

**ISSUES IN SECURITIZATION OF REAL ESTATE
UNDER THE JAPANESE ECONOMY IN TRANSITION**

by

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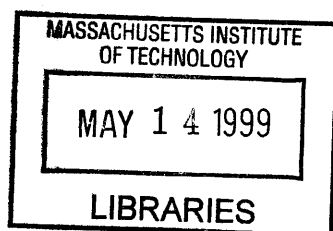
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ABSTRACT

Since the end of the Bubble Economy of 1992, Japan has been suffering from the severest and the longest lasting recession it has experienced in the 50 years following the World War II. In this thesis, the true implications of real estate securitization and its potential contribution to the recovery of the Japanese economy are examined. Repairing real estate market is one of the keys to reversing the economic downtrend. The results show that real estate securitization will contribute significantly to the effort to save the Japanese economy. However, it is important to reform the practices, systems, and infrastructure of the real estate market to carry out successful securitization. The major positive implications of real estate securitization include diversification of financing and investment opportunities, the reduction of liquidity risk of real estate, the expansion of the real estate market by increasing the numbers of transactions, promotion of direct financing rather than indirect, use of widened techniques for managing Japanese individual assets, the identification of new business opportunities, and finally, by promotion of reform of a land evaluation method to meet a global standard.

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INTRODUCTION

Securitizing non-performing loans and mortgaged real estate has attracted the attention of the Japanese Government and the people as a solution to the problem of the non-performing loans that are equivalent to \$500 billion dollars (in book value), now held by the Japanese financial institutions during the Bubble Economy. “Actually, the arrival of securitization offers many economic advantages, including tax reform, stronger security perfection, and improved market liquidity for asset-backed notes”¹. However, the debate has been often held without: 1) why the purpose of securitization is reduced to solving the bad debt problem; 2) if securitization of non-performing loans is really feasible in Japan where there are so many peculiarities in real estate laws, regulations and customs; 3) and why real estate securitization has not really occurred much before in Japan. Contrary to the Japanese regulators’ expectation, what securitization can do should be perceived in a longer perspective, rather than in a short one, such as solving the bad debt problems.

Securitizing a large number of non-performing loans requires well developed infrastructure for regulations, the real estate market and the capital market, all of which are still at the developmental stage in Japan. Securitizing non-performing loans is feasible as long as the loan collateral is generating a stream of cash. However, it is difficult for Japan without changes in regulations, taxation systems, valuation methods, and market transactions, regarding real estate. Therefore, developing a proper infrastructure for real estate securitization is the first and foremost priority. In my thesis, I analyze the trend of the Japanese current real estate and financial market. While taking into account market trends, I propose what needs to be done to carry out successful real estate securitization politically and institutionally. Finally I offer realistic goals of what securitization can do for the currently ailing Japanese real estate market

¹ Masato Tanaka, A New Approach To Solving Japan’s Real Estate Crisis, (Massachusetts, July 1998), p7

and the financial system.

A. Methodology

For the purpose of this thesis, I have collected and scrutinized data related to real estate securitization from literature and articles. I also obtained important information from interviews with people in charge of real estate securitization in four companies: two American investment banks; an American consulting firm; and a Japanese commercial bank. Information procured by interviews helped me refine the assertion made in my thesis.

B. Organization

My thesis has five components. CHAPTER 1 reviews the Japanese financial crisis that resulted from the collapse of the Bubble Economy; and it describes the evolution of asset securitization in Japan. CHAPTER 2 analyzes the securitization tactics used by the Resolution Trust Corporation to solve the U.S. Savings and Loan Crisis in the early 90's, that paved the way for securitizing mortgage backed securities. This chapter also presents an overview of real estate securitization. CHAPTER 3 describes the Japanese real estate market after the end of the Bubble Economy and identifies obstacles to real estate securitization. CHAPTER 4 proposes reforms regarding practices and systems of the real estate market in Japan that would be necessary to carry out securitization, and argues for the merits of securitization. CHAPTER 5, the concluding chapter, focuses upon realistic goals that securitization can achieve to end the current Japanese financial crisis.

CHAPTER 1: THE HISTORY OF THE JAPANESE BUBBLE ECONOMY AND EVOLUTION OF THE ASSET SECURITIZATION IN JAPAN

Chapter 1 discusses: 1) how the Japanese Bubble Economy evolved and finally collapsed; 2) how serious the bad debt problem caused by the collapse of the Bubble is; 3) various difficulties in solving the bad debt problem; 4) the Japanese government's countermeasure to overcome the bad debt problem; 5) the government's intention to securitize non-performing loans, which it learned from the techniques used by the Resolution Trust Corporation; and 6) features of conventional securitized products in Japan.

WHAT'S WRONG WITH JAPAN'S CURRENT FINANCIAL SYSTEM?²

Since the beginning of 1997 there has been a series of failures by Japanese insurance companies, stockbrokerages, and banks. To avoid public panic, the government repeatedly announced that the deposits would be guaranteed. Still, the financial market was sensitive enough to reflect the failures of financial institutions. Concerned about their own liquidity, people changed their banks, thereby slowing the cash flow in the economy.

The state of low liquidity is further worsened by what is called a credit crunch. The enactment of Prompt Corrective Action in April 1998³ compelled banks to apply an internal credit rating system. As a result, some long-standing customers experienced cash flow difficulties.

Credit creation is contracting. The only thing that is expanding is the volume of bank notes printed by the Bank of Japan. The cash ratio⁴ stands at 8.8%, an approximately 1.8% increase

² Yukihiro Endo, *NRI Quarterly*, (Tokyo, July 1998)

³ 'Prompt Corrective Action' is the name for a number of measures designed to make bank operations more transparent and to require banks to adopt proper risk-assessment procedures. The authorities, for their part, will monitor whether the banks comply with the capital adequacy requirements of the Bank for International Settlements and compel those that do not comply to take 'prompt corrective action' by either increasing their capital or reducing their assets. Yukihiro Endo, *NRI Quarterly*, (Tokyo, July 1998)

⁴ Cash ratio = Cash / (Cash + Deposit money + Time deposit + Certificate of deposit)

since 1992. As a result, many customers, including long-standing ones, have experienced difficulties in borrowing money from banks.

The current status of Japanese financial institutions clearly implies the existence of systemic risk. And the difference in interest rates between Japanese banks and foreign banks known as “Japan Premium⁵”, has increased remarkably. In December 1997, it once reached a 1.2% difference from that of U.S. banks, and then settled around a 0.4% difference in June 1998. The “Japan Premium” on interest rates sets a higher hurdle not only for problematic financial institutions but also for financially sound ones to raise capital. Since April 1998, the premium has not been as high as at the end of 1997. This is because of government actions taken by the government to stabilize the financial system by using public funds. Still, the underlying crisis has not gone away.

THE HISTORY OF THE BUBBLE ECONOMY

To understand why the current Japanese financial system is in crisis, one needs to understand the behavior of Japanese banks during the Bubble Economy. There were two key markets; the stock market and the real estate market. Japanese banks made large numbers of loans in these two markets during the Bubble Economy, which were supported by a positive spiral that worked in the following ways. Values in the stock market and the real estate market appreciated dramatically. Borrowers could then use the equity in the assets created by the market appreciation to borrow more money from banks. Borrowers borrowed money and then invested in stocks and real estate. In fact, because of these purchases, both the stock and the real estate markets continued to go up and borrowers again took advantage of further appreciation to raise additional and then increase their investment in stocks and real estate. Everyone believed that this positive spiral would continue

⁵ The higher rates Japanese banks are charged to borrow funds overseas

forever during the Bubble Economy. No one, not even the banks thought these markets would collapse. Banks ignored their credit policy and invested in stocks and real estate to maximize their short term profits. Literally, everyone followed the “greater fool theory.” At that time, Japanese real estate, especially the commercial real estate market, had very high liquidity and it was just like a financial instrument.

