved in a cash reserve account, which is prepared in case the interest or principal of bonds would default.

The notes will expire on February 2007. The trust will sell the property between February 2005 and February 2007 under the bid competition. But (1) If MM Property re-issues bonds or (2) if Morinaga Nyugyo, the investor of Tokumei-kumiai, reinvests equity and if the amount is enough to pay back the balance, the notes will be paid back on February 2005.

**Japanese Single-Office Deal “MM Property Funding Co. Limited”**

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating</th>
<th>Amount (¥, M)</th>
<th>LTV</th>
<th>DSCR</th>
<th>Interest Rate</th>
<th>Issue Price</th>
<th>Special Maturity</th>
<th>Final Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>AA+</td>
<td>3,500</td>
<td>36.0</td>
<td>n/a</td>
<td>1.745</td>
<td>100%</td>
<td>2/21/05</td>
<td>2/21/07</td>
</tr>
<tr>
<td>B</td>
<td>AA</td>
<td>5,000</td>
<td>36.0</td>
<td>n/a</td>
<td>1.970</td>
<td>100%</td>
<td>2/21/05</td>
<td>2/21/07</td>
</tr>
<tr>
<td>C</td>
<td>A</td>
<td>2,500</td>
<td>46.6</td>
<td>n/a</td>
<td>2.370</td>
<td>100%</td>
<td>2/21/05</td>
<td>2/21/07</td>
</tr>
<tr>
<td>D</td>
<td>BBB</td>
<td>2,500</td>
<td>57.1</td>
<td>n/a</td>
<td>3.070</td>
<td>100%</td>
<td>2/21/05</td>
<td>2/21/07</td>
</tr>
</tbody>
</table>

**Structure Summary**

**Issuer:** MM Property Funding Co., Ltd.
**Originator:** Morinaga Seika Co. Ltd.
**Structure Type:** Direct issuance
**Interest Payment:** Semi-annually
**Redemption:** No
**Property Trustee:** Mitsubishi Trust & Banking
**Property Manager:** Morinaga Seika Co. Ltd.
**Note Trustee:** Daiichi Kangyo Bank
**Principal Paying Agent:** Daiichi Kangyo Securities
**Launch Date:** February 28, 2000

**Portfolio Summary**

**Underlying asset:** An office buildings located in central Tokyo
**Ownership Interest:** Fee Simple
**Property Type:** 15,000sqm net rentable area in total
**Valuation:** ¥23,676 million
**Loan-to-Value:** 57.1%
**DSCR:** 2.5x
(2) US Deal

280 Park Avenue Trust CMBS, which was issued on January 2001 by Morgan Stanley Dean Witter, ABN AMRO Bank N.V. and Tokyo-Mitsubishi International PLC is a Commercial Mortgage Pass-through Certificates backed by a US $270 million, fixed-rate mortgage loan originated on December 18, 2000. The borrower is BP 280 Park Avenue LLC, a special-purpose entity, whose single member is indirectly 100% owned by Boston Properties LP. The collateral is 280 Park Avenue, a 1.2 million square foot, Class A Midtown Manhattan single office property.

The Certificate has 9 different tranches from triple-A to triple-B and most of them are fixed rate except one variable rate that is LIBOR+0.39%. The transaction has 59.3% of the cumulative LTV and the $270 million loan has a DSCR of 1.62x.
US Single-Office Deal “280 Park Avenue Trust”

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating (Moody’s)</th>
<th>Amount ($,000)</th>
<th>LTV</th>
<th>DS CR</th>
<th>Interest Rate</th>
<th>Issue Price</th>
<th>Expected Maturity</th>
<th>Rated Final Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-1</td>
<td>Aaa</td>
<td>35,656</td>
<td>36.3</td>
<td>2.65</td>
<td>6.148%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>A-2</td>
<td>Aaa</td>
<td>56,344</td>
<td>36.3</td>
<td>2.65</td>
<td>6.494%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>A-2F</td>
<td>Aaa</td>
<td>73,000</td>
<td>36.3</td>
<td>2.65</td>
<td>LIBOR+.39%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>B</td>
<td>Aa2</td>
<td>31,000</td>
<td>43.1</td>
<td>2.23</td>
<td>6.640%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>C</td>
<td>A2</td>
<td>31,000</td>
<td>49.9</td>
<td>1.92</td>
<td>6.756%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>D</td>
<td>A3</td>
<td>8,000</td>
<td>51.6</td>
<td>1.86</td>
<td>6.863%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>E</td>
<td>Baa2</td>
<td>23,000</td>
<td>56.7</td>
<td>1.69</td>
<td>7.145%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
<tr>
<td>F</td>
<td>Baa3</td>
<td>11,805</td>
<td>59.3</td>
<td>1.62</td>
<td>7.340%</td>
<td>100%</td>
<td>2/03/11</td>
<td>2/03/16</td>
</tr>
</tbody>
</table>

