THE POSSIBILITY OF SECURITIZATION SYSTEM OF REAL ESTATE MARKET IN JAPAN

by

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Submitted to the Department of Urban Studies and Planning in partial fulfillment of the requirements for the degree of

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ABSTRACT

Although it will take time, a new financing method, securitization, will help supply the real estate market with direct investments and expand capital available to finance real estate, which would stimulate the real estate market and the Japanese economy. However, examining the experience of securitization in the U.S. make it clear that to achieve this goal, there are still many problems to be solved regarding Japan's financing system, including non-recourse system, tax issues, disclosure matters, appraisal methods and the establishment of the secondary market. Not only investors' actions but also the government's actions will decide the success of the securitization in Japan. Its success depends on the diversity of securitization products, which attract many kinds of investors, and the growth of the infrastructure of the securitization market. The above problems will be solved step by step. The facilitation of governmental institutions for securitization is necessary to expand it in Japan faster. If these factors are resolved, the securitization system will revive the real estate market in Japan and make the market a totally different one.

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TABLE OF CONTENTS

Page

CHAPTER 1 INTRODUCTION

Before the depression of the Japanese economy, an increase in real estate prices every year was considered normal in Japan. However, with the prediction of low economic growth, we cannot expect real estate prices to increase. As a result, companies and investors tend not to purchase real estate as they used to, and land prices are falling. With these situations, it is difficult to get investment or financing. A new financing method, securitization, may help supply the real estate market with direct investments and expand capital available to finance real estate, which would stimulate the Japanese economy. The central questions of my thesis are whether securitization provides a vehicle to expand capital investment for real estate in Japan, what conditions must exist for securitzation, and what effect it will have on financing mechanisms and the real estate market in Japan.

The Japanese government has started preparing for a financial reform named the "Big Bang," which aims at deregulating the money market and which will be completed by 2001. This reform will lead to an internationally free, competitive financial market and many variations of financial services and financial commodities available to individual investors. Under this change, there is more potential for securitization to work in the real estate market. It is one method to unite the capital market and the real estate market. And it can provide funds directly to companies. It is highly likely that components of private financial assets would change and financial renovation will open up opportunities for entry into the financial capital market for private individuals as well as for corporations.

It is clear that securitization can be used in two ways: to sell disposed real estate assets, and to sell typical profit real estate. In addition to securitization of the disposed real estate, we have to think about that of typical profit real estate, such as buildings. If the Japanese real estate market does not intend to improve and expand securitization for typical profit real estate when securitization of disposed real estate completes the first stage, the business opportunities of securitization will decrease drastically. If this system were introduced to normal-profit real estate, it would offer a big opportunity to expand the real estate market.

There are several factors to be examined regarding securitization, such as legal issues, market conditions, and institutional perspectives. In this thesis, I will focus on investor perspectives and investigate contributing factors to securitization based on current trends in real estate securities. My study will address many related problems, such as difficulties in projecting the cash flow, disclosure and accumulation of real estate data, and appraisal methods.

Concerning methodology, this thesis is based on literature and articles in this field and interviews with investment bankers and institutional representatives. I will look at the experience of securitization in the U.S. and identify contributing factors such as legal issues, institutional concerns and investors' perspectives. Then, I will review, compare and identify the historical perspectives of Japan's and the U.S.'s securitization of real estate. Finally, I will apply these factors to Japan, identifying the key obstacles preventing securitization such as legal barriers, peculiar business practices and economic conditions.

CHAPTER 2

REAL ESTATE MARKET IN JAPAN

2.1 Securitization

a. New Financing Method: Securitization

Under current real estate conditions caused by the bad loan problems, it is difficult for Japanese real estate companies, whose ratings became low, to get investments or financing. A new financing method may help supply the real estate market with direct investments and expand the capital available to finance real estate, which would stimulate the Japanese economy. One such method is securitization, which is considered a potential solution for Japan's financial problems. Securitization is the process of creating a security marketable in the capital markets that is backed by a package of assets such as mortgage loans. It would not only activate the real estate market but also create an investment market for real estate.

There is no securitized product in real estate which acts as a financial product under the Specified Credit Law (Security Act). Under changes including the Financial Reform, there is greater potential for securitization to work in the real estate market. Securitization in real estate aims at making investment in real estate as easy as it is in stocks, by dividing up ownership rights so that many investors can acquire rights at a low cost. In other words, the financial market can provide funds directly to companies. Securitization is one method of uniting the capital market and the real estate market.

America's private household financial assets represent 17 percent of its total assets. In comparison, Japan's ratio is extremely conservative at 55 percent, which is $11 trillion (1,200 trillion Japanese Yen). Therefore, it is highly likely that private financial assets would change and this resurgence would open up opportunities for entry into the financial capital market for private individuals as well as for corporations. Securitization intends to use these private financial assets for the real estate market.

b. Rethinking of Real Estate Investments in Japan

Before the depression, during the period of high-growth economy, an increase in real estate prices every year was considered normal in Japan; investors could expect capital gain and income gain. With the prediction of low economic growth, however, we cannot expect real estate prices to increase. Neither can we expect rents to increase continuously. In other words, we can no longer depend on the increase of capital gain.

In Japan, concerning financing, financial institutions mainly lend money to corporations. However, they have been in poor condition, with bad loan problems in real estate, for eight years and some banks have gone bankrupt in Japan. Thus, a credit crunch by banks is forcing their clients to seek alternative funding sources.

Current land prices and rents differ widely according to the quality of the property. Since prices have fluctuated according to demand and supply after the collapse of the bubble economy, the investment risk that was hidden by capital gain during the bubble economy became obvious. Risks to be avoided are construction risks--caused by an extended development period or the delay of construction--, feasibility risks, market risks, management risks and deterioration risks. Before the depression, companies and investors invested expecting the advantage of tax-exemptions, an increase in real estate prices, inflation hedges and security of land value. However, after the depression, investing goals changed. Investors have come to expect a stable income-gain, total interest and diversified risk. Securitization can be a good method to satisfy these expectations of investors in the sense that it provides income-gain and diversified risk of real estate.

2.2 Post Bubble Economy

Between 1985 and 1991, commercial land prices tripled in Japan because a great deal of money flowed into the real estate market. This bubble economy was believed to represent the strength of the Japanese economy. In the summer of 1991, the Japanese economy broke down and remained critical until March 1993. Now the economy is in recession; however, problems related to real estate continue. One of the serious problems is the bad loan problem caused by overly optimistic financing for land acquisition and the construction of office buildings. The amount of bad loans from banks and other financial institutions was said to be more than $640 billion[1] as of March 31, 1998.

2.3 Big Bang

The volume of deals on the Tokyo market used to be the largest in the world; however, in 1998, it became about one third that of the New York market. To regenerate the Japanese money market as an international financial market like New York and London, the Japanese government has started preparing for a financial reform named the "Big Bang," which aims at deregulating the money market and which will be completed by 2001. This reform is based on that of the security market in England in 1986, which opened the financial market to international investment and competition and allowed many variations of financial services and financial commodities to be provided to individual investors. Underlying the "Big Bang" is the basic recognition that: (1) The financial market should play an important role in the smooth allocation of Japanese money to new industries and foreign countries seeking funds for development. (2) Within the function of the new financial market, the 1,200 trillion Japanese Yen in individual savings should be invested efficiently so that the Japanese economy can recover more quickly from the long recession in which it is mired.

The main schedule for the Big Bang is as follows[2]:

<u>By 1998</u>

- Freedom of financial transaction inside and outside of Japan
  (abolition of authorized foreign exchange banks)
- Reform of bond market
- Shift from permission system to registration system for new financial products
- Permission for banks to sell mutual funds

By 1999

- Commissions on all stock trades free from government control

By 2000

- International standardization of accounting system
- Introduction of new competitors (promotion of mutual entry into banking, securities, insurance business)

An administrative reform panel, one of the councils for the Prime Minister, submitted a report in December 1996. This report is summarized in Table 1.

Table 1. Outline of Report submitted by the Administrative Reform Panel

Promotion of Wide-Ranging Competition	
First Step (Expansion and acceleration of mutual entry among financial institutions)	
	Elimination of the regulation of business fields in which subsidiaries of financial institutions engage Reciprocal entry between insurance industry and other financial institutions with subsidiaries Lifting the ban on financial holding companies Liberalization of issuing debenture by ordinary banks Relaxation of restrictions on selling securities and insurance products Promotion of competition between banks and nonbanks through eliminating restrictions on the issuance of corporate bond and commercil paper by leasing and credit companies
Second Step (Expansion of regulation in the field of assets management and investment advisory)	
	Dividing Securities and Exchange Law into Asset Transaction Law for fairness of markets and protection of investors, and Asset Management Law for rule of dealers' activity Establishing registration system of each product such as securities, trust, investment advisory, commodity fund, commodity future Allowance of mutual entry into one another's markets by the financial institutions meeting the condition of license or registration through the medium of a subsidiary or holding company Permission of mutual entry among businesses of deposit receiving, insurance underwriting, and assets management services
Liberalization of Assets Transactions	
1	**Improvement of function of capital market**
	Reduction of transaction costs (complete liberalization of stock trading commissions, comprehensive revision of securities taxation) Liberalization of securities trading outside stock exchange through deregulation of restriction on establishing new securities markets and elimination of principle of concentrating securities trading on stock exchange Improvement of the over-the-counter markets Relaxation of restriction on investment in non-registered or non-listed stocks Promotion of new financial technology (establishing market environment suitable to derivatives transaction and securitization) Reform of bonds market, Introduction of stock option
2	**Abolition of the restriction on investment of institutional investors and relaxation or elimination of the regulation of designing financial products**
	Abolition of restriction on insurance companies' investment, shift from permission system to registration system about insurance products Abolition of restriction on pension funds' investment, diversification of way to pay benefits from pension fund Abolition of the limitation of the amount of one security or the ratio of private securities invested by a investment trust, establishing market environment suitable to the company type investment trust, shifting to registration system about investment trust agreement Relaxation of restriction on commodity funds' investment, abolition of minimum unit for sales
3	**Comprehensive reform of Foreign Exchange Control Law**
	Abolition of permission and license system of foreign capital transaction and international settlement Allowing new intermediaries (except foreign exchange banks) to handle foreign exchange Abolition of the limitation on foreign exchange amount held by foreign exchange banks

Source: Administrative Reform panel, "Promotion of Revolution of Economic Structure" 11/1996

2.4 Present Trends of Real Estate Market

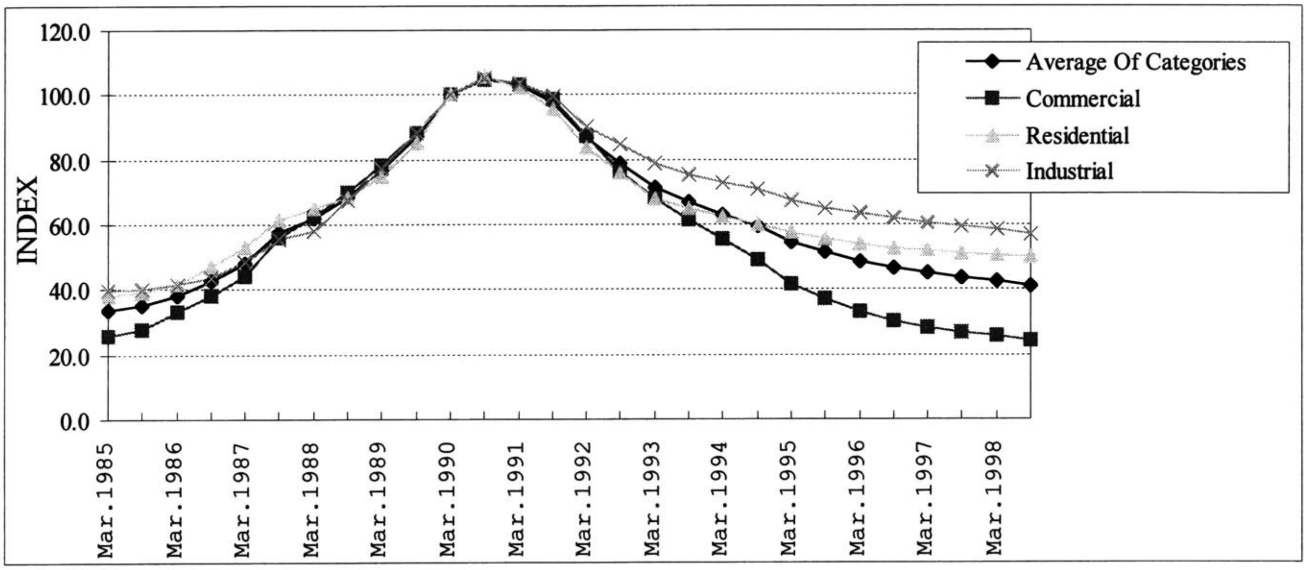
Land prices since 1991 invalidate the myth that Japan's land prices will increase forever. We cannot expect capital gain of real estate anymore. And income gain is becoming more important. The change in rents indicates these points clearly in that rents rise and fall more widely than before depending on the location and grade of the buildings. Also, this condition affects the structure of real estate companies in that each function, such as ownership, management, development and investment, is separated. In this sense, securitization would play an important role since it provides funds from a wide range of investors, which used to be impossible in Japan.