Real Estate prices reached their highest level in December 1989 in the six largest cities; Tokyo 23 wards, Yokohama, Nagoya, Kyoto, Osaka, and Kobe<Exhibit 1>. Urban land prices also increased nearly fourfold between 1985 and 1991. The increase in land prices escalated during the decade after 1986. In Japan as a whole, land prices increased by about 60% between 1985 and 1991.⁶

THE BURST OF THE BUBBLE ECONOMY

In 1992, however, the positive spiral suddenly reversed. Most of the investments in real estate made during the Bubble Economy were for speculation, and the increase in value was supported only by the high liquidity of the real estate market. Faced with the criticism of overpriced lands, the Japanese Government limited bank loans to real estate and other non-banking industries. These regulations signified that no more money could be lent to expand the markets. Soon, there were no new buyers of properties anymore. The liquidity of the real estate market was dramatically decreased, leading to the collapse of the real estate market and the price fall of land values. Real estate lending by the most Japanese banks became under secured, leading to the collapse of the Bubble Economy.

⁶Howard C. Giltuch, and Tadashi Kataoka, Real Estate Securitization Gaining Favor in France & Japan, (London 1997), p3

Exhibit 1: Urban Land Price Index of Commercial Land

In Six Largest Cities in Japan

(Tokyo 23 wards, Yokohama, Nagoya, Kyoto, Osaka, and Kobe)

1990=100

Year	Index
1985	25.6
1986	33.0
1987	44.2
1988	62.6
1989	78.3
1990	100.0
1991	103.3
1992	87.5
1993	67.9
1994	55.3
1995	41.9
1996	30.3

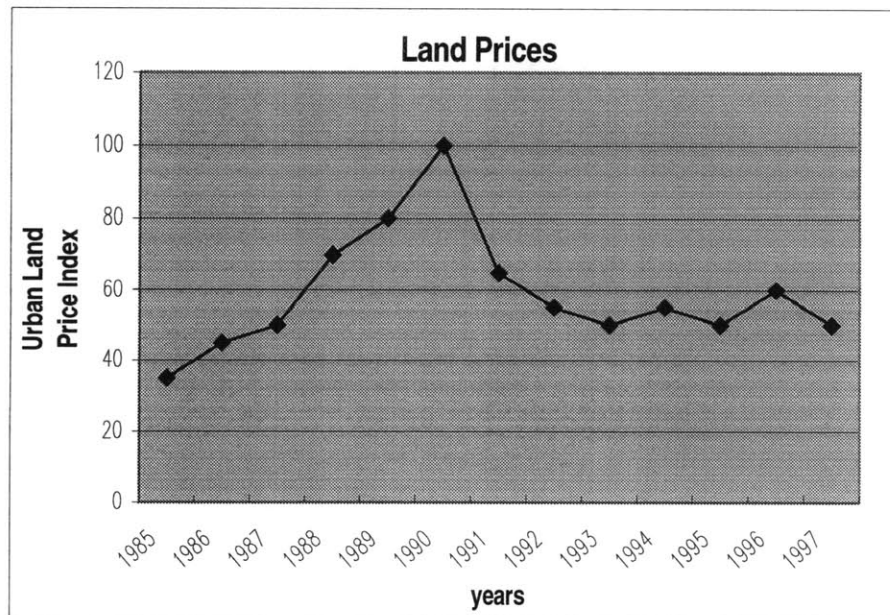
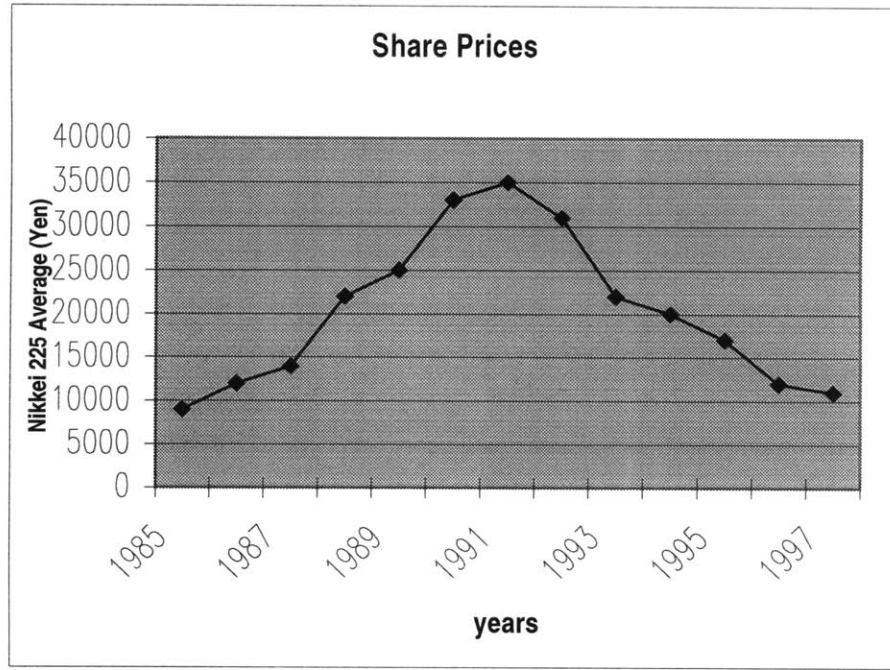
Source: Japan Real Estate Institute

THE BAD DEBT PROBLEM⁷

When the Bubble burst, both shares and property prices fell<Exhibit 2>. As a result, many individual and institutional borrowers had difficulty paying back their loans because they faced their projects such as equity investments and property developments came to a standstill. Because the value of the loan collateral also plummeted, the volume of non-performing assets increased dramatically. In this sense, Japan's financial crisis is something that could be predicted.

⁷ Yukihiro Endo, NRI Quarterly, (Tokyo, July 1998) P22-24

Exhibit 2: Share and Land Prices



Source: Japan Real Estate Institute

The issue of disclosure complicated the problematic volume of non-performing loans. Only a few years have passed since Japanese banks began to disclose their non-performing assets. Even though there were standards for disclosure, the standards did not force banks to disclose certain data and bank officials easily manipulated data regarding bank performance. The published figures for non-performing assets were intentionally underestimated because bank officials and government officials were afraid of creating panic that would cause a loss of public confidence in the financial system. Although the regulatory authorities had been trying to persuade banks to merge and commit their own capital in order to save the weaker ones, the sounder banks and insurance companies being called on to do the rescuing did not trust the published figures----presumably because they knew that the figures were not accurate. An actual example⁸ is the aborted merger between Hokkaido Takushoku Bank and Hokkaido Bank. Skepticism about the scale of the former non-performing assets led to the merger being called off and the ultimate collapse of one of Japan's city banks.

The volume of non-performing loans that emerged after the bank collapsed turned out to be double the published one. Also, the figures for non-performing assets recently published by the banks based on self-assessment were apparently more than triple the previously published figures---even allowing for the fact that the definition of non-performing assets was different from the previous one<**Exhibit 3**>. There is a definition of non-performing assets, but the fact that people do not or can not know what the situation really is only exacerbates their concern.

⁸ Yukihiko Endo, NRI Quarterly, (Tokyo, July 1998) P22-24

Exhibit 3: Trial Self-assessment of the Quality of Bank Loan Assets (Aggregate Figures)

(dollars)

	Total outstanding loans				
		Category 1	Category 2	Category 3	Category 4
City, long term, and trust banks	3.69 trillion	3.23 trillion	387.19 billion	59.24 billion	17.98 billion
Top-tier regional banks	1.19 trillion	1.07 trillion	111.63 billion	8.53 billion	3.45 billion
Second-tier regional banks	461.78 billion	394.17 billion	59.21 billion	6.79 billion	1.62 billion
Total	5.34trillion	4.69 billion	558.03 billion	74.57 billion	23.04billion

Note: Category 1= Sound, performing; Category 2= Substandard(requiring additional monitoring

effort); Category 3= Doubtful; Category 4= Value impaired

Source: Nomura Research Institute

The Prompt Corrective Action (PCA) was introduced in April 1998 when many banks began reporting losses and depleting their equity as a result of writing off non-performing assets. To comply with the new law, banks began to make efforts to recover their loan assets. This led to a credit crunch, which ended up increasing non-performing assets.