Structure Summary

Borrower: BP 280 Park Avenue LLC
Structure Type: Senior/subordinate pass-through
Interest Payment: Monthly
Seller: Morgan Stanley Dean Witter Mortgage Capital Inc.
Underwriter: Morgan Stanley Dean Witter
Trustee: LaSalle Bank National Association
Master Servicer: Wells Fargo Bank, National Association
Special Servicer: Wells Fargo Bank, National Association
Fiscal Agent: ABN AMRO Bank N.V.

Portfolio Summary

Underlying Asset: One office property(two towers) located in Mid-Manhattan
Location: On the west block-front of park Avenue, between 48th and 49th
Property Type: Class A office with 1.2 million rentable square feet
Property Management: Boston Properties Limited Partnership
Appraised Value: $455 million
Cumulative LTV: 59.3%
Cumulative DSCR: 1.62x
4.3.2 Comparative analysis of the Japanese deal

Both deals are single office deals and the big portion of the default risk comes from the risk of the asset. The water-fall distribution process is the same in both deals. We discuss the following differences.

**LTV**

From the tables above, the overall LTV is almost the same in the same tranche of the Japanese and the US deals. It indicates the Japanese deal is considered as stable as the US deal. We think this is the result of tradeoff between its more stable factors and its less stable factors. Following are the factors which affect the risk of the Japanese and US deals. First we mention positive factors of default risk for the Japanese deal and second we point out the negative factors for the Japanese deal.

- The Japanese deal has cash reserve of ¥1,400M. This is paid by Morinaga Nyugyo as Kumiai-in of Tokumei-kumiai. This is prepared in case of default of the principal and interest. (+)
The roll-over risk in the Japanese office is smaller because the expiration date of the main tenant, Morinaga Nyugyo, is longer than the final maturity of the bonds, while in US the tenants roll-over risk is also small because just ten of fifty-one tenants have expiration dates before the maturity of the bonds, representing 36.5% of the total rentable area. (+)

The Japanese economic situation as well as the cycle of the real estate market in 2000 is near the bottom and most investors expect the market upward. This trend can be a positive factor for the security rating. (+)

Both assets are in the center of business districts, Tokyo and NY. But the Japanese office is not a class AAA building while the U.S. property is a class AAA building. (-)

A group company of the originator, Morinaga Nyugyo, is the main tenant of the Japanese office. The number of tenants is much more diversified in the U.S. deal. The number of tenants is 51 in the U.S. office. (-)

As discussed before, in Japan a lease term is typically two years and tenants have a right to terminate the contract. (-)

In Japan, principal is paid back by sales of the properties or reissue of bonds or buy-back by the group company of the originator, while in the U.S. principal is paid back by refinancing mortgage loans. It is clear that refinancing mortgages is easier than selling properties or reissuing securities. (-)

Considering these negative and positive factors of the Japanese deal, the default risk is almost the same as that of the U.S. deal resulting in the same level of LTV of each tranche.

The number of tranche

The same as the discussion of the multiple offices.

No triple A tranche in Japanese deal

The same as the discussion of the multiple offices.
4.4 Case study of Multiple Retails

4.4.1 Deal Description

(1) Japanese Deal

New Shopping Centers Funding Co., Ltd. ("NSCF"), a Cayman Island Special Purpose Vehicle, issued unsecured, domestic notes with limited recourse.

Mycal group 5 retail companies ("Mycal 5") entrusted their 10 retail properties located in Hokkaido, Kanto (including Tokyo), Kansai (including Osaka) and Shikoku to a trust under the terms of a trust agreement with Yasuda Trust & Banking (Property Trustee). Property Trustee issued the first, second, and third beneficiary interests to Mycal 5, who sold them to the Tokyo branch of Shopping Centers Funding Co, Ltd ("SCF"). The Tokyo branch of SCF bought them by (1) borrowing a non-recourse loan secured by the first beneficiary interest from the Tokyo branch of NSCF, (2) borrowing a mezzanine loan secured by the second beneficiary interest and (3) preferred stock issued by SCF secured by the third beneficiary interest. The note, total amount ¥41,000M backed by the non-recourse loan, was issued by NSCF.