Nowadays, foreign companies enter the real estate industry using securitization, which should expand the securitization business and the market in Japan.

a. Land Prices

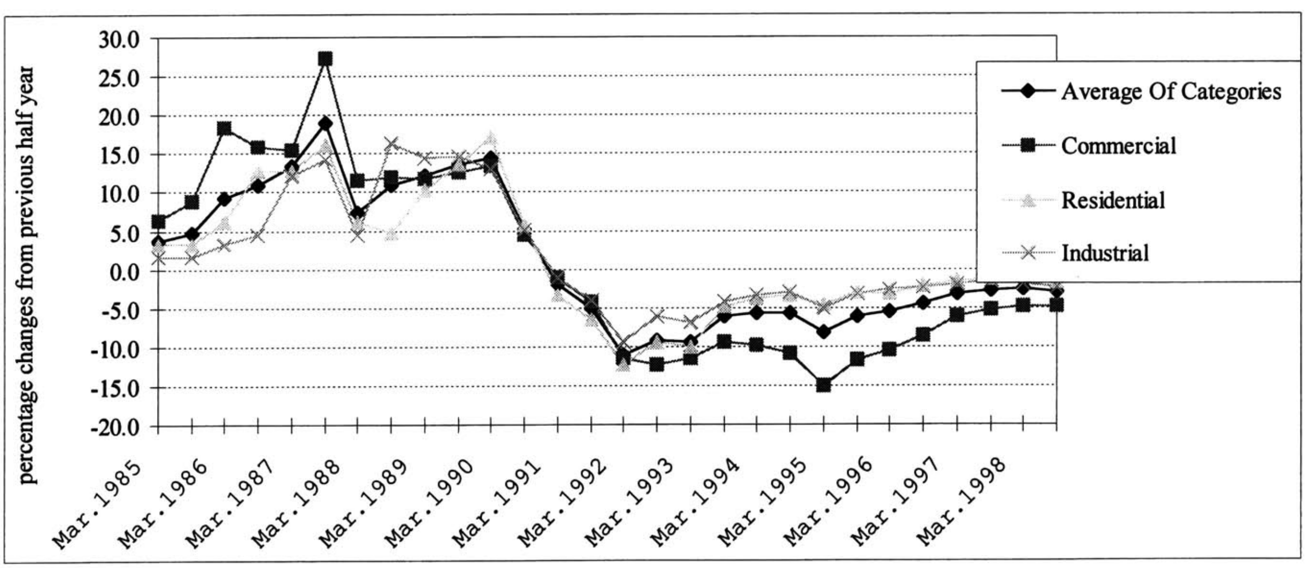
When the bubble economy began in 1986, commercial real estate prices started going up and, in 1991, they reached a level three times as high as those in 1986. Now commercial prices (nominal) are almost the same as in 1986 (Figure 1). Although some pieces of superior real estate in Tokyo have been bought recently and the annual ratio of declining prices has recovered (Figure 2), there still is anxiety that prices will decrease further. Land prices announced in January 1998 indicated that prices of the best districts rose after an initial decline, while those of other districts continued to decrease.

Figure 1. Urban Land Price Index of Biggest 6 Cities



Note: Biggest 6 Cities are Tokyo 23 wards, Yokohama, Nagoya, Kyoto, Osaka and Kobe
Index: 1990=100
Source: Japan Real Estate Institute

Figure 2. Urban Land Price Index of Biggest 6 Cities in Percentage Change



Source: Japan Real Estate Institute

b. Rents

As Table 2 indicates, rents for office buildings are still decreasing. However, like land prices, the percentage decline of rents has recovered. Also, in 1998, we believe that rents for well located, highly functional and large-scale office buildings have reached the bottom. Because office floor space under construction bottomed out in 1995 and then began to increase, rents are still adjusting. The occupancy rate of such buildings is also recovering. (e.g., Otemati--Tokyo's main office district—had a 3.1% occupancy rate in 1997.) However, it is said that the occupancy rate in Japan is almost always lower than that of other countries. (e.g., in 1996, occupancy rate in Japan is 5.9% while that in New York in midtown is 11.2%.) We can see that rents and occupancy rates show greater variation than before depending on the location and grade of the buildings.

Table 2. Rent Index by Area

OFFICE	1996		1997		1998	
	index	percentage decline	index	percentage decline	index	percentage decline
Greater Tokyo Area	95.9	-4.1%	95.0	-0.9%	94.3	-0.7%
Greater Osaka Area	95.6	-4.4%	95.0	-1.3%	93.8	-1.3%
Japan	96.1	-3.9%	95.5	-1.2%	94.4	-1.2%

RESIDENCE	1996		1997		1998	
	index	percentage decline	index	percentage decline	index	percentage decline
Greater Tokyo Area	97.8	-2.2%	96.7	-1.1%	95.8	-0.9%
Greater Osaka Area	97.9	-2.1%	97.3	-0.6%	95.4	-2.0%
Japan	98.4	-1.6%	97.7	-0.7%	96.4	-1.3%

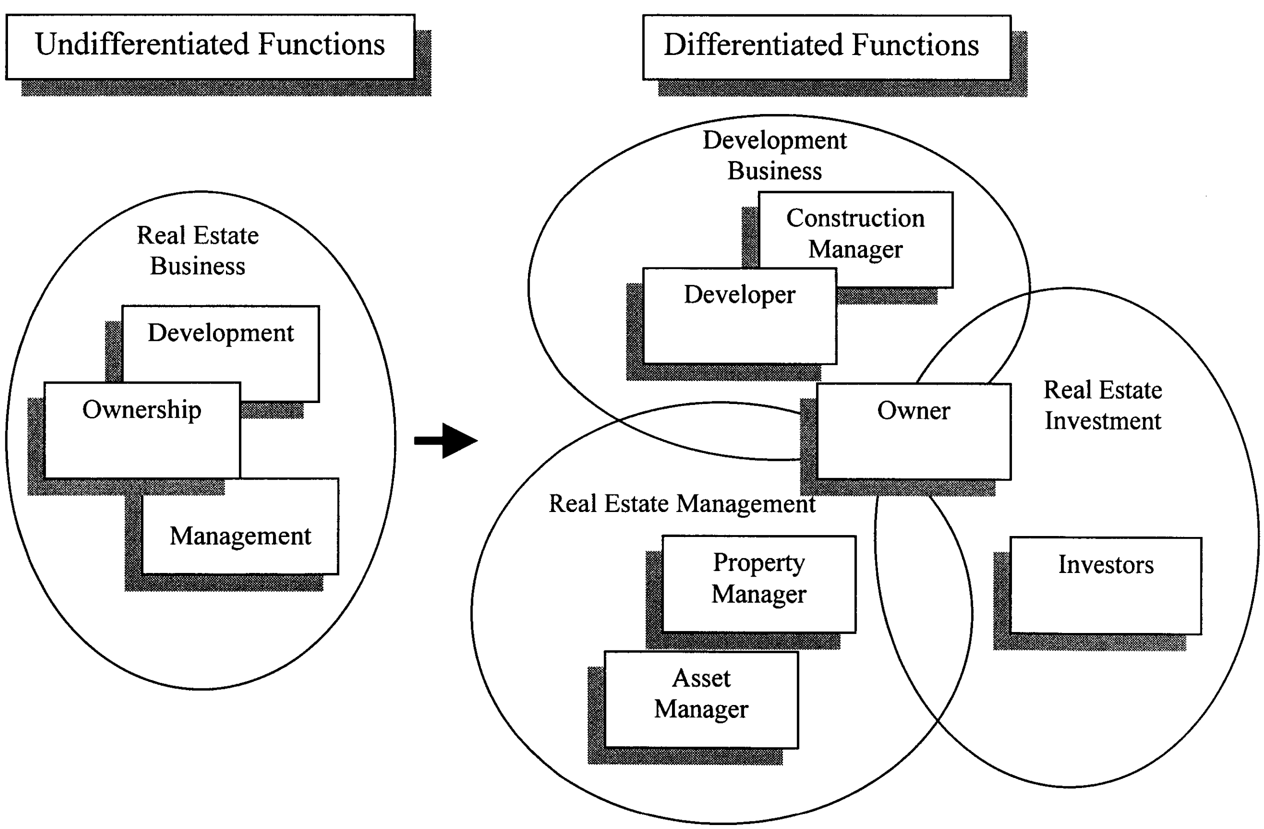
Note: Index: 1995=100
Source: Japan Real Estate Institute

c. Changes in the Functions of Real Estate Industry

Up to now, investors in Japan's real estate market have been limited to Japanese-type developers, banks and life insurance companies, which is totally different from that of the U.S. In the U.S., there are additional companies such as pension funds, REITs, banks, insurance companies and foreign investors, which invest in real estate. Companies such as stock companies/investment banks mainly engage in trading stocks and bonds and do not act as real estate companies in Japan. On the other hand, such companies play an important role in real estate financing in the U.S. Also, the roles of developers, or real estate companies, in Japan are different from those in the U.S. The business that developers do in the U.S. does not exist in Japan. Japanese real estate companies are different for two reasons: (1) They have strong financial resources; (2) They tend to own the projects, which they develop on a long-term basis. What this implies is that real estate companies can be regarded as permanent equity investors. Japanese real estate companies tend to retain real estate for future income and appreciation[3]. Since real estate developers need large sums of money to acquire land, as well as long-span development periods, ordinary profits are low and they depend highly on loan debt in comparison to other industries. Nowadays, because of the deflation of assets, the financial affairs of Japanese developers have degenerated. Since the structure and financial conditions of companies need improvement, developers are likely to start selling projects and concentrate on development and management.

Also, since investment risks have become apparent, the structure of the risk burden is likely to change. To achieve these goals, the functions of the real estate industry will be unavoidably differentiated into development, investment and management functions (Figure 3). Under this situation, we can expect other kinds of companies, such as investment advisory services, investigating firms for due diligence and property management companies, to enter the real estate industry and new business to be created. Securitization can be a good method to facilitate the separation of these functions, gather investments from investors and diversify the risk of investment.

Figure 3. Differentiated Functions of Real Estate Industry



Sources: NLI Research Institute

d. Purchased Non-Performing Loans

Many companies have a great deal of real estate that they bought before the decline of the economy. They have huge non-performing loans and have not completed their redemption. They cannot sell the real estate, for if they do, they will sell at a lower price than they paid. This real estate is called "disposed real estate." This stalemate has triggered a downturn in the real estate business and in urban development.

Japanese companies and institutions have no power to buy this disposed real estate. Foreign firms such as Goldman Sachs, Merrill Lynch and Morgan Stanley use investment funds derived from pension funds and real estate investment trusts in the U.S. to buy Japanese real estate[4]. These funds are called “Vulture Funds” because they buy the wreckage of real estate at the lowest price without mercy. They intend to securitize superior property and get profits by selling it to investors in the U.S. It is said that Goldman Sachs and Secured Capital have bought over $9 billion; altogether, foreign firms have bought over $182 billion in disposed real estate[5]. These activities will expand the opportunities for securitization in the first stage in Japan. We can expect that securitization will grow in popularity. When the infrastructure of securitization is arranged, including the problems of tax issues, disclosure matters, appraisal methods and the secondary market, securitization will become more widely used.

CHAPTER 3

EXPANSION AND ROLES OF CMBS AND REITS IN THE U.S.

Japanese regulators and investors are now seeking the type of securitization product that will fit the Japanese system. The SPC (Special Purpose Company), discussed in Section 4.2, is one method, based on these developed securitization products in the U.S., to solve the problems of disposed real estate. This is a kind of CMBS (Commercial Mortgage Backed Securities) product and one start to expanding securitization in Japan. CMBS type securitization is likely to be used as a solution to disposed real estate in the first stage, with the evolution to equity type products being introduced later into Japan's real estate securitization market.