The aim of the of the PCA is to enable the authorities to spot potential problems at an earlier stage, e.g., by monitoring criteria such as equity ratios, and to take appropriate action before banks actually collapse. Banks have therefore had to set up their own internal systems for rating borrowers, and this has made them extremely cautious about extending new loans and led them to try to recover existing ones. Many observers, including politicians who are supported by small-sized companies, argued that PCA was introduced at an improper time and should have been postponed.⁹

⁹ Yukihiko Endo, *NRI Quarterly*, (Tokyo, July 1998) P22-24

DIFFICULTIES IN SOLVING THE BAD DEBT PROBLEM¹⁰

Since March 1998, banks and other financial institutions in Japan have had bad loans for real estate equivalent to \$500 billion, according to information from the Ministry of Finance. However, it is often said that Japanese banks have \$800 billion of non-performing real estate loans. There is an urgent need to tackle the bad debt problem. However there are some obstacles to solving bad loan problems such as time-consuming foreclosure process and “minimum foreclosure price.”

1. Time-consuming Foreclosure Process

If a foreclosure process was effective, banks would have exercised their recourse right and gotten their money back. However, this was not the case in Japan. First of all, there was court congestion. Second, in Japanese history, not many foreclosure filings had been made within a short time period. Therefore, Japanese courts could not accept so many filings from financial institutions. Especially, Tokyo and Osaka District Court were notorious for court congestion. In some cases, it took more than two years to complete the foreclosure process.

2. Minimum Foreclosure Price

Another problem is that in the foreclosure process, the Japanese court decides on a minimum foreclosure price based on an appraisal. If the actual bid is lower than this price, the foreclosure sale is not accepted. Since it takes a long time to complete the foreclosure process, the real estate market level may fall below the minimum foreclosure price determined at the first stage of the foreclosure process. This may have further delayed the completion of foreclosure process.

¹⁰ Goldman Sachs, Japan Research, (Tokyo, May 1998) P3-6

Resolving Japan's bad debt crisis can be achieved partially through the disposition of the real estate collateral, with a vital part to be played by debt forgiveness or giving up loans made to borrowers. However, there are number of reasons why banks did not chose debt forgiveness.

3. About Debt Forgiveness

The government's action in March 1998 for monitoring banks before they end up having a large number of non-performing loans is an appropriate move. The key question is whether the banks will actually respond to the government's action to a significant degree.

If a lending bank is a senior lender, the bank can get some money back regardless of current depreciation of land prices after the real estate bubble. However, if a lending bank is one of many subordinate lenders collateralizing the same property of a borrower, a lending bank has a high risk of not receiving any money that it lent. In such a case, there is no merit to holding such non-performing loans theoretically. Rather, it is to a bank's advantage to forgive debts: a bank can increase the return over asset ratio (ROA¹¹) and improve its balance sheet. However, there are some reasons banks did not give debt forgiveness as follows: 1) if they allow debt forgiveness, the amount that they 'forgive' or 'lose' would be published publicly; 2) if the debt is collateralized by the real estate, banks may want to wait until the condition of real estate market improves and the once-plummeted land prices recover since current land prices in Japan seem to be at the bottom; 3) Japanese banks mistakenly believed until recently that the real estate market could recover within a reasonable time period and that they would be able to

¹¹ Return over asset ratio = (net income + net tax or interest expense) / average total assets. A higher ROA indicates a better performance on the company's management and leads to higher stock prices and higher bond rating of the company.

withstand it until the recovery by taking advantage of hidden assets in their portfolio (Fukumi-Eki¹²). Furthermore; 4) under Japanese taxation, banks needed to prove the possible loss amount to obtain a tax deduction for the grant for debt forgiveness. In most cases, banks have to use an appraisal report to show the value of the collateral. However, there was a difference between appraisal value and actual market value of real estate. This caused difficulties in getting a full tax deduction for enough grants for debt forgiveness. Clearly, banks did not want to choose debt forgiveness without a tax deduction, so they preferred to defer dealing with non-performing loans.

4. Problems Associated with Selling Collateralized Real Estate

There are a number of obstacles to the sale of collateralized real estate because they often include:

- Properties without permission to develop, such as farmlands that can not be converted to commercial properties.
- Properties without construction permission, such as urbanization controlled area, and irregularly shaped land that is not appropriate for development.
- Leased land; collateralized leased land must follow a complex process when being foreclosed.
- Conflicts among mortgagees; even if the senior lender wants to foreclose the property immediately, subordinate lenders often do not agree since they are unlikely to collect loan value from the foreclosure because of the plummeted land price after the Bubble Economy. Mortgagors involved may have conflicts in deciding whether to foreclose the property, and

¹² Fukumi-Eki, or hidden asset is created by the difference between book value and the market value of a company's asset. A company's hidden asset increased during the Bubble Economy when the company's property value (market value) increased significantly.

if so, when they should do so.

Besides property issues, there are other problems facing investors and realtors.

- A limited number of buyers for loan collateral; generally speaking, buyers of property are composed of individual investors and corporate investors. The percentage of individual investors remained at 60%-65%¹³ of all property investors during 1990-1993. However, corporate investors declined significantly from 24% in 1990 to 14% in 1993.
- Land developers' reluctance to buy more land; generally, collateralized real estate is sold to both individual and corporate investors via realtors and construction dealers. However, the overall amount of properties obtained by them decreased significantly from \$494 billion (59.3 trillion yen) in 1990 to \$332 billion (39.9 trillion) in 1993¹⁴. The reasons for this decrease are following; 1) a small number of properties that attract developers, since most land prices are expected to fall further, making developers reluctant to buy properties at this moment; 2) the developers' own lack of funds because of the collapse of land price; and 3) the current lack of investors interested in property investment because of the collapse of the "land myth".

INEFFECTIVE COUNTERMEASURE: THE COOPERATION CREDIT PURCHASING AGENC

The Resolution Trust Corporation (RTC) contributed to resolving the U.S. Savings and Loan Crisis through liquidating or reorganizing failed savings banks. Getting some ideas from the RTC, the Japanese Government created CCPC in January 1993 for the purpose of solving bad loan problems. Although CCPC was a good start to solve the bad debt problems, it has not

¹³ Bank Study Corporation (Ginkou Kensyuu-sya), Liquidating Real Estate Collateral, (Tokyo, July 1995) p27

¹⁴ Bank Study Corporation (Ginkou Kensyuu-sya), Liquidating Real Estate Collateral, (Tokyo, July 1995) p29

contributed enough to banks' disposing non-performing loans.

The mechanism of CCPC is that: 1) banks sell bad loans secured by real estate to CCPC¹⁵ based on the value of collateral; 2) the selling bank makes a loan to CCPC to fund the purchase of bad loan to CCPC, so that even though CCPC buys bad loans of banks, the selling bank provides the source of funds to purchase the bad loans; 3) the bank continues to service and handle all the negotiations and processing of the bookings after the sale of their bad loans to CCPC; 4) when a debtor of loans sells real estate collateral, CCPC receives income from the debtor, and CCPC pays it back to a bank that sold bad loans to CCPC; and 5) financial institutions can take advantage of this system by realizing the loss, and receiving a tax deduction for the realized loss based on the value of the collateral.

Although banks can sell bad loans to CCPC, the problem is that the liquidity of loan collateral has remained very low. In other words, loan collaterals are not sold off significantly.

Initially, banks sold bad debts to CCPC at discounted prices. If CCPC can sell the real estate collateral at the same price it was bought from banks, there is no problem. However, in many cases, CCPC has to sell a real estate collateral at a lower price¹⁶. Therefore CCPC must realize the loss from the sale of loan collateral. Again, since CCPC is financed by banks that originally sold bad debts to CCPC, CCPC's loss directly affects these banks negatively. For those banks that can cover the large loss, selling loan collateral at a discounted price is fine. It is certainly better than getting no money back. However, if banks cannot cover the loss from the sale of CCPC's real estate collateral, banks will fail. It is true that if only the price of real estate

¹⁵ In September 1998, CCPC purchased bad loans of banks equivalent to \$500 million at the overall price of \$50.4 million (10% of the \$500 million approximately).