Property Trustee leased the 10 retail properties to each former owner in the long term. The cash, ¥2,200M, is reserved in NSCF, which is prepared in case the interest or principal of bonds would default.

The notes will expire in March 2007. If the SCF Tokyo branch gets enough capital to payback the non-recourse loan from NSCF Tokyo branch by mainly selling the first beneficiary interest, NSCF will prepay the certificates in September 2004. SCF Tokyo branch will sell the properties or beneficiary interests or will refinance from a new mezzanine lender between September 2004 and March 2007.

**Japanese Multiple-Retail Deal “New Shopping Centers Funding Co. Limited”**

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating</th>
<th>Amount (M yen)</th>
<th>LTV</th>
<th>DSCR</th>
<th>Interest Rate</th>
<th>Issue Price</th>
<th>Special Maturity</th>
<th>Final Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Aa1</td>
<td>41,000</td>
<td>40.6</td>
<td>2.61</td>
<td>2.0</td>
<td>100%</td>
<td>9/30/04</td>
<td>3/30/07</td>
</tr>
</tbody>
</table>
**Structure Summary**

<table>
<thead>
<tr>
<th>Issuer:</th>
<th>New Shopping Centers Funding Co., Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originator:</td>
<td>Mycal group 5 retail companies</td>
</tr>
<tr>
<td>Structure Type:</td>
<td>Direct issuance</td>
</tr>
<tr>
<td>Interest Payment:</td>
<td>Semi-annually</td>
</tr>
<tr>
<td>Property Trustee:</td>
<td>Yasuda Trust Bank</td>
</tr>
<tr>
<td>Property Manager:</td>
<td>Mycal group 5 retail companies</td>
</tr>
<tr>
<td>Note Trustee:</td>
<td>Fuji Bank</td>
</tr>
<tr>
<td>Principal Paying Agent:</td>
<td>Pariba Securities</td>
</tr>
<tr>
<td>Launch Date:</td>
<td>September 30, 1999</td>
</tr>
</tbody>
</table>

**Portfolio Summary**

| Underlying asset: | Ten Retail Properties in Hokkaido, Kanto(including Tokyo) etc. |
| Ownership Interest: | Fee Simple |
| Property Type: | from 8,000 to 16,000 sqm net sales area |
| Valuation: | 95,600 million yen |
| Loan-to-Value: | 40.6% |
| DSCR: | 2.61x |
US Deal

The GGP-Homart Commercial Mortgage-Backed Securities was issued on November 1999 by Goldman Sachs & Co. and Lehman Brothers. The transaction consists of a single floating rate loan of $590 million secured by first liens on fee simple and or leasehold. It is backed by 10 regional shopping malls, all of which are located at primary markets and have tenancies that cater to the demographics of the trade area.

The loan term is 21 months, with a 21 months extension option. The certificate has 7 different tranches from AAA to BBB and all tranches are floating rate, indexed off the one-month LIBOR and adjusted on a monthly basis. The transaction has 59.3% of the cumulative LTV and the $270 million loan has a DSCR of 1.62x.

US Multiple Retail Deal “GGP-HOMART”

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating (Moody’s)</th>
<th>Amount ($,000)</th>
<th>LTV</th>
<th>DSCR</th>
<th>Interest Rate</th>
<th>Issue Price</th>
<th>Expected Maturity</th>
<th>Final Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Aaa</td>
<td>345,244</td>
<td>32.2</td>
<td>2.77</td>
<td>LIBOR+0.41%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
<tr>
<td>B</td>
<td>Aa1</td>
<td>41,429</td>
<td>36.1</td>
<td>2.47</td>
<td>LIBOR+0.61%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
<tr>
<td>C</td>
<td>Aa2</td>
<td>55,239</td>
<td>41.3</td>
<td>2.16</td>
<td>LIBOR+0.81%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
<tr>
<td>D</td>
<td>A2</td>
<td>64,446</td>
<td>47.3</td>
<td>1.89</td>
<td>LIBOR+1.40%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
<tr>
<td>E</td>
<td>A3</td>
<td>25,740</td>
<td>49.7</td>
<td>1.80</td>
<td>LIBOR+1.60%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
<tr>
<td>F</td>
<td>Baa1</td>
<td>30,367</td>
<td>52.5</td>
<td>1.70</td>
<td>LIBOR+2.25%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
<tr>
<td>G</td>
<td>Baa2</td>
<td>27,535</td>
<td>55.1</td>
<td>1.62</td>
<td>LIBOR+2.50%</td>
<td>100%</td>
<td>6/10/03</td>
<td>6/10/08</td>
</tr>
</tbody>
</table>