Since the U.S. has over 25 years of securitization history with real estate, it can inform the types, structure and legal regulations, needed to introduce the securitization system in Japan. As mentioned in the introduction, it is important to look at experiences of securitization in the U.S. and identify contributing factors such as legal issues, institutional concerns and investors' perspectives, in order to apply these factors to Japan and identify the key factors preventing securitization. Also, there are some players in the securitization transaction, such as originators, who sell assets on a non-recourse basis, and issuers who purchase assets from the originators and issue securities. Unlike the U.S., it is clear that, in Japan, these players and the structure of securitization are not established yet and a wide range of concerns and issues have been raised and debated.

Nowadays, two main securitization products are used to securitize commercial real estate in the U.S.: (1) a debt type-CMBS (Commercial Mortgage Backed Securities), and (2) an equity type-REIT (Real Estate Investment Trust),

3.1 History of CMBS and REITs

a. Summary[6]

Under U.S. laws and conditions, securitization has advanced and made attractive products in the U.S. For example, individual investors can invest small sums of money, which used to be impossible in Japan. In 1980s, Ginnie Mae, Fannie Mae, and Freddie Mac issued home MBS (mortgage-backed securities). After this, the U.S. market offered a wide array of securitization alternatives. Equity REITs (Real Estate Investment Trust) were created for the purpose of providing the public with a vehicle to participate in the equity ownership of commercial real estate. Mortgage (i.e., debt) REITs are REITs which make and hold loans and other obligations that are secured by real estate collateral. MBS (Mortgage Backed Securities) are the products of creating a security backed by a package of assets such as mortgage loans. CMBS (Commercial Mortgage Backed Securities) are such products for commercial real estate.

Prior to 1990 little securitization of commercial real estate was completed and the issuance volume of securitization was small. Due to numerous Saving & Loan (S&Ls) failures, the Resolution Trust Corporation (RTC) was established by the U.S. government to liquidate financially distressed S&L assets, including commercial real estate loans. The mechanism that the RTC used to liquidate the assets of insolvent S&Ls paved the way for large-scale securitization. This process contributed to the expansion of the market in commercial mortgage backed securities. REITs were first introduced in 1960 and offered ownership in large-scale commercial real estate properties to many different types of investors. As a result of the Tax Reform Act in 1986, the increase in new issuance of REITs rose to approximately $2 billion per year in the late 1980s. In 1992, the use of REITs began to expand. They offered an attractive high-yield equity security that brought liquidity to real estate investments. For example, the issuance amount of CMBS was $171 billion between 1985 and 1997 and the total amount of equity REITs was over $140 billion.

The following is a summary of the history of CMBS and REITs.

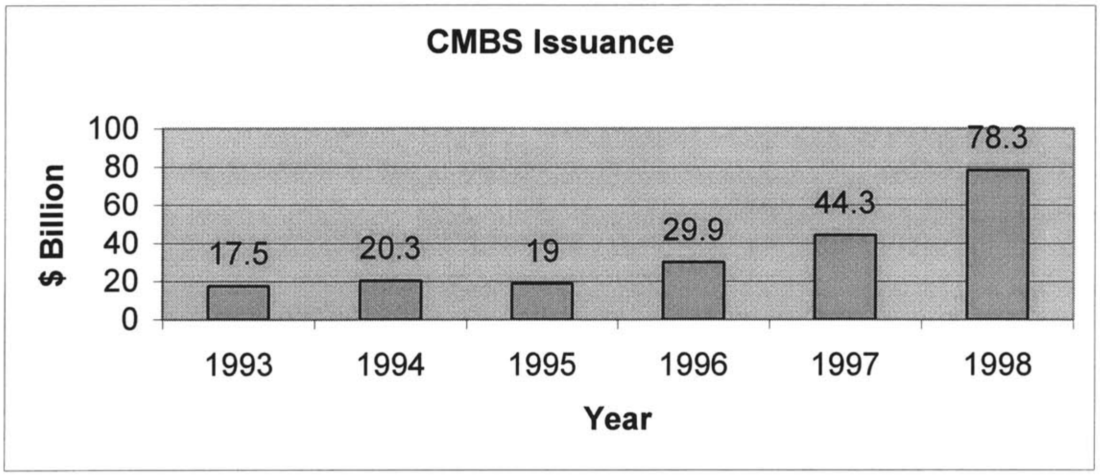
b. CMBS (Commercial Mortgage Backed Securities)

CMBS is one kind of MBS --Mortgage Backed Securities-- product, which makes investors share a large pool of similar mortgages. In the early 1980s, although the payment of principal and interest was guaranteed, the range of investors was not very broad: the major investors were institutions. In 1983, the first multiclass mortgage backed security, the Collateralized Mortgage Obligation (CMO), was introduced. Cash flows from the pool were allocated to investors, enabling investors to choose a particular cash flow stream. About 40 percent of the first CMO was purchased by pension funds and insurance companies. REMICs (Real Estate Mortgage Investment Conduit), multiclass mortgage securities like CMOs, but without the tax impediments, were introduced in the Tax Reform Act of 1986. REMIC used this conduit system. The flexibility in structuring REMICs has made it possible to attract a wide variety of investors. A typical REMIC contains ten to twenty different classes tailored to meet investors' portfolio needs.

CMBS started in 1984 when three office buildings in New York were securitized at the cost of $1 billion by Olympia & York (O & Y). The RTC (Resolution Trust Corporation) --government-sponsored corporation-- was set up in 1989 to solve the problems of the Saving & Loans (S&Ls). In the early 1990s, the RTC had completed disposing about $70 billion worth of real estate. Of this, 53 percent was disposed of by securitization. The rest was disposed of by bulk sales or auctions. Japan's securitization first takes into consideration cleaning up non-performing loans as the RTC did, establishing the Cooperative Credit Purchasing Company (CCPC) for these problems. However, the CCPC has not produced a significant restructuring of underlying assets.

The RTC contributed a lot to the development of CMBS. The total amount of CMBS was $17.5 billion in 1993, but it increased to $44.3 billion in 1997 and $78.3 billion in 1998. In 1998, after financial crisis in Russia and Asia rocked the global capital markets and sent investors racing for the safety of U.S. Treasury securities, CMBS spreads widened dramatically and their price became volatile.

Figure 4. The Issuance Amount of CMBS Each Year (1993-1998)

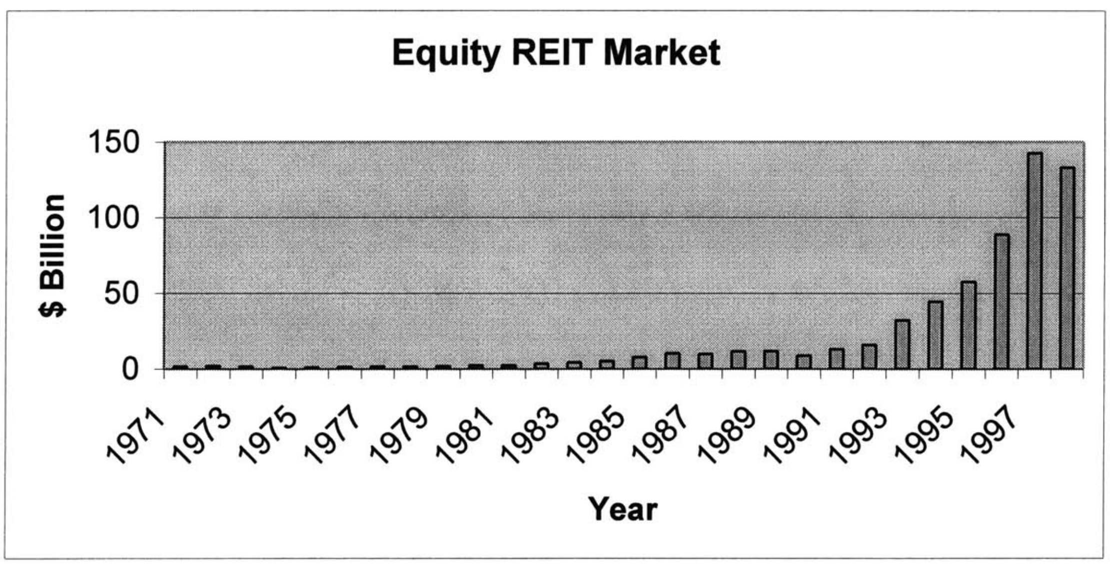


Source: E & Y Kenneth Leventhal, Commercial Mortgage-Backed Securitization Survey, 1998/1999

c. REITs (Real Estate Investment Trusts)

In 1960, REITs were introduced to expand the opportunities for real estate investment by investors on a large scale. At first, lots of investment banks financed the construction of office buildings by mortgage REITs. The scale of the market expanded from $1 billion in 1968 to $20 billion in the middle of the 1970s. After the oil crisis in 1973, the scale of the market was reduced by the sudden rise of interest rates caused by inflation. Though the Economic Recovery Act of 1981, which permitted investors to offset income with interest payments and depreciation costs, the Master Limited Partnership (MLP) became more popular than REITs. After this phenomenon, the commercial real estate market became oversupplied in many regions. Under the Tax Reform Act of 1986, REITs were permitted to own real estate and administrate properties. This change is said to have encouraged the establishment of more attractive REIT products. REIT products varied in their combination of securitizing several industries' REITs, under which the "IPO Boom" expanded. And, because of their liquidity, investors preferred to invest in REITs rather than in real estate directly. We can see from Figure 5 that the REIT market reached $142.5 billion in 1997 after dramatically increasing for several years, but dropped to $132.8 billion in 1998, for the first time in the 1990s. Their return went down to a negative number in 1998 from 20 percent return performance in the previous year, also for the first time in the 1990s. Considering that the S&P 500, the daily index based on common stock prices for 500 corporations, remains high, we can say that this situation is serious and REITs face an identity crisis. If prices of real estate go down, there is a possibility that conditions will form a vicious circle. Also, a notable point is that, if stocks decline, it is not clear how much REITs will be affected.

Figure 5. The Market Capitalization of Equity REITs



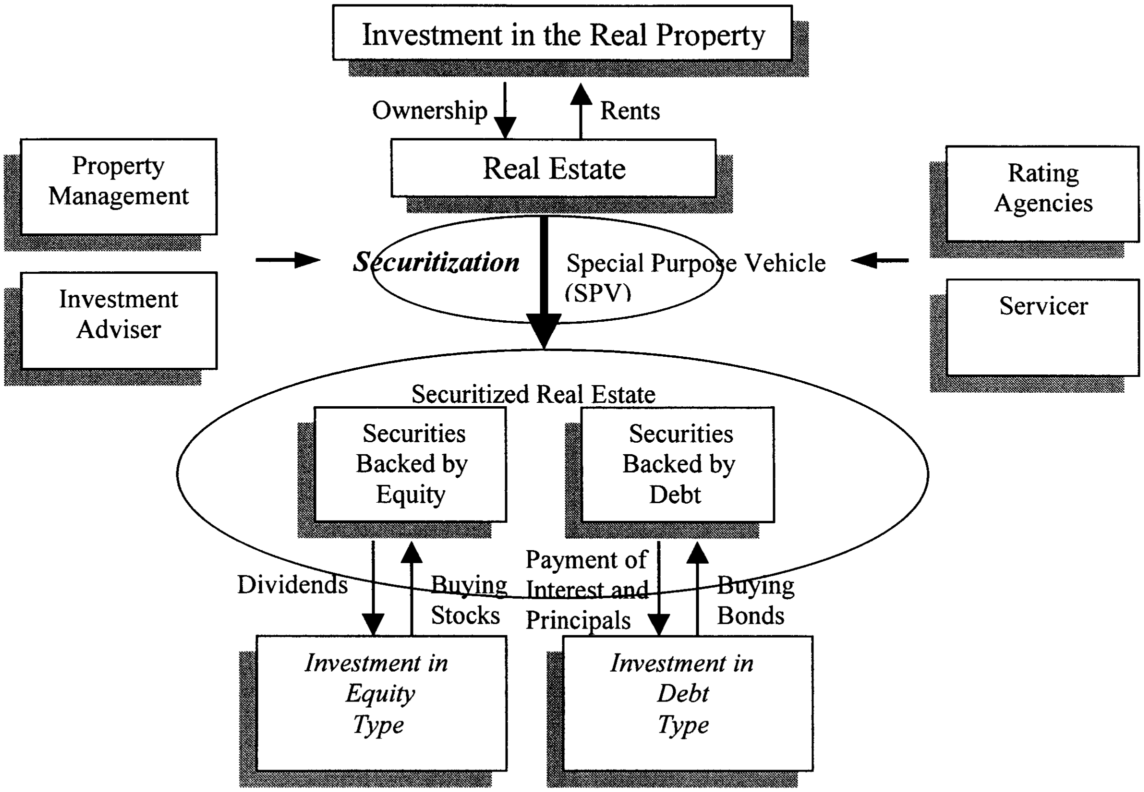
Source: NAREIT (The National Association of Real Estate Investment Trusts)

3.2 Structure of CMBS and REITs

The process of securititzation is depicted in Figure 6.