¹⁶ Property prices need to reach the discount cash flow (DCF) level to find buyers. Prices at DCF level often indicate much lower property prices than those during the Bubble Economy.

collateral goes down, there would be some investors to buy it. However, neither CCPC nor banks want to sell their loan collateral at a super discount price. CCPC can expedite writing off of bad debts from a bank's accounting book, but it is not able to promote the sale of collateral sufficiently.

The Japanese government should consider compensating for the loss from the sale of loan collateral to increase the liquidity of mortgaged real estate. Without government funding, it is unlikely that CCPC can sell loan collateral at a lower price to find buyers.

In September 1998, CCPC bought bad debts whose values are \$488 million (58.6 billion yen) at the price of \$49 million (190 million yen) which is approximately 10% of the original value. Since the inauguration of its operation in April 1993, CCPC has bought bad debts that amount to \$11.6 billion (1.39 trillion yen) in value. However, this is only 2.32¹⁷ of the entire bad loans that Japanese financial institutions have. Needless to say, CCPC is not sufficient to cope with the bad debt problem of Japanese financial institutions since it could not promote the disposal of bad debts to a significant degree. It remains to be seen if CCPC can get funding from the government to cover the loss from the sale of loan collateral, and starts working efficiently.

THE JAPANESE GOVERNMENT CONSIDERES SECURITIZATION AS A MEANS TO SOLVE BAD DEBT PROBLEMS

Earlier in this chapter, I have described the complexities and obstacles associated with solving the Japanese bad debt problems. The Japanese financial crisis is becoming worse day by day because of the delayed solution to the bad debt problems.

¹⁷ 2.32% is based on the official number of \$500 billion non-performing loans.

In Japan, “securitization” is one of the most recent buzzwords. This is because Japanese authorities are considering allowing the use of special purpose companies (SPCs) as part of the process of securitizing loans as well as the use of public funds to act as a guarantee. The government came up with using the securitization technique of the Resolution Trust Corporation (RTC) to dispose of non-performing loans. However, the debate is often being held without a clear definition of the economic meaning of “securitization.” In most cases, the government considers securitization a means of disposing of non-performing loans.

FEATURES OF CONVENTIONAL SECURITIZED PRODUCTS¹⁸

Since the Japanese government now shows strong interest in securitization, one may think that there is no history of securitization in Japan. The issue of mortgage-backed securities, however, targeting residential mortgages and housing loans boasts a long history. Nevertheless, only for the last ten years has Japan debated the question of converting commercial real estate to securities as investment products.

In 1987, for the first time in Japan, small-denomination real estate financial products were sold to multiple investors with shared real estate equity. After that all real estate companies sold similar commodities which, based on the premise of rising land prices, were touted for their tax advantages (income tax advantages for income assessment, depreciation merits, and inheritance tax evaluation advantages). Law did, however, restrict transfers between individuals.

Later, partnership-type securitized products arose from developers qualified as special real estate joint ventures under '95 Corporate Law. These also had minimal liquidity.

¹⁸ Masanori Oka, NLI Research Reports, (Tokyo, April 1998), p2

Apart from this trend towards small-denomination products in the property industry, we find the recent involvement of financial bodies in processing bad debts by converting them to securities. The system that has been developed is complex and is limited to corporate investors and therefore, does not offer liquidity. It also ultimately requires the disposal through sale of mortgaged property and the risk of price falls at this time affects banks and similar institutions negatively<Exhibit 4>.

Exhibit 4: List of Recent Securities Issued by Financial Institutions

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

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

In principle, securitized real estate products, like other financial products, should retain their small size (for mass use) and liquidity to allow free buying and selling by a large number of investors including individual investors. However, conventionally there has been a limited number of investors in real estate investment products and securitized products from real estate collateral of non-performing loans. This is due to the fact that these products are only sold to a

limited number of institutional investors and they are not very liquid.

An overall policy to free up mortgaged real estate in March '97, deals with barriers to securitization in the tax system, laws, and regulations by calling for reforms limited to the non-performing loans and real estate collateral held by financial institutions. While this may set the ball rolling with regards to financial institutions' disposing of their non-performing loans, what happens in reality is to remove the real estate collateral from balance sheets for a certain period, which postpones the reporting of losses. Unless the real estate market conditions improve in the future, it is likely that buyers won't appear and therefore, banks will have to buy the loans back.

The goal of real estate securitization is not to protect realtors or rescue financial institutions but to create an attractive market and property investment products for both domestic and foreign investors. This is why we need to create full-scale security products that are freely available for purchase and transfer.

SIMILAR CRISIS IN THE BANKING SYSTEM, BUT NOT QUITE

There is a close parallel between the U.S. in 1988 as it struggled to solve its savings and loan crisis (the S&L Crisis) and Japan in 1998 as it tackles the ailing banking system with huge bad debt problems. Since the U.S. overcame the S&L Crisis, it must offer a road map for Japan's solution¹⁹. To find a solution to the bad debt problems resulting from the plummeted land prices in the 1990s, the Japanese government followed in the footsteps of the U.S. by imitating what the Resolution Trust Corporation (RTC) did. The RTC was a United States-government-sponsored corporation created by the Financial Institutions Reform Act of 1989 in order to clean

¹⁹ Richard W. Stevenson, Tailoring the S&L Crisis To Save Japan's Banks, The New York Times, (New York, October 18, 1998)

up the S&L disasters of the late 1980s. The RTC was in charge of disposing of insolvent S&L assets. The means and strategies used by the RTC to liquidate the assets paved the way for large-scale securitization. RTC sold securities backed by pools of commercial mortgages (commercial mortgage backed securities, or CMBSs) through investment bankers to a wide range of mortgage investors²⁰.

There are many lessons above for combating the woes of the Japanese financial system. However, it is thoughtless to expect that Japan can fix its financial system as nicely and easily as the U.S. did, using exactly the same strategy as the RTC. One of the main reasons is the difference in scale. Japanese banks have much more non-performing loans relative to the size of the economy than U.S. S&Ls ever had. The second reason is that in the case of the RTC, it dealt with only a part of the banking system, which is the savings and loan industry that focused on real estate and real estate lending. The U.S. did not have to face what Japan is facing with its entire banking system being subject to the effect of non-performing loans²¹. The third reason is that the Japanese government waited long enough to solve the banking system crisis, that it worsened the situation. Because of the government's late action, the cost borne by taxpayers in Japan might be at least \$400 billion while the S&L Crisis cost borne by U.S. tax payers was roughly \$130 billion. According to Bert Ely, a banking consultant in Alexandria, Virginia, "If they had dealt with it five or six years ago, it would have cost what U.S. S&L situation cost²²." The Japanese government much prefers a "harmonious solution"- that is, to try to save almost all banks. However, it is inevitable that the government and people have to choose a painful solution such as allowing some insolvent banks to fail in order to clean up decay underlying the

²⁰ Masato Tanaka, A New Approach To Solving Japan's Real Estate Crisis, (Massachusetts, July 1998)

²¹ Ikuo Anai, Solving Bank Crisis Means Pain But Also Gain, The Daily Yomiuri, (Tokyo, October 6, 1998)

²² Melissa Wahl, Japanese Confront Enormous Bank Tab, Chicago Tribune, (Illinois, September 19, 1998)

Japanese banking system. Finally, the fourth reason is that there are many peculiar factors to Japan's real estate market that block securitization of real estate collateral as follows: 1) leasing Code; 2) too many real estate regulations; 3) lack of information about rents; 4) absence of the secondary market; 5) Tax system, and; 6) servicers. I will detail these factors later in Chapter 4.

Whether Japan can actually restructure its banking industry and get over the seven-year recession depends on the Japan's ability to come up with tailor-made tactics combined with lessons learned from the U.S., and the ability to take action. Even if it is painful to the government, the banking industry and the taxpayers, it must be done.

SECURITIZATION IS NOT A QUICK AND EASY SOLUTION

If non-performing loans are to attract investors, they will have to trade at a considerable discount, requiring the current holder of the loan assets to write off a loss from their sale. However, these assets tend to be accounted for in an unclear manner, and asset holders tend not to want to take a loss on their sale. Furthermore, there must exist a group of institutional investors capable of accurately judging risk and return of securitized products. Creating a mechanism that makes securitization possible is indispensable.