Structure Summary

Issuer: Alderwood Mall LLC., Carolina Place LLC., etc
Structure Type: Senior/subordinate pass-through
Interest Payment: Monthly
Collateral: Regional Shopping Centers/Commercial Mortgage Loan
Underwriters: Goldman Sachs & Co., Lehman Brothers, Banc of America
Trustee: LaSalle Bank National Association
Servicer: First Union National Bank
Fiscal Agent: ABN AMRO Bank N.V.
4.4.2 Comparative analysis of the Japanese deal

(1) Similarities

- Water-fall distribution process
- Cross collateralized asset characteristic
(2) Differences

Assets

In the Japanese deal, assets are ten retail properties located all around Japan. In the U.S. deal the assets are 10 commercial mortgage loans secured by 10 regional malls.

LTV

From the table above, we found that the overall LTV and DSCR level in the same tranche is almost at the same level. It indicates that the Japanese deal is considered as stable as the U.S. deal. As mentioned in the single office comparison, this is the result of tradeoff between more stable factors and less stable factors in the Japanese case. First we mention positive factors of default risk for the Japanese deal (+) and second we point out the negative factors for the Japanese deal (-).

- The cash, ¥2,200M, is reserved in the Japanese deal, which is prepared in case the interest or principal of certificates default. This amount is almost the same as 2.7 years interest of the certificate. (+)
- All of the 10 retail properties in Japan have lease terms of 20 years, which is unusual in this country. It has happened because there is only one tenant in this deal. Lease rollover risk for the portfolio in the U.S. deal is also modest. No greater than 9% of the space expires in any given year through 2006 and only 11% through 2008. (+)
- In the Japanese deal, the 10 properties are geographically well diversified, as they are located in Hokkaido, Kanto (including Tokyo), Kansai (including Osaka) and Shikoku. The mortgaged properties from the U.S. deal are geographically as diverse. In the case of the U.S. deal, the 10 properties are located in 9 different states. The state with the largest concentration, Texas, has two properties and accounts only for 21.3% of the pool by allocated loan balance. (+, -)
- In Japan, the Mycal group is the only tenant of all the properties. Although the ten retail tenants consist of five companies, their parent company is Mycal and these five subsidiary
companies get capital not only from their own retail income but also from Mycal. This means Mycal financially supports them. These retail properties are thus considered as single tenant. On the other hand, the tenants of the ten shopping malls in the U.S. are well diversified. (-)

- Single borrower transaction: Both deals consists of single borrower structure, but in the U.S. risk is smaller because the borrower for each property is structured as separate, special purpose, bankruptcy-remote entities. In Japan, the owners of the ten properties are owned virtually by Mycal and if Mycal faces financial trouble, they may default. (-)

Considering all the points above, we think that the credit risk levels of both deals are about the same.

The number of tranche

The same as the discussion of the multiple offices.

No triple A tranche in Japanese deal

The same as the discussion of the multiple offices.
CHAPTER V - THE REASONS FOR FEATURES of JAPANESE DEALS

In this chapter, we discussed the reasons behind the features of Japanese deals, including why CBIS are dominant, why CMBS are few thus far and why there are no CBIS in the U.S. at all.

5.1 Why do CBIS dominate the Japanese market?

The primary reason that most securitized assets are real estate properties (beneficial interest) is because of the amendment in accounting system enacted in April 2000, which requires market to market pricing. In Japan most real estate is owned by companies, including real estate companies and life insurance companies, and companies are now required to mark up the market price of their properties frequently. Many properties owned by companies now have face values much lower than their market values. As a result, many companies must sell these undervalued properties. Otherwise their balance sheets will become large and they will face decreasing ROA.

One example is a company’s head office. A company wants to sell its head office because of the new market to market accounting system (off balance) but it still needs the head office. The best way to do this is to sell the head office to a vehicle and issue securities. Then they lease back the office from the vehicle and furthermore they will manage the office.