Investors play a vital role in the success of the securitization market. In fact, without their willing participation, only a limited market would exist. Unlike the U.S., it is clear that, in Japan, the structure of securitization is not well established yet. In addition to the Special Purpose Vehicle, companies which function as property management companies, rating agencies, and investment advisors are well organized in the U.S. The role of property management would increase because securitization makes ownership and management separate. Rating agencies are important in the sense that investors use ratings to compare the safety of products when they decide whether to invest or not. Since investment opportunities would increase, individual investors, institutional investors, and investment advisors are critical.

Figure 6. Basic Structure of Securitization



a. Debt Type

Originators sell assets on a non-recourse basis. Trustees monitor asset balances, invest daily collections, and calculate and pay principal and interest to security holders. Issuers purchase assets from the originators and issue securities which are paid solely from the cash flow generated by the assets. Issuers are either a limited purpose subsidiary or an unrelated third-party corporation or trust, formed by an originator or a group of originators. SPV (Special Purpose Vehicle) is a special purpose entity created solely to purchase the loans and issue asset-backed securities based on that collateral. These conduits are not subject to taxation under present laws, which is one of the reasons that this system was introduced. This produces low risk and low return compared to equity securities. CMBS returns rely on tranches in which the security is divided up into payment classes. Prepayment risk is shifted from safe tranches to residual tranches. These are created according to expected maturity. The short-lived tranche receives interest, pool principle and prepayment until the investment tranche is retired. Once the short-lived one is paid off, the next begins receiving excess cash flows, etc. The residual receives whatever cash flows are left over from each payment period. This system is good for investors to invest in securitization products since they can select them according to their preference. This is an important factor to expand the securirtization market in Japan in the first stage. Conduit-CMBS is a loan originator with the intent of securitization. This introduces new strategic considerations for conduit-investment banks, which can now tailor loan contracts and pool composition to better fit perceived demand of security holders. CMBS is treated based on non-recourse system.

The rating obtained on a fixed income security is critical because of its price effect. The assignment of a high rating means that interest costs are lower than when a low rating is assigned. The rating process is based on measures like property type, LTV (Loan to Value), DCR (Debt Coverage Ratio), pool size, and pool diversification. The rating assigned to a particular CMBS investment class is an assessment of default or credit risk. Commonly used rating categories are AAA, AA, A, BBB, BB, B, and so on. Rating below BBB is referred to as non-investment grade, which implies that there is significant default risk associated with the ownership of the securities. Each particular tranche is assigned a rating based on its perceived credit riskiness. Therefore, the role of rating agencies is critical. In general, insurance companies, banks, pension funds and hedge funds buy category BBB and above, looking for a low-risk bond. Junk bond funds and mutual funds buy category B and BB (Mezzanine Tranches), looking for superior risk-adjusted returns. Mortgage REITs, hedge funds and investment banks buy high-risk tranches. Also, in CMBS, credit enhancement is very important in the sense that each tranche can be divided into particular ratings. Servicers, who collect debt payment, administer mortgage loans, and deal with borrower default, also play an important role in CMBS because they collect and manage the underlying assets. Their ratings also effect the grade of securities[7]. Servicers relieve investors of having to address collection of default issues.

b. Equity Type

In this type, the securities are backed by real estate equity. The REIT (Equity Type) is registered or listed on the capital market and therefore offers liquidity. The market reacts sensitively to change in the projected cash flow and the market value of REIT securities fluctuates accordingly. In this sense, this product is high risk and high return. The three categories of REITs are Equity REIT, Mortgage REIT and Hybrid REIT.

<u>Legal Regulations of REITs</u>

A REIT is basically a real estate company or trust that has elected to qualify under certain tax provisions as a pass-through entity that distributes to its shareholders substantially all of its earnings in addition to any capital gains generated from the sale of disposition of its assets. This real estate investment trust does not pay taxes on its earnings in accordance with the tax provisions; however, the distributed earnings represent dividend income to its shareholders and are taxed accordingly. In the same way, any distributed capital gains are taxed at the shareholder's applicable tax rate. On the other hand, general companies have to pay taxes on their earnings and any distributed dividend, and capital gains are taxed at the shareholder's applicable tax rate. The real estate investment trust is treated simply as a conduit regarding the income distributed to beneficiaries of the trust; thus, it is not taxed at the corporate level. Only beneficiaries pay tax on the distributed income.

To qualify as a REIT for this tax purpose, the trust must satisfy the following regulations[8]:

Organization Requirements

- Must have at least 100 or more shareholders for most of the year.
- Not more than 50 percent share ownership can be owned by 5 or fewer stockholders.

Asset Requirements

- At least 75 percent of the value of a REIT's assets must consist of real estate assets, cash and government securities.
- Not more than 5 percent of the value of the assets may consist of the securities of any one issuer if the securities are not includable under the 75 percent test.
- A REIT may not hold more than 10 percent of the outstanding voting securities of any one issuer if the securities are not includable under the 75 percent test.

Income Requirements

- At least 95 percent of the entity's gross income must be derived from dividends, interest, rent, or gains from the sale of certain assets.

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

Distribution Requirements

- Distribution to shareholders must equal or exceed the sum of 95 percent of REITs taxable income.

Operating Requirements

- As part of the 1986-tax law reform, REITs were allowed to be self-managed/self-administrated.

3.3 Investors of CMBS and REITs

In the U.S., there are several real estate investors, such as pension funds, banks, insurance companies and individual investors. (Figure 7-9 shows investors in real estate.) On the other hand, in Japan, the real estate market has been limited only to Japanese-type developers, banks and life insurance companies. Past real estate expenditure of pension funds and postal life insurance[9] is almost zero in Japan. Regulations prohibited these funds from being invested in real estate.

The comparison of investment types is indicated below. (Table 3)

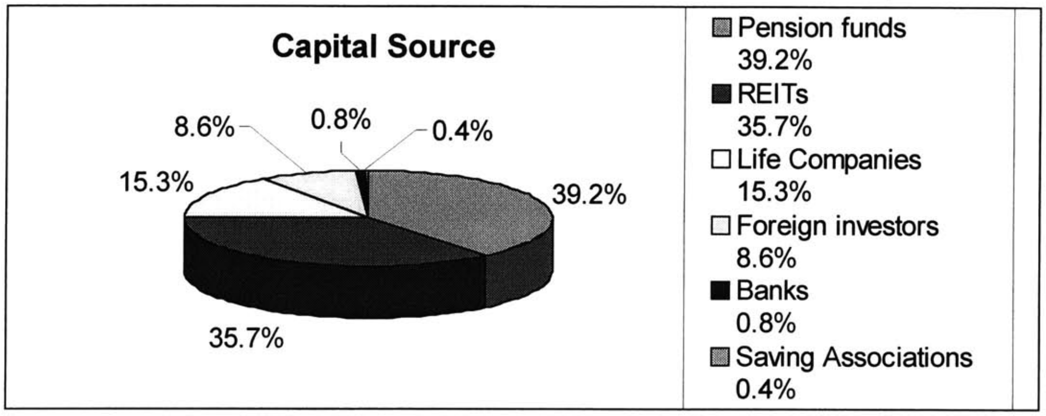
Table 3. Comparison of Investment Types

		1	2	3	4
Investment	**Type**	Assets	Unit of Investment	Liquidity	Profit of Property
Debt	MBS	Residential	small	high	unable to get
	CMBS	Commercial	small	relatively high	unable to get
	Mortgage REITs	Commercial/Residential	small	high	unable to get
Equity	Equity REITs	Commercial/Residential	small	high	able to get

		5	6	7	8
Investment	**Type**	Management Ability	Period of Investment	Dispersion	Leverage
Debt	MBS	no need	7~30 Years	high	
	CMBS	no need	15~30 Years	depends	50-80%
	Mortgage REITs	Yes	No limitation	high	60-80%
Equity	Equity REITs	Yes	No limitation	high	30-50%

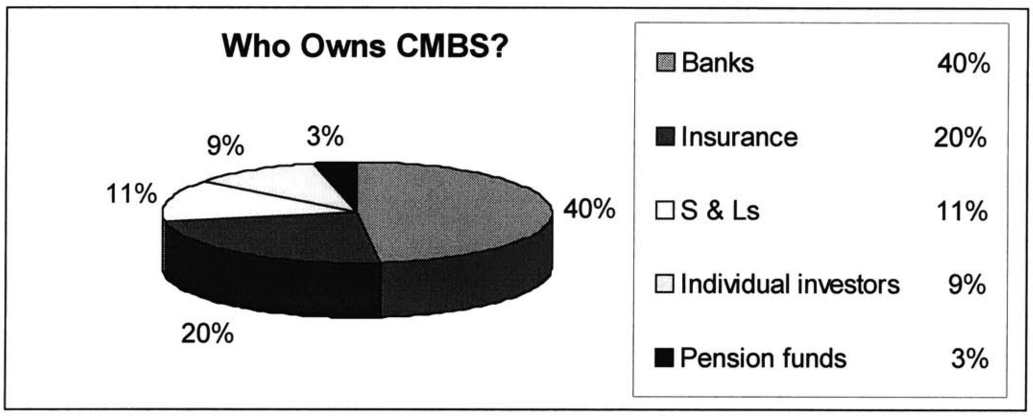
Source: Yasuo Ide, Real Estate Investment is Financial Business, Tokyo:Forest, 1998

Figure 7. Capital Source (U.S. Equity Real Estate <Institutional>)



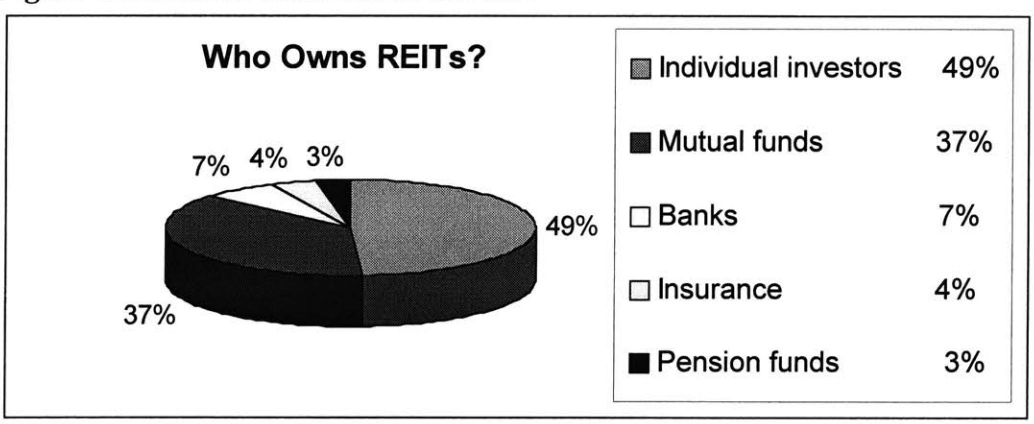
Source: Emerging trends in Real Estate

Figure 8. Investors of CMBS in the U.S.



Note: The total amount is $171 billion (1985-1997). Source: Federal Reserve 1997

Figure 9. Investors of REITs in the U.S.



Note: The total amount is $140.5 billion (1985-1997). Source: NAREIT 1997/PaineWebber

3.4 Summary of the Success of Securitization

The reasons for the success of securitization can be summarized as follows. First, investors can invest depending on their preference of return and risk, using the CMBS tranche system and REITs to meet investors' portfolio demands. Second, tax treatment is an important factor for expanding securitization. Investors can avoid double taxation, which attracts investors and enhances the value of assets. Third, the system has been under strong guard by governmental institutions, including the SEC (Securities and Exchange Commission), and the protection of investors has been planned strictly. Disclosure of information and rating of products are arranged properly. Fourth, intermediaries and key players are well organized to package assets and issue securities. Especially, investment banks play an important role in this system to expand securitization. Last, public institutions contribute in the sense that they prepare laws, the tax system and the secondary market. It should be remembered that public institutions such as the RTC, etc expanded the securitization market. In order to introduce the securitization system in Japan, these factors should be resolved.