It seems that the government expects too much of securitization as a solution to the bad debt problem. The government short-term objective to develop an asset securitization system mainly stems from the expectation for what securitization can bring to the banking industry. However, the government is too myopic about the potential of securitization. Securitization should not be restricted to disposing of non-performing loans. As its long-term objective, the government should also consider securitizing sound assets that accompany cash flow more aggressively. Otherwise, a secondary market for securitized products will not develop efficiently.

THE DIRECTION OF THIS THESIS

This thesis points out the Japanese government's insufficient consideration of securitization as a merely technique to solve the bad debt problems. The government's perspective of the potential of securitization is clearly narrow and it is viewed in a short-term frame. However, rather than expecting securitization as a solution for bad debt problems, the government should evaluate more broadly what securitization can do for the Japanese economy in a long run: 1) promote a shift from indirect financing to direct financing; 2) expose Japan's individual assets to a more efficient type of investment opportunities; 3) increase real estate transactions; 4) increase liquidity of real estate including collateral and; 5) bring new businesses into the real estate industry.

CHAPTER 2: LESSONS FROM THE U.S. S&L CRISIS AND AN OVERVIEW OF REAL ESTATE SECURITIZATION

Chapter 2 will describe: 1) lessons obtained from the U.S. S&L Crisis; 2) the RTC's way of handling the financial crisis; 3) an overview of asset securitization; and 4) securitization of real estate.

THE U.S. S&L CRISIS

Before Japan faced its current banking crisis, the U.S. banking and S&L industry in the early 1980s faced one of its own financial crisis. This was of a magnitude not seen since the Great Depression of the early thirties when 9755 banks were closed with deposits worth \$1.4 billion lost¹.

Except for the Continental Illinois National Bank and Trust Company (Continental), and the New York savings banks, the early 1980s's bank and thrift failures were mostly small institutions, many with roots in the agricultural or energy sectors. Continued trouble in the energy sector and a collapse of several real estate markets increased the number of banking failures.

Between 1980 and 1994, 1,617 federally insured banks with assets equivalent to \$302.6 billion, either collapsed or received financial assistance from the Federal Deposit Insurance Corporation (FDIC). During the same period, 1,295 savings and loan institutions with \$621 billion in assets were closed by the Federal Savings and Loan Insurance Corporation (FSLIC) or the RTC, or

¹ Federal Deposit Insurance Corporation, The First Fifty Years, A History of the FDIC 1933-1983, (Washington, D.C., FDIC 1984)

received FSLIC financial assistance.

“The failure of 2,912 federally insured depository institutions is equivalent to one failure every other day over the 15-year period. The combined total of \$924 billion in assets from the failed institutions is equivalent to \$168 million in failed bank or savings and loan assets that had to be liquidated or otherwise resolved each day for the 15-year period. The timing of the bank and savings and loan failures between 1980 and 1994, however, was not evenly distributed. At the height of the crisis, which was the five-year period between 1988 and 1992, a bank or savings and loan failed on an average of once a day, bringing with it a daily influx of \$385 million in assets.”²

COMBATING FINANCIAL CRISIS: THE RTC’S WAY³

Between August 1989 and December 1995, during the RTC’s existence, the agency was in charge of resolving 747 insolvent thrifts with assets totaling \$402.6 billion. The cost to taxpayers resulting from RTC’s clean up activity was approximately \$87.5 billion.

It is worth knowing how the RTC dealt with the S&L Crisis. The actions taken by the RTC to clean up the S&Ls made a great contribution to practices in the field of securitization in the U.S. In the first place, the RTC used various techniques to deal with insolvent institutions, including the sales of whole institutions and of individual securities, ranging from treasury paper to so-called “junk bonds.” In addition, they sold other assets in “whole loan” style, which required neither conversion to a security nor a program of “bulk sales” in which investors were offered “pools” of assets (usually real estate). The pools of assets, some of that were well performing and some non-performing, were sold at the market value. Mainly, investment banks or investors

² Federal Deposit Insurance Corporation, Managing the Crisis, The FDIC and RTC Experience 1980-1994, (Washington, D.C., August 1998)

³ OECD, Securitization, An International Perspective, p.28, (Paris, May 1995)

who wished to obtain managerial control over the asset purchased the pools of assets. At some point, the RTC learned that the purchasers were later securitizing a large share of the assets, using “repackaging” operations.

After April 1992, direct securitization took precedence for the RTC, as a disposing method of assets. Although some mortgages were qualified to be included in the pools of the Government National Mortgage Corporation (“Ginnie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), the largest part of the assets were sold under RTC “private label”, commercial mortgage obligation (CMO), for single-family mortgages. “These securities received credit enhancement from subordination and overcollateralization and through reverse funds which the RTC was pledged to maintain, provided losses remained below certain levels⁴”. From the first, it has consumer receivables that were relatively easy to securitize. Somewhat more different claims were eventually securitized in large numbers, including single-family mortgages with high delinquency rates and pools of multi-unit residential mortgages. Most of the RTC’s securitized products were rated AA or AAA.

After having cleaned up the easily saleable assets, the RTC encountered problems because remaining assets became increasingly harder to dispose of. This trend was similar to those that have hindered commercial mortgage securitization in a number of ways: the large size of individual loans, the highly specific terms which limit homogeneity and transferability, the problems in developing reliable payment histories, and the difficulties encountered in obtaining acceptable diversification. Nevertheless, having rated the different tranches of these securities from AAA (the highest) to BBB (the lowest for investment), the RTC was able to securitize pools of commercial mortgages with credit enhancement. Some were given fixed rates, others

⁴ OECD, *Securitization, And International Perspective*, p.29, (Paris, May 1995)

floating rates. The RTC still needed to sell a great number of non-performing or “underperforming” mortgages. These mortgages required foreclosure and/or renegotiations of terms, in a similar way to real estate directly owned by the RTC, which, as a result of foreclosures, were consolidated in “structured transactions.” The RTC sold an asset at an estimated market value, which was below book value, and the investor assumed control over the asset with a potential for its appreciation, provided that the assets were managed properly. Although higher-rated tranches such as AA or AAA were widely sold, less saleable assets, especially these in the subordinated tranches, were mainly distributed to single investors who wished to keep control over the assets or maximize rates of recovery on their assets.

The RTC developed methods for liquidating insolvent institutions, which may have wider applicability and may make it possible to sell huge assets that don’t have good marketability. It is widely believed that the prices received through securitization compare advantageously with those received from alternative financing methods.

WHAT IS SECURITIZATION?: OVERVIEW OF ASSET SECURITIZATION

To understand accurately the tactics of securitization, which the RTC used, it is important to understand the mechanism of asset securitization.

“Asset backed securitization is the pooling of assets which have an income stream and the repackaging of those assets in the form of marketable securities, for sale to investors. The assets themselves or the income arising from them collateralizes the securities. The income from the assets is the primary source of payment of income or interest to the investors. The effective packaging of portfolios can create securities that are particularly suited to the needs of investors. In many cases, the securitized investments are more marketable and attractive to

investors than the underlying assets supporting the structure. The most usual types of asset to be securitized are those which generate regular and relatively certain income stream, which have standard terms, a historically low delinquency and loss experience and which are appropriately serviced. However, assets which do not satisfy all these criteria can also be securitized successfully⁵.” Assets that can be securitized include: real property mortgages, loan receivables, credit card receivables, income-producing real estate as well as, and any asset, which generates a regular or predictable income.

Asset backed securitization first began in the U.S. with the development of the secondary mortgage market that grew rapidly during the 1970s and 1980s. The U.S. government made an effort to create a secondary market for residential mortgage loans; this encouraged banks and S&Ls to sell, and then later to securitize their mortgage portfolios. The techniques that were used in the securitization of bank assets were later adapted to the securitization of almost all types of assets.

The first issuers of mortgage-backed securitized bonds emerged from US government initiatives in the 1970s, namely: the Government National Mortgage Corporation (“Ginnie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”).

Residential mortgages are the most common assets that are securitized today while large markets have been created for commercial mortgages, auto loans, consumer loans and credit card receivables.