The other reason that most securitized assets are real estate properties (beneficial interests) is that many industrial companies including real estate companies suffered from lack of capital. This is because Japanese banks still have huge non-performing loans and they cannot provide real estate companies with enough capital. Companies want capital but they do not want to sell properties to third parties because they still want to use the properties for themselves or because they do not think it is the best timing to sell properties to third parties. From these reasons, they sell properties to a vehicle and securitize them.

One example is the new shopping center transaction where the retail companies, suffering from lack of capital, securitized ten shopping centers and they lease them back. The other example is the multiple offices transaction where the real estate company wants to get capital but does not want to sell them to a third party right now. They have the option to buy the properties back just before the securities’ expiration date.
5.2 Why are there only a few Japanese CMBS to this point?

The primary reason is that the real estate loans were made mainly corporate-style in Japan. The US real estate-based lending system is that the loans are non-recourse to the borrower. In the event that such a non-recourse loan defaults, the lender or investors have recourse to the property but not to the borrower’s other assets.

On the other hand, in Japan there was no real estate-based lending of non-recourse loans in commercial properties prior to 1998-1999. In the past, Japanese banks made loans corporate-style to industrial and real estate companies secured by real estate but with recourse. Because the debt service is not directly pegged to the rental income of the properties, real estate companies can pay debt service with income from other projects or even other methods. This is why corporate-style real estate lending is hard to securitize and there are only a few commercial mortgage backed securities to this point.

However, from 1998 banks began to lending non-recourse loans to investors in Japanese real estate and NPL, and the non-recourse loan market is growing at very high rate right now. J.P. Morgan reported that the total non-recourse loans figure was about ¥450 billion as of June 2000. This kind of a market did not previously exist and these non-recourse loans will be securitized in the near future. In addition, Moody’s Japan has made a prototype of conduit loans and many banks try to make conduit loans to real estate owners. Furthermore, we can find non-recourse loans even in development projects. Based on these facts, we feel sure that commercial mortgage backed securities must become prevalent in a few years.

5.3 Why are there no CBIS in the U.S. at all?

One reason is that in the U.S. properties are typically owned by funds or REITs. Companies usually do not own properties as their own assets and properties are deemed as the objective of investment. This is totally different from Japan.

The second reason is that in the U.S. UP REIT structure is admitted. That is, real estate owners do not have motivation to issue bonds but have motivation to list the real estate on the stock exchange. In the UP REIT structure, the real estate owners can defer the capital gain tax as unit holders and get the capital when/after listing them on the stock exchange. Also, real estate owners could get capital gains when prices rise. On the other hand, in CBIS real estate owners
must pay capital gain taxes when selling the properties to the vehicle and they also do not have upside potential.
CHAPTER VI: CONCLUSION

In the near future, Japanese Commercial Real Estate Debt Security market is expected to become the second largest market in the world. The magnitude and rate of growth are considered to be higher than those of the U.K. and other European countries. Demand of securitization is high because companies want to sell off assets on their balance sheets as well as to get capital. Commercial banks and their subsidiary security companies in Japan are expected to gain more market share. Their business network and low underwriting fees give them a competitive edge over their U.S. counterparts.

As for investors, Japanese institutional investors, including life insurance companies and agricultural cooperatives, are willing to buy from AAA to A tranche. The problem is that still there are only a few investors of BBB tranche and very few investors of below investment-grade, including equity investors. The amendment of accounting system, where off-balance of the property was not admitted when originators had more than a 5% piece of equity or securities of the sold property value, was enacted in April 2001. This means below investment-grade investors are essential for the commercial real estate security market to develop further.

Currently CBIS dominate the Japanese market. Because Japanese companies would like to own properties and manage them, and because companies’ demands of off-balance and getting capital are expected to remain high, CBIS are expected to remain active in Japan. We think the development of the J-REIT market also positively affects the CBIS market, and an emergency of mortgage REITs is especially expected because these companies would be active investors of lower tranches. The only concern of the future of CBIS is the introduction of UP-REIT to J-REIT. In that case, the owners of real estate could desire to list their properties on the stock market to avoid paying capital gain taxes. Considering the current growth of non-recourse loans by Japanese banks and emerging conduit loans, Japanese-CMBS are also expected to grow.

However, due to the many unique real estate and finance practices in Japan, the Japanese Commercial Real Estate Debt Security market should adjust to the local systems and create customized security products that suit investors’ demands. It is essential to resolve the current problems, including lack of disclosure of tenant information, unavailability of standardized property reports by property managers to investors, lack of the secondary market, inadequate research and indices and unavailability of standardized real estate appraisal.
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