Securitization introduced liquidity in the real estate market. Direct real estate is characterized by a lack of liquidity. In the past, investing in real estate involved tying up large amounts of funds for long periods and the risk of not being able to find a buyer when ready to sell.

For investors, securitization provides the opportunity to invest funds in a diversified portfolio of real estate. Previously, investors could not invest in real estate unless they had large amounts of funds. They could acquire real estate in small lots, assuming less liquidity risk in light of the ability to sell that equity at any time. Also, investors could obtain proper information for investing in real estate properties that have traditionally been closed.

CHAPTER 4

OUTLINE OF SECURITIZATION OF REAL ESTATE IN JAPAN

4.1 Historical Perspectives

a. History of Securitization in Japan

While Japan's securitization market has been slow to develop, Japan has a long history of securitization structure of mortgage-backed securities targeting residential housing. In Japan, unlike in the U.S., there is no secondary market in which these securities are traded and are priced every day. The first securitization, Teito Shoken (Mortgage Securities), appeared in 1931 under the Mortgage Deed Act. Jutaku Teito Shoken (Residential Mortgage Certificate) and Jutaku Loan Saiken Shintaku (Residential Mortgage Trusts) followed in 1972 and 1974 respectively. Concerning the basic system, mortgage companies provide housing loans to borrowers, and obtain approvals from the borrowers to sell the loans. Since mortgage companies guarantee payment to investors, risk gets associated with the mortgage companies. Strictly speaking, since these products are based on the Mortgage Deed Act, disclosure is not mandatory and the protection of investors is not well arranged. Also, these are no financial products which can be listed and which have the liquidity of securities under the Specified Credit Law (Security Act).

In 1994, the Real Estate Syndication Law was enacted, which made real estate investment in small amounts possible. However, its main purpose was to save taxes and to convert real estate ownership into small lots. The same as the previous product, this product does not act as a financial product suitable to individual investors because the security is too large and non-liquid.

b. Securitized Real Estate in Japan

To clean up disposed real estate, Japanese regulators followed in the US's footsteps by copying what the RTC did. The Resolution Trust Corporation was established to clean up the savings and loan of S&Ls in the late 1980s. The Japanese regulators established the Cooperative Credit Purchasing Company (CCPC) to resolve these problems. However, the CCPC has not produced a significant restructuring of underlying assets. As of March 31, 1997, the CCPC had purchased -at a discount- \$49 billion (5.44 Japanese Yen) of debt collateralized by real estate primary from major Japanese banks and insurance companies. Only \$6.9 billion (approximately 15%) has been repaid with the proceeds of real estate collateral sales[10].

Recently, Japanese financial institutions began to securitize their loan assets. However, the system that has been developed is complex and limited to corporate investors. Furthermore, the risk of a price decrease falls largely on banks and other institutions (Table 4). In mid-April 1998, Goldman Sachs (GS) securitized the properties owned by Yamato Life Insurance Company, which is the twentieth largest asset holder in Japan's life insurance industry. In this deal, Credit Suisse First Boston Securities (Japan) Ltd. set up a real estate trust for the properties and then GS bought all trust beneficiary rights for \$54 million. They judged that they could expect 0 percent vacancy rate and 5 percent annual return. Also, GS will securitize the head office building of Toho Life Insurance Company in cooperation with GE Capital in March, 1999.

Table 4. Latest Securities Issued by Finance Institutions

Date Issued	Name of Bank	Sum ($ million)	Converted Security	Risk of Price Drop for Targeted Property
Jul, 95	Former Mitsubishi	90	Real estate	70% covered by bank trusts
Aug, 96	Fuji Bank	37	Real estate	100% covered by bank, etc
Sep, 96	Sanwa Bank	272	Loans	100% covered by third party
Dec, 96	Nippon Credit	29	Real estate	100% covered by bank, etc
Mar, 97	Asahi	103	Loans	100% covered by bank, etc
Mar, 97	Tokyo Mitsubishi	48	Loans	Investors
Jul, 97	Yokohama	72	Real estate	
Sep, 97	Sakura Bank	91	Real estate	

Source: Japan Real Estate Institute/http://www.reinet.or.jp, Newspaper

4.2 New Securitization System: SPC Law (Special Purpose Company Law)

a. New Law

Since Japan's legal system prevented companies from securitizing their assets, the Japanese government introduced a new law, the Special Purpose Company Law (SPC Law), to bypass many other laws. Real estate lacks liquidity compared to other assets such as cash, bank deposits and securities. Hence, the SPC Law came into effect on September 1, 1998, with the aim of authorizing and promoting an SPC to securitize designated monetary debts and real estate.

If this law works in the real estate market, it will be a new start for securitization of real estate in Japan.

This law was intended to be a scheme for eliminating bad debt in order to help companies, institutions and investors because many companies have a great deal of real estate which they bought before the decline of the economy and have not finished their redemption. The formal name of the law is the Bill of Law Pertaining to the Liquifying of Specified Assets by Means of the Issuance of Securities by Specific Purpose Company.

b. Special Feature of the SPC

Since the SPC aims at managing CMBS (debt) products and REITs (equity) products, by issuing priority investment securities and specific bonds, the regulations of the SPC are restrictive with respect to free use of real estate funds. This is because the SPC, first, was established to solve bad loan problems caused by overly optimistic financing for land acquisition.

Key points concerning the SPC cover several topics. Since, by the SPC law, additional issuance of securities is impossible, in the event of a shortage of funds, the only way to obtain financing is through the issuance of commercial paper. Furthermore, additional acquisition and disposal of real estate is restricted, so it cannot be expected to grow as REITs do, by obtaining and disposing of appropriate products. Also, in principal, the SPC securities cannot be listed. Thus, securities, issued by the SPC, would have less liquidity and transparency than listed. Since the SPC does not take initiative in management, the SPC cannot gain incremental value as REITs do by active management, which is one of the companies' values. Also, the impact of a bankruptcy is still not clear. When owners file for protection under bankruptcy, the payment of interest to investors could be affected. At any rate, it is definitely true that the SPC Law is the first step to securitize not only disposed real estate but also normal-profits real estate and make possible investment in small lots of real estate.

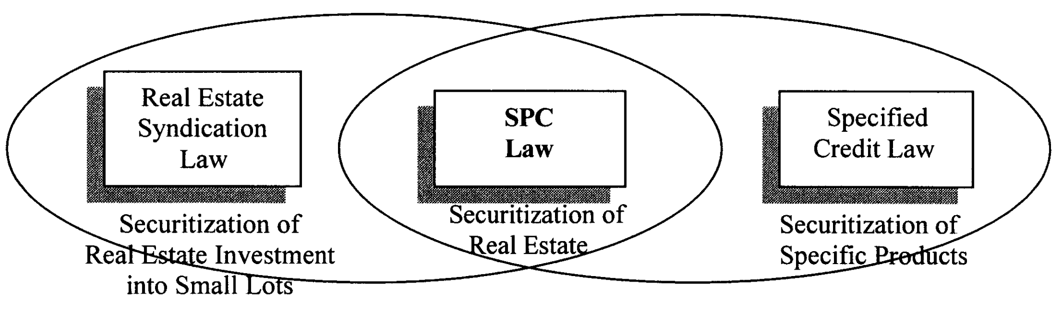
c. Framework

Below is the framework of the SPC Law. Basic structure is indicated in Figure 11.

<u>Basic Laws related to the SPC Law</u>

The SPC Law is the result of demands to combine and expand two existing laws, the Real Estate Syndication Law and the Special Credit Law. The purpose of the former, established in 1994, was to convert real estate into small lots with a legal basis. That of the latter was to add liquidity and create new added value for a limited range of certain financial products (Figure 10).

Figure 10. Basic Laws related to SPC



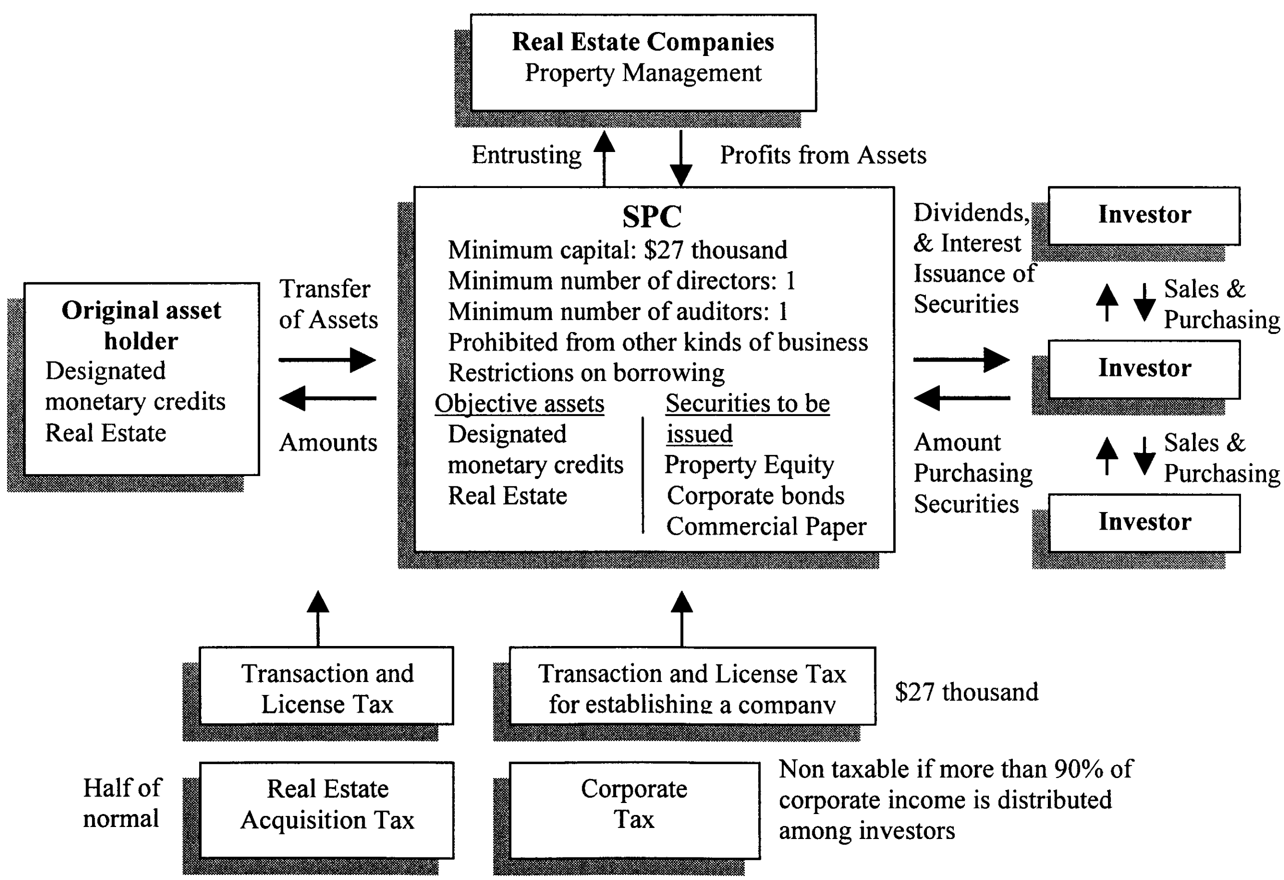
<u>Framework</u>

Taxation is the main factor which prevents the direct flow of cash to investors. In Japan, since the corporate tax rate is about only 50 percent, half of the cash flow goes to investors.

So a Pass-through vehicle is needed, which avoids taxation at the corporate level. Before the SPC was established, trust systems and associations were the only ways to use this vehicle; however, these two conduits could not issue securities. The SPC was established to solve this problem.

The main framework of the SPC is as follows[11].

Figure 11. Scheme by the Use of SPC



Source: Mitsui Realty

- The activities of SPCs are restricted to the issuance of securities using assets as collateral.
- Kabushiki-Kaisya (joint-stock companies with capital of $27,300 [3 million Yen]) established by financial institutions or general corporations. General joint-stock companies need $91,000 at the first level.
- Assets subject to securitization include loan credits, accounts receivable, real estate, etc.
- Issued securities include stocks, bonds, commercial paper, and other marketable securities as defined by the Securities Exchange Law.
- In addition to information disclosures required by the Securities Exchange Law, assets and business plan must be disclosed.
- Taxation system:

  Exempt from corporate tax, provided at least 90 percent of profits are disbursed as dividends.