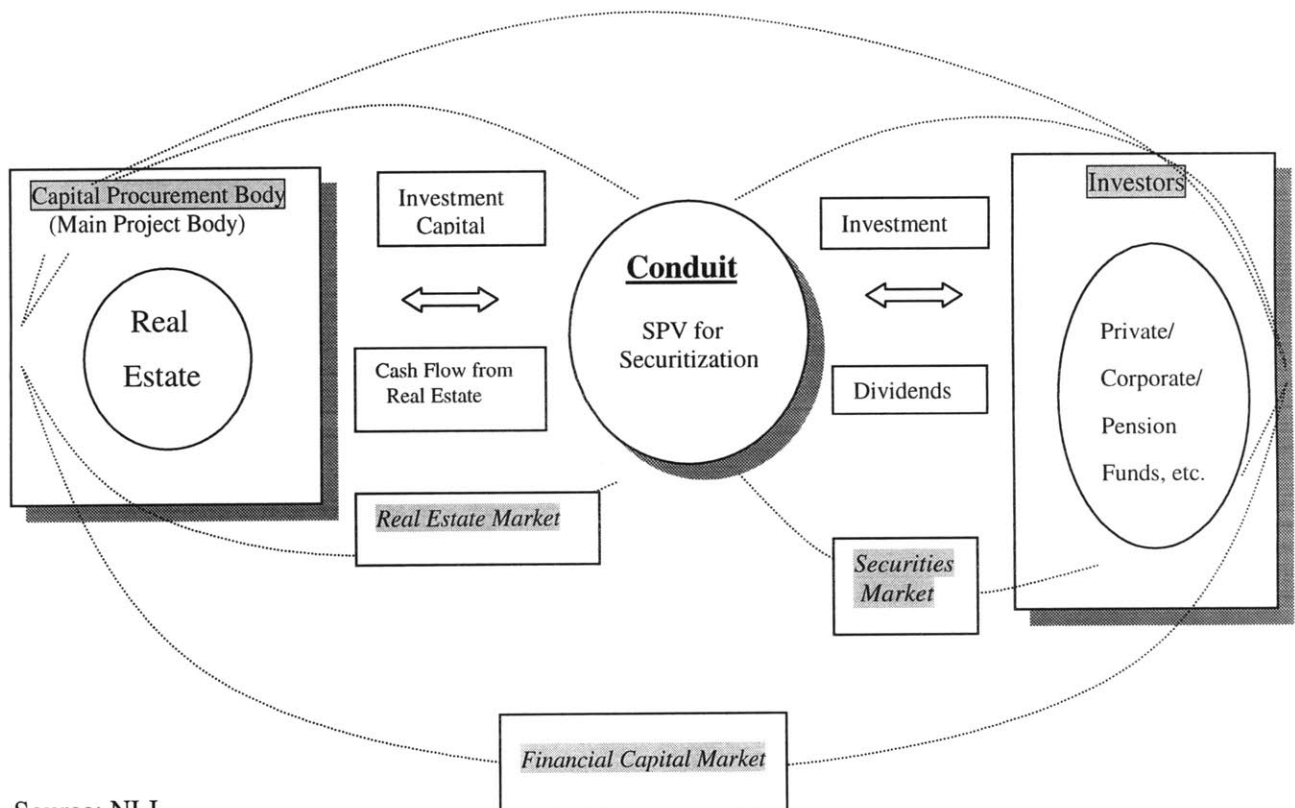
⁵ Adrienne Showering, et al., “The Growth of Asset Securitization in Asia Pacific”, Asset Securitization in Asia, p3, (Hong Kong, 1997)

OVERVIEW OF SECURITIZATION OF REAL ESTATE IN JAPAN

1. The System of Securitization of real estate in Japan

In real estate securitization, a real estate operator (capital procurement body) converts the ownership or profit rights from real estate properties into negotiable securities through a conduit (special security issuing body), and sells them to investors <Exhibit 5>. This system is identical to that in which investors purchase regular shares and bonds with a view to procuring dividends and interest. The conduit is made up of special purpose investment companies or groups and is not subject to taxation. Interest and principal are repaid to investors, similar to other securities. Investors including individuals should be able to freely buy and sell the securities. However, real estate investment products and securitized mortgaged real estate of non-performing loans are only available to a limited number of investors and therefore, illiquid.

Exhibit 5: Basic System of Securitization of Real Estate



Source: NLI

2. Proposed Regulatory Changes

To promote more securitization, the Japanese Government have made several changes to be incorporated into trust and special-purpose company (SPC) structures to securitize real estate and loans backed by real estate in Japan. These changes include the following⁶:

a. Trusts

- Redefine trust certificates that represent an interest in a pool of corporate loans collateralized by real estate as securities under the Securities & Exchange Law.
- Exempt the transfer of real estate into a trust and the corresponding sale of trust certificates from certain taxes imposed on land sales.

b. SPC

- Permit special-purpose companies to purchase bank loans.
- Introduce a Uniform Commercial Code-like system⁷ within 1998 to permit the SPC's security interest in loans to be legally perfected.
- Pass legislation for establishing SPCs that will address tax and Japanese Commercial Code problems, including minimum capital requirements, corporate income tax, real estate capital gains tax, and registration taxes.

3. Market Impact

The Ministry of Finance (MOF) and other governmental agencies have started working on all the proposed initiatives. However, it may be later than 1999 before many of the initiatives become laws. The impact of those initiatives on the market in a long run include the following⁸:

⁶ Moody's Investors Service "Structured Finance: Special Report," (Tokyo, August 1998), p2

⁷ The Uniform Commercial Code (UCC) in the U.S. offers the buyer of financial assets with the ability to secure its claim to the specified assets by financing statement with the secretary of state or other designated public official.

⁸ Moody's Investors Service "Structured Finance: Special Report," (Tokyo, August 1998), p3

a. Special-Purpose Vehicles

The U.S. tax code has specific provisions, such as real estate mortgage investment conduits (REMICs) and real estate investment trusts (REITs), which make it easier to securitize assets by eliminating SPV level taxes. On the other hand, the Japanese tax and commercial codes were not made for SPCs or trusts to act only as asset financing or selling vehicles between issuers and investors. The proposed regulatory changes implicate supports for decreasing SPV level taxation, lowering capital requirements, and removing other restrictions. Furthermore, establishing a legal infrastructure for SPCs and trusts to act as single-purpose vehicles in Japan will promote bankruptcy-remoteness by decreasing potential SPV obligations irrelevant to the securitization.

b. Liquidity

Liquidity for real estate backed instruments will increase by making trust certificates similar to securities and by creating a secondary market. Unfortunately, there has not been much progress in measures to reduce the cost and the time necessary for foreclosure and the sale of real estate collateral in Japan. The liquidity of real estate collateral and complexities among lien holder continue to be serious problems.

c. Security

The introduction of an Uniformed Commercial Code-like system can greatly facilitate asset-backed securitization in Japan. “The difficulty in establishing a secured interest in financial obligations has been a major deterrent to Japanese securitization. The Specified Credit Law (Tokusai-ho) for perfecting a security interest in monetary obligations did help certain asset types (e.g., auto loans and leases). However, for such assets as real estate loans, which do not come under the law, the perfection process can be a deal breaker because each debtor must be notified or must consent to the sale of identified existing receivables. If expanded to include other forms of corporate debt (trade receivables and unsecured bank loans), efficient filing of

security interests could stimulate a large potential asset pool and help refocus Japanese securitization on asset strength and not on seller guarantees”⁹.

d. Credit Enhancement

“By opening up credit enhancement to property and casualty insurers, more innovative support structures will be made available. In the short term, however, the danger is that insurers will be an additional crutch to wrap poorly disclosed real estate assets in corporate guarantees – again hampering the development of securities based on real estate performance.”¹⁰

e. Information

The proposed initiatives put an emphasis on disclosure rules and a market valuation system. However, concrete measures have not been announced yet, except the development of databases on real estate held by the Cooperative Credit Purchasing Corporation (CCPC), and general information about rents of commercial real estate.

4. Securitization’s Focus

a. Residential or Commercial?