  License tax on the registration of real estate transfer is 2.5 percent and acquisition tax is 2.0 percent (half of the usual rate).

  Exemption from special land ownership tax is disbursed as dividends.

  Real estate tax and city planning tax are as usual, 1.4 percent and 0.3 percent respectively.

d. Securitized Real Estate by SPC

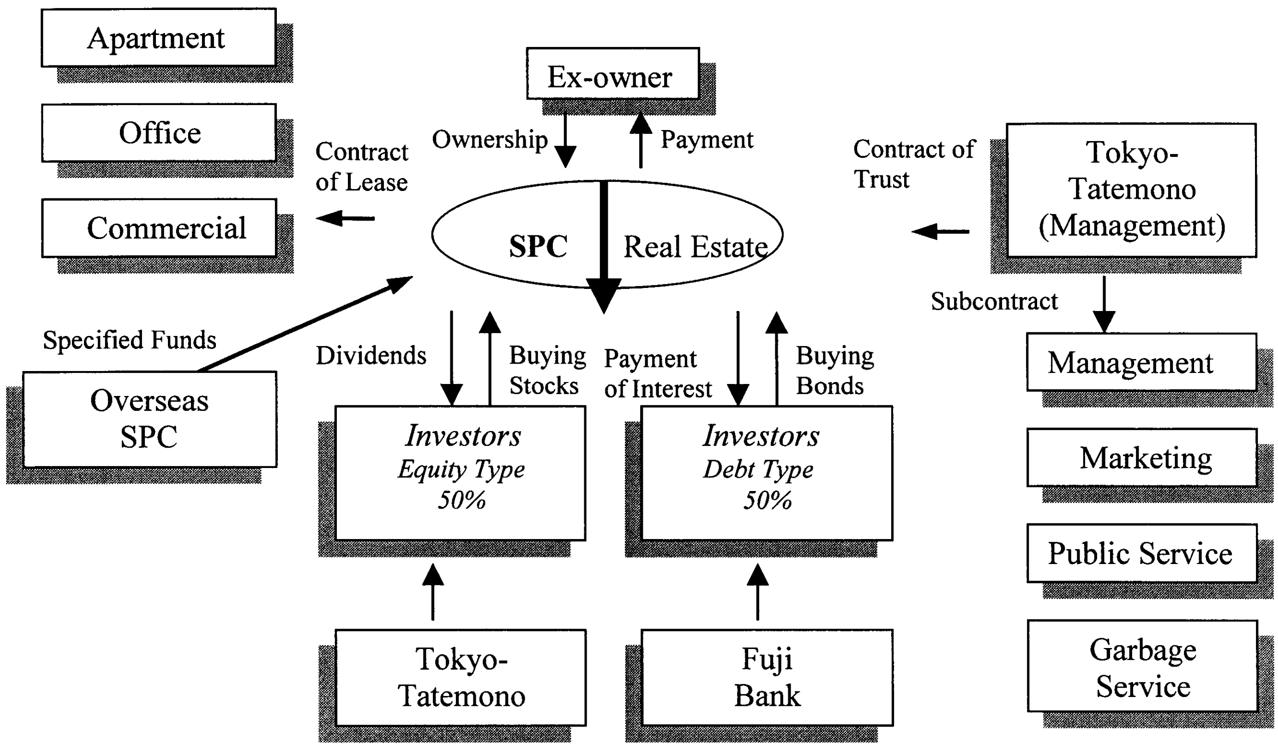
Table 5 indicates recent securitized products in Japan. We can see there are some special features in these deals. First, objects are well-located, high-grade buildings and are expected to yield high return or high cash flow. Second, some companies used an overseas SPC, which is, in some cases, cheaper than using a domestic SPC. This is a serious point for the SPC in Japan, which indicates that the SPC needs some improvement. Third, investors are now investigating which method, equity, mortgage or hybrid, is the best for securitizing in Japan. Finally, some companies are examining securitizing even their own head offices. This is because most Japanese companies are in bad financial states, in addition to dealing with deflation, so continuing to have assets is a disadvantage. Companies should be managed efficiently, which is the top matter for executives. In this sense, securitization is a good way to improve companies' balance sheets. This process is called off-balance.

Table 5. List of Latest Securitized Products by SPC[12]

No.	Date	Company	Real Estate	Sum $ million	Security Type
1	Nov, 98	Tokyo-Tatemono	Lease-residence for foreigners	59	Priority investment securities (equity) 50%, specified bond (debt) 50%
		etc: Expected return is about 6%			
2	Sep, 98	Ito-Yokado & City Trust Bank	Shopping Center	91	
		etc: Average return is 4%. Period id 5 years.			
3	Jan, 99	Japan Energy & Mitsui Realty	Head office of Japan Energy	636	Priority investment security and specified bond
		etc: Building was built in one of the best place in Tokyo in 1987. 20F/67,000m2			
4	Jan, 99	Tokyu Realty & Mitsui Trust Bank	Shopping Center	45	Priority investment security and specified bond
		etc: Period is 5 years. Located in Chiba prefecture (adjacent to Tokyo)			
5	Feb, 99	Daikyo & Morgan Bank	Lease-residence 1,184 units	60	
		etc: Used overseas SPC. First CMBS type product in Japan.			
6	2002	Tokyo Marine Insurance & Mitsubishi Industry	Residence	42 out of 109	Priority investment security and specified bond
		etc: Will use overseas SPC. Not transfer real estate to SPC to avoid tax on the registration of real estate transfer and acquisition tax.			
7		The International Bank of Japan & Dai-ichi Insurance	4 office buildings	136	
		etc: Will use overseas SPC. Expected return is about 5-6%			

Sources: Nihon-Keizai Newspaper

Figure 12. Scheme by the Use of SPC: Tokyo-Tatemono Lease Residence



Sources: Real Estate Securitization, Organization for Promoting Urban Development

Table 6 also indicates that not only real estate and finance companies but also industrial companies and the public sector are paying attention to the possibility of securitization. More companies are expected to consider securitizing their assets in order to reinforce financial conditions. In 1998, Toshi-Mirai research laboratory, one of the biggest thinktanks in Japan, sent out a questionnaire to over 700 companies. The answers indicated that 39 percent of companies thought they had to examine effective use of their real estate assets and 29 percent had been examining or promoting it.

Table 6. Trends of Securitization in Japan[13]

No	Date	Company	Contents
1	Oct. '98	Tokyu Realty	Announced in "New Management Plan" that they will securitize their assets/lease-buildings in order to reinforce financial conditions.
2	Dec. '98	Kanagawa Prefecture	Will securitize public land in Kanagawa prefecture.
3	Dec. '98	Mitsubishi Material	Will securitize their assets worth $545 million including its head office in Otemati, Tokyo in order to reinforce financial conditions.
4	Jan. '99	Sumitomo Marine Insurance	Will cooperate with American Appraisal Associates with respect to know-how in securitization in Japan.
5	Jan. '99	Cosmo Oil	Will securitize their 1,500 filling stations all over Japan in order to reinforce financial conditions.
6	Jan. '99	Sumitomo Life Insurance	Will securitize their assets worth $910-1,820 million in order to reinforce financial conditions.
7	Feb '99	Recruit	Will securitize their asset in Kawasaki worth $110 million with Colony Capital and Kennedy Wilson Group.
8	April '99	Sumitomo Bank	Will securitize their 20 branch offices in Japan worth $270-280 million with SPC in order to reinforce financial conditions. Priority investment security and specified bond.

Sources: Nihon-Keizai Newspaper

4.3 Problems to be solved in Real Estate Market in Japan

During the long history of securitization, securitization products for real estate in the U.S. have grown in popularity with investors. Originally, there was not a large securitization market in the U.S. In addition, this system has been under strong guard by the SEC (Securities and Exchange Commission), and the protection of investors has been enforced strictly. Since Japan's securitization in real estate has just begun, there are many obstacles which have prevented the securitization market from expanding. To achieve a variety of securitization products like U.S. products, these problems should be solved. The problems, which must be solved during the first stage, are addressed in Chapter 5.

a. The SPC

As mentioned, the regulations of the SPC Law are restrictive with respect to free use of real estate funds because the SPC was established to clean up bad loan problems. This law creates disadvantages for some market players. If investors are not interested in this scheme, this law would have a negative impact on the securitization market.

As mentioned in Section 4-2-b, the SPC still has several problems, including the issuance of additional securities, tax issues and the secondary market. With the problems, companies cannot grow, investors cannot benefit from increasing economies of scale, and it is difficult to change the capital structure. In addition, although the cost to establish the SPC was less than that of joint-stock companies, the SPC needs some capital to start itself. Using overseas SPCs is, in some cases, cheaper than using domestic SPCs. In this sense, structured costs should be reviewed.

<u>Revision</u>

On March 10, 1999, the Liberal Democratic Party set to work on the revision of the SPC Law in answer to the requests for the reduction of cost and flexible management, etc. Main problems to be examined are the abolition of the acquisition tax and the permission for real estate companies to issue securities. This revision will also discuss the additional issuance of securities in the event of a shortage of funds.

<u>J-REITs</u>

To achieve attractive products, revision and improvement of the SPC or application of a corporate investment trust to real estate securitization is important. In addition, the introduction of a REIT-type product may activate the real estate market. There are several movements toward creating so-called J-REITs (Japanese REITs) which can be listed. The concept of the J-REITs came onstage in the Liberal Democratic Party's fourth round of economic stimulus measures in February 1998. Since the SPC cannot be listed, securities that the SPC issues would have less liquidity and transparency than those listed. The J-REITs plan is aimed at attracting not only institutional investors but also many individual investors, to expand the use of the SPC, which means increasing liquidity through the listing of securities. The Tokyo Stock Exchange and the Osaka Stock Exchange are investigating the securitization market handling Japanese REITs (J-REITs) and corporate investment trust. The Ministry of Construction is also examining equity-type products for securitizing real estate. However, at present, the characteristics of J-REITs have not been clearly defined; it seems that only their name or title has been established. Currently, one possible idea for listing an SPC is that the investment trust would be listed after it purchased securities issued by the SPC. It is also possible to establish a corporate investment trust and put real estate into it. However, this seems impossible because real estate is not a permitted product for investment trusts. At any rate, if established, J-REITs will increase investor participation by listing the securities to maximize the liquidity.

b. Finance and Real Estate[14]

In the U.S., real estate has long been treated as a financial product. Conversely, in Japan, real estate and finance have been overseen by separate government bodies, the Ministry of

Construction and the Ministry of Finance. Banks have not been allowed to set up holding companies to run real estate companies. Given such an environment, it is doubtful that Japan will instantly move harmoniously toward the creation of liquidity through securitization.

c. Appraisal Method

Because before the depression, the increase in real estate prices had been considered normal, the value of real estate mostly depends on land price, not on cash flow. In Japan, the ownership of land and structures is recorded separately, while, in other countries, it is recorded together. This made it possible for the Japanese system to depend on the prices of land and pay less attention to its cash flow. Now, since we can not expect land prices go up, it is necessary to pay attention to cash flow. The appraisal methods of projects are not clear because of the transition from systems based on past records to systems based on discounted cash flow. Also, the globalization of economic activity and internationalization of investment money flows are forcing the Japanese real estate market to be more globally standardized and more open. Thus, Japan is expected to move toward the U.S.-type business evaluation method, centered on building -related earnings.

d. Rent Rule and Leasing Code

It is difficult to project the future cash flow of a building because the normal rent contract of buildings in Japan is based on 2-year periods. In addition, under the Leasing Code, protections for tenants are considered to be excessive by most Japanese experts. Owners tend to bear unexpected expenses. A lease can be canceled with six months' notice without penalty. A new Leasing Code was introduced; however, it will take time to have an effect. The new code is applicable only to new contracts; leases under existing laws remain in effect under those laws. These factors make the prediction of cash flow difficult, leading to the difficulty in evaluating the projects. This produces increased risk, which leads to increases in the cost of securitization.

e. Undifferentiated Functions

In Japan, companies that function as property management, rating agencies, investment advisors and inspection agencies have not been established or well organized. In addition to the Special Purpose Vehicle, these companies and institutes are necessary infrastructure for expanding securitization in Japan. Current trends by Japanese companies are summarized in Table 7.

f. Group of Japanese Companies

In Japan, there are several groups of companies and it is common to do business within a group. Also, the cross-holdings of stocks with a group is still common. In fact, several securitization schemes indicate the cooperation of companies in the same group. For example, Figure 12 shows that same group companies, Tokyo-Tatemono and Fuji Bank, made a securitization scheme. This does not mean the true expansion of securitization; however, on the other hand, this seems necessary until the infrastructure of securitization is arranged.

g. Japanese Character

There are still some particular problems in investing with securitization in the real estate market for the Japanese. There still exists a strong sense of resistance to selling real estate assets, which is a major Japanese characteristic. The Japanese strongly adhere to possession, so the concept of owning real estate assets by securitization may not take root easily. Also, the Japanese are very conservative in the sense that they tend to avoid risks even though there is a possibility they can get high return. Unlike Americans, they deposit over 50 percent of their money in a bank. The Japanese investment style shows a tendency to regard sellers' credit as more important than the value of investment products. At the same time, the Japanese are not used to investing, which means that they are not familiar with risk or return.