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

Fifty five percent of the total Japanese individual assets equivalent to 10 trillion dollars is kept in bank accounts, which provides financial institutions with a dependable, low-cost funding source. Therefore, contrary to the United States experience, Japanese financial institutions

⁹ Moody’s Investors Service “Structured Finance: Special Report,” (Tokyo, August 1998), p3

¹⁰ Moody’s Investors Service, “Structured Finance: Special Report,” (Tokyo, August 1998), p4

(both private and public) have generally been content to retain and fund residential mortgage pools on their balance sheets. The same, however, cannot be said for commercial mortgage debt. The issue here is not one of funding, but of asset risk and liquidity. Commercial real estate – traditionally a high price volatile asset – has been on an uncontrollable roller coaster ride in Japan over the past 10 years. This is the problem regulators appear most anxious to confront. As a result, Japan's initial forays into securitization have been backed by relatively undiversified commercial real estate holdings or large loans collateralized with commercial real estate – a trend that is likely to continue.

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

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

On the other hand, the Japanese government also intervenes to promote real estate development and home ownership; however, it takes a far different approach. With deposits of \$1.8 trillion (¥225 trillion) from the postal savings system, the Japanese government directly competes as a residential mortgage lender through Japan's Housing Loan Corporation (HLC), which in recent years have held a massive 41% share of the residential mortgage credit outstanding in Japan. Stimulating residential mortgage lending through funded loans, in contrast to indirect support for loan securitization, has been a key structural factor in preventing residential MBS development in Japan.

The situation, however, may soon change. Government officials recently announced their

intentions to securitize part of the HLC's huge residential mortgage portfolio to reduce its dependence on postal savings for funding. Depending on the scale, that would not only provide an excellent foundation for an MBS market in Japan, but it could also stimulate investor interest in other securitized products.

A move by non-government mortgage lenders to incorporate mortgage backed securities as a funding alternative in Japan will likely depend on the degree to which deregulation (i.e., increased investment opportunities) and the disintermediation, which will result, will cut into the banks' deep deposit base. The shrinking deposit base of mortgage originators (banks and savings and loans) brought on by deregulation and by the corresponding competition for investment funds was a driving force in U.S. residential mortgage securitization."¹¹

b. Debt or Equity?

In the U.S. market, equity REITs and mortgage REITs, REMICs (offering both debt and residual equity investment), MBS and CMBS provide a wide range of securitization alternatives. The Japanese government indicates that it also seeks to create markets for securities backed by both real estate equity and debt collateralized by real estate. In the past, transactions regarding securitization were limited to certain preapproved parties. However, the needs of issuers and investors would be better met if: 1) clear legal guidelines were provided; 2) structuring of these guidelines were left to market forces.

¹¹ Moody's Investors Service, "Structured Finance: Special Report," (Tokyo, August 1998), p.4-5

CHAPTER 3: THE REAL ESTATE MARKET AND ITS INSTITUTIONAL PROBLEMS ASSOCIATED WITH SECURITIZATION

This chapter describes: 1) the trend of the commercial real estate investment market in Tokyo; 2) the need to enhance the liquidity level of the real estate market in Tokyo; 3) the structural changes now occurring in the market; 4) the real implication of the falling land prices; 5) the dual structure of land prices; 6) the institutional factors that blocked securitization; and 7) a factor that is currently impeding securitization.

THE COMMERCIAL REAL ESTATE INVESTMENT MARKET IN TOKYO¹

According to an announcement of the government's land price surveys in September 1997, commercial property prices in central Tokyo rose for the first time since the collapse of property markets at the end of the Bubble Economy. However, except for the superior properties, the overall real estate market remains depressed. Many properties have no prospect of becoming profitable, and many buildings remain vacant in spite of overall rent declines. There is not much progress observed in the liquidation of non-performing loans and collateral of real estate, and the entire real estate market in Japan remains uncertain in the midst of the recession. In this chapter, I focus on trends in the Tokyo market, the nation's largest real estate market in terms of real estate stock.

1. Trends in the Office Leasing Market

Vacancy rates in Tokyo's 23 central wards² peaked in 1994 and continued to decline, reaching

¹ Masanori Oka, *NLI Research Reports*, (Tokyo, April 1998), p1-10

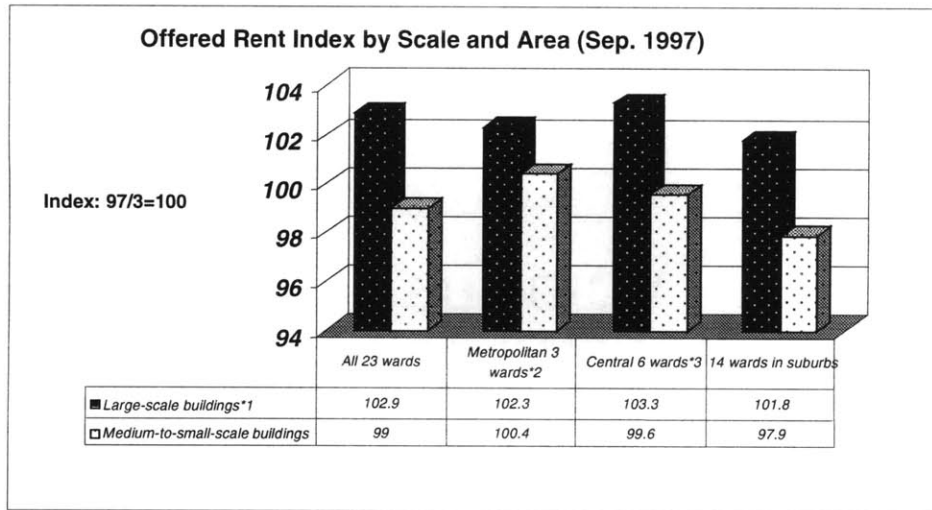
² Metropolitan Tokyo is broadly divided into three areas: the 23 wards, which largely define the urbanized areas of the city; western Tama district, which contains suburban cities, farm land and mountains; and a number of islands, including the Bonin group, in the Pacific Ocean. The total area of the 23 wards is 618 square kilometers, or roughly 70 percent of land area of New York City.

4.8% in 1997. While rents of large new buildings in central Tokyo finally bottomed out, rents of smaller buildings in peripheral areas continue to fall <Exhibit 6 and 7>.

Office demand is high when three conditions are met: good location (central city, proximity to train stations, etc.), good quality (new and well equipped) and large size (at least 3437.5 sqft). The degree of demand for these buildings is due to their scarcity. According to the survey of the National Land Agency, large buildings which were constructed after 1990 with a floor space of at least 2,883 sqft consist of only 5% of the building stock in Tokyo's 23 wards.

Since the supply of new large office buildings is limited, demand for offices goes beyond the superior properties described above to older, smaller buildings in good locations. However, the demand for large buildings located away from the city center remains low. Therefore, it is difficult to figure market conditions based on average values.

Exhibit 6: Offered Rent Index by Scale and Area



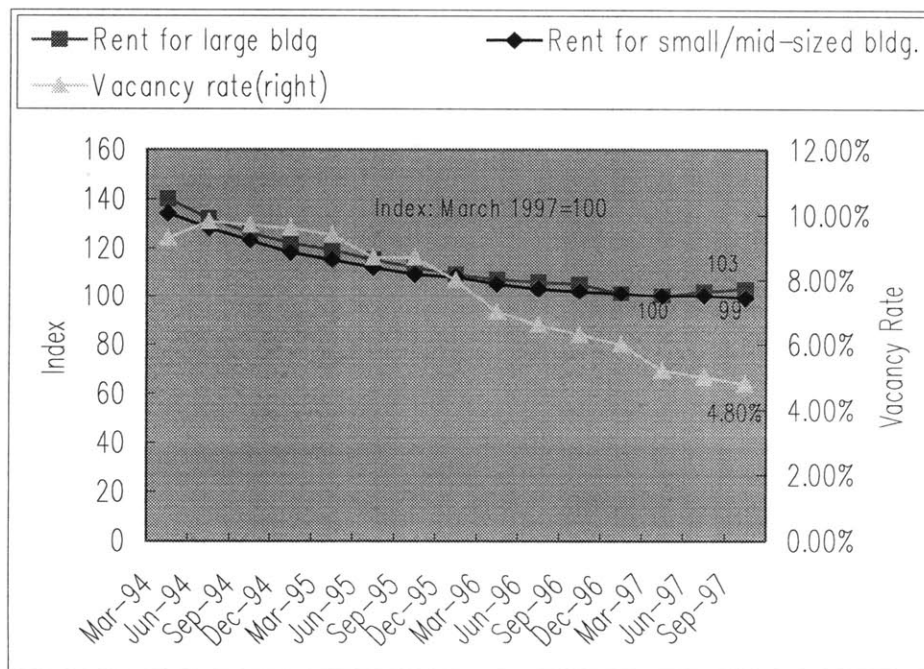
*1) Large-Scale Building: More Than 550,000 sqft of Total Floor Area

*2) Metropolitan 3 wards: Chiyoda, Chuo, and Minato

*3) Central 6 wards: Shinjuku, Shibuya, Shinagawa, Toshima, Bunkyo, and Taito

Source: Japan Real Estate Institute

Exhibit 7: Advertised Rent Indexes and Vacancy Rate



Note: Large buildings have at least 3,437.5 sqft: small & mid-sized buildings have less than 3,437.5 sqft.