If the securitization system is introduced, the Japanese must have management ability because investment requires complete self-responsibility. It seems to take time for individual investors to learn about the complicated structure of securitization, the securitization market and investment decisions based on knowledge of credit ratings. These factors indicate that it will take time for the Japanese household to be potential investors in real estate securities.

CHAPTER 5

POSSIBILITY OF SECURITIZATION IN JAPAN

5.1 Main Obstacles

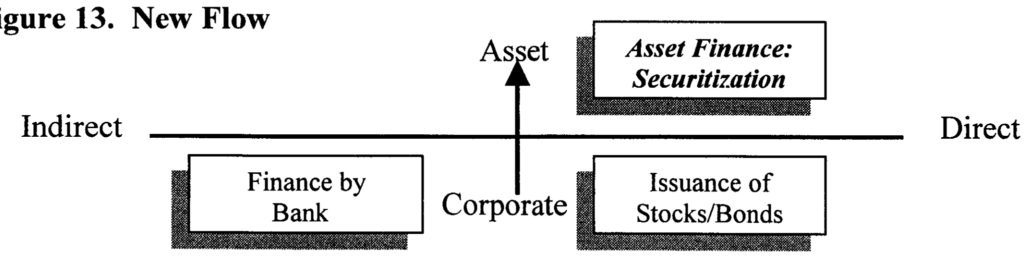
In addition to securitization of the disposed real estate, we have to think about that of typical profit real estate, such as buildings. If the Japanese real estate market does not intend to improve and expand securitization for typical profit real estate when the first stage of securitization of the disposed real estates is completed, the business opportunities of securitization will decrease drastically. As a result, foreign investors and companies, which get most of the profits, would go away from Japan. Also, there is a possibility that securitization may end up being a temporary phenomenon. In this sense, the development of securitization in Japan depends on the arrangement of the secondary market and the supply of a wide variety of products in which investors or companies will invest.

The main obstacles, which prevent securitization in Japan from expanding and should be overcome immediately, are as follows:

a. Financing System

Real estate is normally traded on a very large scale, involving huge amounts of money. However, in Japan, since the depression, it has been difficult to trade and realize any kind of gain. Only companies and investors with plentiful funds can invest in real estate these days. This is because, in Japan, the traditional rigid system of investment has centered on indirect financing, and corporate credit is considered the most cost-effective means of financing an investment. In Japan, financial institutions lend money to corporations, which have the potential for developing technology and producing fundamental and exportable goods. They recognize a corporation as a total unit, having various kinds of products, technologies, and human resources; they do not evaluate the strength of a corporation by researching each business. While the financial institutions may have researched and carefully evaluated the environment surrounding a corporation, such as trends in the industry, the corporation's position within the industry, etc., they are not interested in how each business or project would contribute to corporate profit or cash flow. This tradition of not evaluating each project is the type of corporate finance that is generally accepted in Japan. On the other hand, the U.S. practices project finance, which evaluates the cash flow from projects. However, in Japan, up to now, this method has been applied to large-scale and high-grade projects which are expected to yield stable high return or cash flow. For example, Universal Studio in Osaka, which will be completed in 2001, was financed at $1.2 billion by several banks and the electricity project in Osaka was financed at $120 million by two Japanese main banks in 1998. It is said that project collateral by real estate was not familiar with Japanese: it does not fit into the Japanese system easily.

Figure 13. New Flow



b. Non-recourse System

As mentioned in (a), the Japanese system allows corporate finance because it evaluates the creditworthiness of a corporation rather than the cash flow of the project itself. Non-recourse loans have not been widely used in Japan. This means that the risk of every project is not evaluated strictly. In Japan, recourse loans have been popular. For banks, they can get security of real estate and credits of companies they finance. However, with the decrease of real estate prices and bankruptcies in Japan, recourse loans could be risky. In reality, only a few foreign companies used this system in Japan. Also, the nature of secured credit is different in Japan from that in the U.S. in that, in case of default, a claim on a secured property cannot be transferred to other creditors because the security consists of all the assets owned by the debtor, not just a secured asset[15]. This not only makes investors accept project risk unwillingly but also makes securitization itself difficult.

c. Tax Issues

We can see from Table.5 that recent securitization trends indicate that companies use overseas conduits rather than domestic ones. One of the reasons for this is that some countries apply a low-corporate tax on overseas companies, so it is cheaper to establish an SPC overseas. Even though license taxes on the registration of real estate transfer and acquisition taxes were reduced to half the usual rate by the SPC law, benefits from the low-tax are not enough. Clearly, the whole tax system regarding real estate should be reviewed. Actually, Tokyo Marine Insurance & Mitsubishi Industry have planned a scheme not to transfer real estate to the SPC in order to avoid the tax on the registration of real estate transfer and the acquisition tax. (Table.5)

d. Disclosure

Compared with financial products, real estate is traded individually with no public market and the information about past records is not open to public. Consequently, it is difficult to predict the expected return. Since investors decide whether they should invest or not by examining total return of the assets in the district around the project, the information about offering rents, contract rents, occupancy rate, management cost, tax cost and past records of dealings is essential. The index involving this information is regarded as one of the important infrastructures of the securitization market. Especially for investors, this information is very important when they decide whether to invest or not. In the U.S., the NCREIF (National Council of Estate Investment Fiduciaries) index is popular, which gives information quarterly. On the other hand, in Japan, disclosure has not yet been established. It is difficult to evaluate the return and risk in investing because market data and past records are not open to the public and disclosure is still not perfect. Offering rents are different from contract rents, and the latter are not public. The most serious point is that Japanese companies still have a strong resistance to making this information public, fearing that it would interfere with competition. To request too much information from companies would lead to delaying the spread of securitization. At any rate, the standard contents of information disclosure should be established. Ideally, government should lead the arrangement. In reality, governmental institutions and private companies are promoting it. The disclosure would decrease risk premiums, leading to the reduction of the cost of securitization.

5.2 Securitization Market

How many investors will there be in the securitization market? How much money will flow into the market?

a. Investors' View

Up to now, the real estate market has been limited only to Japanese-type developers, banks and life insurance companies, which is different from the U.S. In the U.S., there are several investors, such as pension funds, banks, insurance companies and individual investors. (Figure 7-9 shows investors in real estate.)

The amount of pension funds in Japan is about $345 billion, 20 percent of which is permitted to be used in real estate. However, past real estate expenditure is almost zero. The amount of postal life insurance is $840 billion, which is not permitted to be used in real estate. The possibility of easing these regulations is now being examined. So it may take time for pension funds and postal life insurance to be invested. In the U.S., investment banks contributed to expansion of the securitization market. After the depression, new investors, foreign firms, appeared in the real estate market. They mainly use investment capital derived from pension funds and real estate investment trusts in the U.S. It is said that they request high return in exchange for accepting risk aggressively. On the other hand, domestic investors, such as financial institutions and Japanese life insurance, will again be potential investors if securitization of real estate progresses. In Japan, a Japanese-type developer used to be a main player in the real estate market. However, the roles of financial institutes are getting more important in terms of their ability to securitize. Also, insurance companies, which have a lot of experience in real estate investment, and securities companies, which view securitization as a new business opportunity, should contribute to the formation of the securitization market along with governmental financial departments. Also, although it seems to take time, individual investors will contribute to the securitization market, provided environments concerning securitization are set up. One important question is whether it is beneficial for an owner, such as a Japanese-type developer, to securitize his/her assets. As mentioned in Section 5-1-a, in Japan, corporate finance is popular and the interest on money is extremely low. So if owners pay a higher interest rate, securitization will be an unattractive financing vehicle. Securitization will work when it can provide an alternative source of capital whenever traditional sources cannot provide large sums of capital. This applies more to companies which have good credit in Japan. Companies with limited credit will use this system efficiently.

Merits and demerits of securitization and important points for investors are summarized as follows.

Merits

- It is possible to invest in real estate in small lots, which makes it possible to invest without large amounts of money.
- Using debt type securities and equity type securities, investors can select their preferable return and risk products.

- It makes it possible to diversify investment risks

Demerits

- The market value of securities reacts sensitively to changes in the financial market. Even though the real estate market is stable, there is a possibility that if the financial market goes down, the market value of REIT-type securities will decline accordingly. Also, we can see that the return of REITs in the U.S. dropped to a negative number this year, even though the S&P 500 remains high, so this correspondence requires further study. The price of CMBS decreased even though the real estate market is stable. These facts indicate that the availability of capital may be effected by investors' preferences, not related to the soundness of underlying real estate.

The system in the U.S. has been under strong guard by governmental institutions including the SEC, and the protection of investors has been carefully enforced. To protect investors is essential for the development of the securitization market. In Japan, government should lead the arrangement to establish standards. Governmental institutions and private companies have discussed this matter.

Key factors influencing the decision to invest

- To secure high liquidity of real estate
- To secure risk dispersion
- To expect cash flow for sure and high quality management
- To disclose information thoroughly
- To secure bankruptcy remotely if using the SPC (If the originator goes bankrupt,

the SPV and the originator must be separated)

- At least, to secure the coverage in case of price drop
- At best, to secure high return including risk premium to a maximum.

The ideal real estate to securitize

To promote expanding securitization for typical profit real estate, for the present, excellent real estate should be securitized. The ideal real estate to securitize is buildings with:

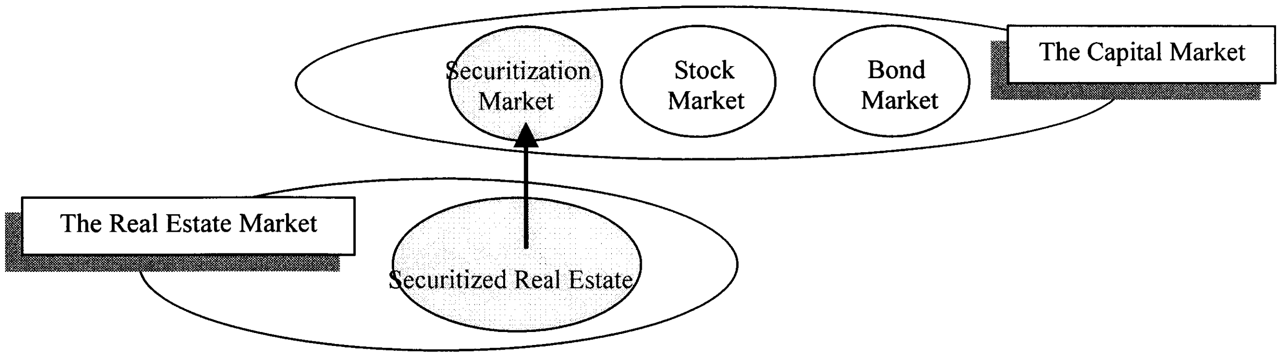
- Low occupancy rate
- Location in the best district with good environment and access to traffic
- New substantial facilities
- Proper management
- Arranged data concerning cash flow and structure
- Long time stable income

b. Formation of Securitization Market

Securitization is one method to unite the capital market and the real estate market (Figure 14). It aims at making investment in real estate as easy as it is in stocks, by dividing up the rights to buy so that many investors can acquire it at a low cost. There is great potential that securitization will work in Japan's real estate market.

As mentioned above, The Tokyo Stock Exchange and the Osaka Stock Exchange are investigating the Securitization market handling Japanese REITs (J-REITs). In January 1999, they announced that a concrete framework would be undertaken, first making sure the demand for it exists.

Figure 14. Image of the Securitization Market



Up to now, it seems possible to securitize excellent real estate which produces stable return and whose risk is low through the SPC. To spread the securitization market, there seems to be a limit to attractive products of securitization by the SPC. In this sense, again, the development of securitization in Japan depends on the supply of a wide variety of products in which investors or companies will invest. It is important to set up systems and laws by solving problems in real estate market.

Not only the securitization system but also businesses related to it, the infrastructure of securitization, are of importance for expanding securitization investment and the securitization market. Summaries and current trends are summarized in Table 7.

We can see that the infrastructure of securitization has been prepared step by step. It is important to expand specialists in each infrastructure so that competition will increase and the accuracy of information will increase. This will lead to increasing trust in products and the efficiency of trades. In all cases, it is of the essence for securitization not only to end up cleaning up the disposed real estate but also to give opportunities to invest for many investors, including individual ones.

Table 7. Current Conditions of Securitization Infrastructure

Law	Year	Current Conditions
SPC Law	March '99 started	In March '99, the abolition of the acquisition tax and the permission of securities by real estate companies and the additional issuance of securities are discussed.
J-REITs		Under preparation
Servicer Law	'99	Now only lawyers can engage in this practice by law. It will remove the ban to private servicers.
Leasing Code	'98	Problem is that this revised law applies to only new contracts, not old continual contracts.
Information	**Year**	**Current Conditions**
Investment index by private companies	'98	Council for Real Estate Syndication is now drawing up in corporation with real estate companies and Life Insurance companies. Japan Real Estate Institute will cooperate with IPD (Investment Property Databank) with respect to know-how of investment index. STIX (Sumitomo Trust Property Index) by Sumitomo Trust Bank
Rent Data by private companies	'98	Japan Real Estate Institute announces twice a year and makes the projection model of rent in coorporation with Sanki-Shoji, building mediator company.
Special Functions	**Year**	**Current Conditions**
Due Diligence	since '97	After foreign firms began buying the disposed real estate, due diligence increased. E&Y Kenneth Leventhal, Real Estate Group started business in 1996, using JIV (Japanese Investment Value) model based on DIV (Derived Investment Value) for the RTC.
Servicer	'99	CCPC (Cooperative Credit Purchasing Company) announced its engagement in Servicer activity. In April 1999, four private companies including two U.S. subsidiary ones (GM) were permitted to do business.
Investment Advisory Services	'98	Mitsui Real Estate,the largest real estate company in Japan, established Mitsui Investment Advisory Services.
Rating Agencies		Up to now, the main companies are the S & P (Standard & Poor's) Japan and Moody's Japan. Also, two Japanese institutions started business.
Assets	**Year**	**Current Conditions**
Pension funds	'99	The ratio of distribution of funds will be abolished. Permitted to be used in securitization products
Postal life insurance	'99	ABS (Asset-Backed Securities) will be added to the use of savings. Permitted to be used in securitization products

Sources: Newspaper, NLI CCPC: Refer to Chapter 4.1.c

5.3 Possibility of Securitization in Japan

a. Conclusion

As discussed in Sections 4.3, 5.1 and 5.2, there are still several problems to be solved, in order to shape the securitization market. It seems that securitization will not expand at a stretch and will take time to take root in Japan as it did in the U.S. This is because Japan's peculiar problems tend not to be solved easily. However, the infrastructure of securitization has been arranged step by step by private companies and the government. Securitization in Japan will slowly but surely be established in cooperation with governmental organizations, private companies and investors. In Japan, the problems concerning disposed real estate have been investigated, which is a situation similar to the U.S. in the early 1990s. But the true purpose of securitization is to make real estate into products in the real estate public market and to develop and activate the real estate market.

Even though there are many obstacles, participants, including foreign firms, think that the securitization market in Japan will ultimately become the second largest one after the U.S. Now that securitization has already started, its success depends on the diversity of securitization products, which attract many kinds of investors, and the growth of the infrastructure of the market, such as the existence of the secondary market, the establishment of the disclosure system and non-recourse system, tax issues, and the support of public institutions. The problems will be solved gradually. If these goals are achieved, bringing liquidity and transparency to the real estate market, the securitization system will certainly provide a vehicle to expand capital investment for real estate, unite the real estate market and the capital market, and make the real estate market a totally different one.

Considering the current state of securitization in Japan, it is important for securitization to become a popular method for a variety of investors to use in the real estate market. To achieve this goal, CMBS-type products or Hybrid REIT-type products should be promoted strongly in the first stage. It seems to take time to expand REIT-type products because, in the beginning when the market is still dark, nobody wants to buy equity. The key player, such as investment banks in the conduit-CMBS process, should be established in Japan. Foreign firms can be these players in the first stage. Though Japanese securities companies have been engaged only in trading stocks and bonds, they may potentially play the same role as investment banks in the U.S. to produce CMBS-type products. Japanese securities companies would be able to develop securities products, pool the loans, and determine appropriate cash flow allocation. Also, governmental institutions may be a potential player in this business and may give incentives to securities companies to motivate them to expand their business. Regarding conduits to provide the diversity of securitization products, the SPC in Japan is considered a beginning and will be improved. The cooperation of Japanese companies in the same group is acceptable until the infrastructure of securitization is arranged.

Although there are no legal obstacles to non-recourse system and project finance, they have not taken root in Japan. Most importantly, private companies should introduce the non-recourse system as soon as possible. In the first stage, the role of the government is important because its actions can facilitate the expansion of securitization in Japan. Concerning the finance system, the government should take the initiative in the leading projects and set an example of non-recourse system and project finance. Achievements of non-recourse system and project finance by public financial institutes will lead gradually to the expansion of their use by private financial companies. Taxation should be relieved by the government so that the SPC can be used with less structured costs. The acquisition tax and the permission necessary for real estate companies to issue securities should be abolished. Thus, the opportunities for using securitization would increase, which would facilitate the expansion of securitization.

Foreign firms and insurance companies tend to be the main investors, a trend that is likely to continue. Ideally, individual investors and pension funds will participate in securitization activities to expand the securitization market in real estate. Therefore, disclosure is critical in that it provides investors with the necessary information to decide their investment preference. To complete disclosure, rent rules and appraisal methods should be developed. The government at first should establish the standard contents of information disclosure. Also, especially in Japan, investment advisors will be increasingly critical because the Japanese, unfamiliar with investment, are conservative and lack the knowledge of credit ratings and securitization. In Japan, securitization's role will effect the participation of not only institutional investors but also individual investors. Insurance companies, which have a lot of experience in real estate investment in Japan, could be critical players in this role. Also, governmental advisory institutions might be established to set standards of investment advice, to grant advisory licenses to private companies, and to educate individual's investors. It can be one incentive that, during the formation of the market, before its maturity, some actions/incentives by public institutions, such as the coverage of individual investors' losses, are acceptable to some extent, so that they feel comfortable investing in securitization.

During the second stage, REIT-type products should be introduced and the secondary market should be arranged with cooperation of private companies and governmental institutions.

5.4 Calculation of Securitization Market in Japan

The securitization market can be calculated based on some assumptions. The Organization for Promoting Urban Development, an incorporated foundation of real estate in Japan, tested a calculation, which indicated that the scale of the securitization market in Japan would be around $180 billion (Table 8). The NLI (Nissei Life Insurance) Research Institute calculated that even disposed real estate has a $30 billion market and that the office building market is $40 billion. Adding in other facilities, this amount would rise further.

With the arrangement of the infrastructure of securitization, in all events, the formation of securitization will revive the real estate market in Japan.

Table 8. Scale of Securitization Market

The Prediction of Supply

[1]	The Presupposition		
		The total amount of commercial real estate: about $3.5 trillion The total amount of REITs: $140.5 billion; The ratio: $140.5 biillion/$3.5 trillion = 4.0% The total amount of CMBS: $171 billion; The ratio: $171 biillion/$3.5 trillion = 4.8% Source of numbers: Merrill Lynch	
[2]	The Scale of Commercial Real Estate in Japan		
	There is no exact figure for amount of commercial real estate.		
	[a]	Assumption 1: from property tax	
		A property tax for land: $33.7 billion, A property tax for structures: $30 billion The amount of commercial real estate: ($33.7 billion/0.014+$30 billion/0.014) X Ratio of rent (unknown)=$910 billion-$2.73 trillion Source of numbers: The Ministry of Finance	
	[b]	Assumption 2: from real estate prices	
		The total amount of real estate: about $21 trillion (housing $2.3 trillion, other structures $2.7 trillion, land $16 trillion) The amount of commercial real estate: $21 trillion X Ratio of rent (unknown)=$910 billion-$2.73 trillion Source of numbers: Mitsui Realty	
[3]	The Amount of Securitization Products in Japan		
	The scale of supply = $2 trillion (amount of commercial real estate) X (4.0%+4.8%) **= $ 180 billion**		

The Prediction of Demand

[1]	Individual investors		
	[a]	The Conditions of Purchaser in the U.S.	
		Of $140.5 billion in REITs, individual investors own $68.8 billion (49%). Of $171 billion in CMBS, individual investors own $15.4 billion (9%). Source of numbers: NAREIT, Federal Reserve 1997	
	[b]	The Ratio of Products	
		Of $21 trillion in private financial assets in the U.S., REITs equal $68.8 billion (0.3%). Of $21 trillion in private financial assets in the U.S., CMBS equals $15.4 billion (0.1%).	
	[c]	The Scale of Market of Individual Investors	
		$11 trillion (private financial assets in Japan) X (0.3%+0.1%) = $ 44 billion	
[2]	Institutional investors		
	[a]	The Ratio of REITs and CMBS to Total Assets	
		Of $16.8 trillion in total financial assets in the U.S., REITs and CMBS occupy 1.2% (REITS 0.4%+CMBS 0.8%).	
	[b]	The Scale of Market of Institutional Investors	
		$11 trillion (institutional financial assets in Japan) X 1.2% = $ 132 billion	
[3]	The Amount of Investment in Japan		
	The scale = [1]-[c] + [2]-[b] = $ 176 billion		

Source: The Organization for Promoting Urban Development

FOOTNOTES

[1] \$1=110 Japanese Yen

[2] Toshiro Yoshioka, *"Deregulation and internationalization of capital markets in Japan",* M.I.T., 1997

[3] Tadashi Ebihara, *Developers in Japan and its Future,* U.C.Berkely, 1993

[4] Recently, foreign companies have been buying not only real estate in Japan but also Japanese companies that have been in poor condition. For example, AIG, the U.S. financial company, purchased Nissan Mutual, the life insurance group. GE Capital effectively bought the new business of Toho Mutual, another life insurance group.

[5] Asahi Weekly AERA, *The U.S. Funds Buy Japan*, April 1998

[6] Block R.L., The Essential REIT, Brunston Press, 1998
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[7] Tim Riddiough, *Real Estate Capital Market*, M.I.T. Press, 1999

[8] Brueggeman and Jeffery D.Fisher, *Real Estate Finance and Investment*, Chicago, Irwin 1996

[9] Government-managed life insurance with small sums of premium, which is popular in Japan.

[10, 15] Masato Tanaka, *"A New Approach To Resolving Japan's Real Estate Crisis",* M.I.T., 1998

[11] The Conference of Real Estate, *SPC (Special Purpose Company) Law*, February 1998

[12] Tokyo-Tatemono: ranked 108th in real estate and transport industry with the sales of \$640 millions in 1998
Ito-Yokado: ranked 2nd in commercial industry with the sales of \$14 billions in 1998
City Trust Bank: ranked 99th in financial industry with the sales of \$15 billions in 1998
Japan Energy: ranked 5th in oil industry with the sales of \$13 billions in 1998
Mitsui Realty: ranked 12th in real estate and transport industry with the sales of \$5.2 billions in 1998
Tokyu Realty: ranked 26th in real estate and transport industry with the sales of \$2.4 billions in 1998
Mitsui Trust Bank: ranked 10th in financial industry with the sales of \$269 billions in 1998
Daikyo: ranked 15th in real estate and transport industry with the sales of \$4.6 billions in 1998
Tokyo Marine Insurance: ranked 19th in service industry with the sales of \$12 billions in 1998
Mitsubishi Industry: ranked 1st in machine industry with the sales of \$24 billions in 1998
The International Bank of Japan: ranked 19th in financial industry with the sales of \$149 billions in 1998

[13] Mitsubishi Material: ranked 9th in steel industry with the sales of \$6.9 billions in 1998
Sumitomo Marine Insurance: ranked 35th in service industry with the sales of \$5.1 billions in 1998
Cosmo Oil: ranked 3rd in oil industry with the sales of \$13.7 billions in 1998
Sumitomo Life Insurance: ranked 9th in service industry with the sales of \$31 billions in 1998
Recruit: ranked 65th in service industry with the sales of \$3.2 billions in 1998
Sumitomo Bank: ranked 2nd in financial industry with the sales of \$339 billions in 1998

[14] Goldman Sachs (Japan) Ltd., *Japan Research*, Tokyo: April, 1998

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