Source: Office Building Research Institute for rents, and Ikoma Data Service System for vacancy rate

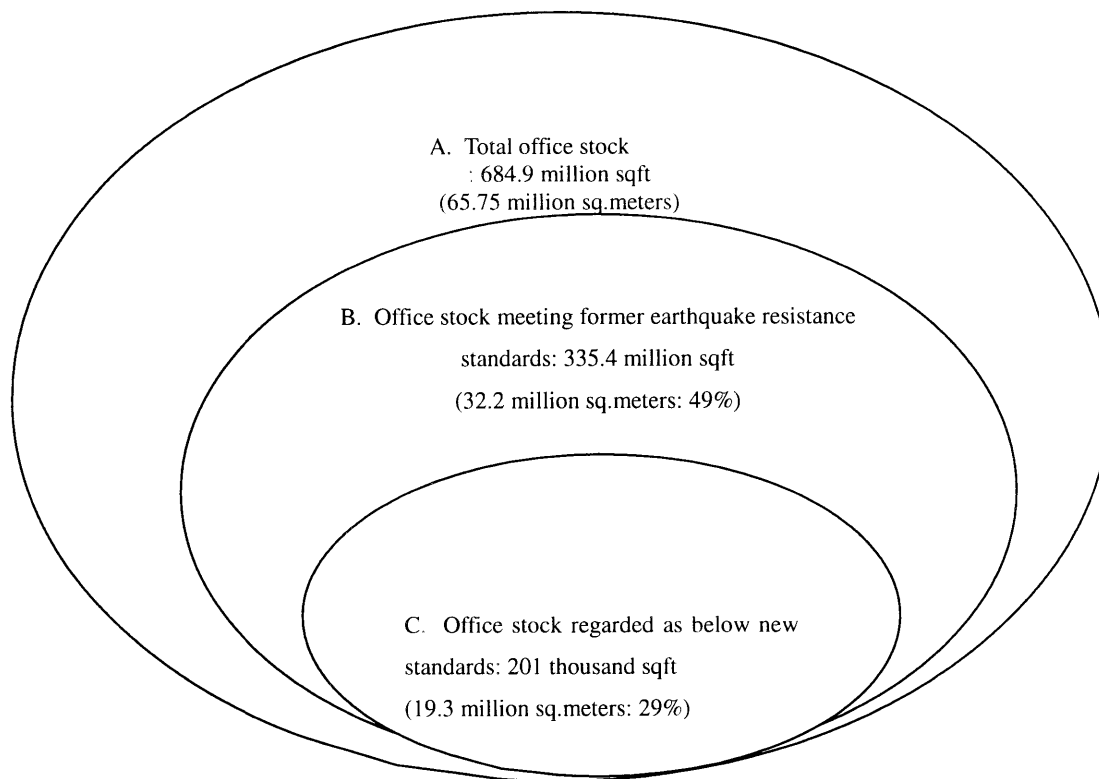
2. Trends of Demand for Office Buildings

Judging from recent declines in the vacancy rate, office demand is increasing. However, this increase relies heavily on the falling rents. And since rents of good buildings seem to have reached the bottom, growth in future demand may be less likely.

However, while the future demand for office buildings is unclear, the conditions sought for office buildings are rising steadily. Because of the impact of a large-scale earthquake in Kobe (Hanshin Big Earthquake) tenants are now seeking not only the three conditions of location, newness, and size, but also resistance to large-scale earthquakes. This will create differences in demand for buildings and location of buildings. Currently, one-third of the office building stock in the Tokyo 23 Ward area does not meet the latest standards of earthquake resistance and thus is significantly exposed to risks arising from potential natural disasters. <Exhibit 8>

Demand patterns are also shifting by location. In the greater Tokyo metropolitan area, demand for office buildings appear to be returning to office districts in the central Tokyo. The return to the central Tokyo area can be explained by companies' reevaluation of the advantages of economic concentration in central areas where real estate prices have currently fallen. According to a survey by the National Land Agency in 1996, 51% of the companies in the 23 Ward area recognized advantages to an economic concentration in central areas, including proximity to their customers and richness of information that companies need for their business.

Exhibit 8: Office Stock in the 23-Ward Area of Tokyo (January 1, 1994)



Source: NLI

3. Trend in Commercial Land Prices

In July 1997, Standard land prices of Shinjuku and Ginza showed their first increase since 1991. Those two districts are among ten of the 171 commercial districts in the five central wards in Tokyo, namely, Chioda-ku, Chuo-ku, Minato-ku, Shinjuku-ku, and Shibuya-ku.

The land value in Shinjuku-ku rose in January 1997 while the land value of Chioda-ku and Chuo-ku rose as of July 1997. These three locations are among the most expensive districts in Tokyo (valued at over 7 million yen per sq. meter). The trend of these three districts may indicate that the reversal in land prices is a phenomenon of prime real estate in Tokyo.

According to the National Land Agency, each ward's variable coefficient³ of commercial land prices in the five central wards, namely, Chioda-ku, Chuo-ku, Minato-ku, Shinjuku-ku, and Shibuya-ku, has risen notably since 1996 particularly for Chuo-ku. This indicates that disparities in land prices are increasing in each ward depending on the area and specific property. However, it remains unclear if the price reversal observed in prime properties will spread to other areas.

4-a. Real Estate Auctions held by JNR Settlement Corporation⁴

In land auctions held by the JNR Settlement Corporation in the first half of 1997⁵, even though many properties in good location in central Tokyo received higher prices, surrounding land prices were not affected very much⁶. Besides, because of the revival of the demand for office buildings in central Tokyo, land prices in outlying areas such as Yokohama and Chiba continue to decline.

Companies have recently been showing a strong interest in acquiring or constructing buildings for their own use. The primary purpose of owning buildings varies, including reducing the cost of rent, improving business efficiency by integrating operations, and establishing a flagship.

Looking at major building acquisitions and plans since 1995, the number of incidences is the highest in 1997 at 44, but in terms of floor space, 1998 is the highest.

³ A measure of variance for comparison purposes; the standard deviation is divided by the mean value.

⁴ Japan National Railway Settlement Corporation was created to liquidate a large amount of debts made by the former Japan National Railway Corporation before. This national railway corporation was privatized and now exists as Japan Railway Corporation (JR).

⁵ JNR Settlement Corporation auctioned properties which were used to be owned by the former publicly owned railway company, Japan National Railway Corporation

⁶ NLI Research Institute Homepage, The Commercial investment Real Estate Market in Tokyo, (Tokyo, 1998), p7

One reason for this trend is the recent decline in commercial land prices. However, it is not clear whether this trend will remain the same in the future because, long-term risks of owning real estate and cost-effectiveness of leasing versus ownership will be determined by the future condition of the real estate market in Japan, which is still in the adjustment phase at this moment.

4-b. Real Estate Auctions held by the Tokyo District Court

According to the information of the Sanyu System Real Estate Finance Research Institute, in the auctions aimed at liquidating real estate collateral of non-performing loans of financial institutions, 100 properties were auctioned by the Tokyo District Court in the second half of 1996 (those auctions include that of vacant land, land with buildings, leased land, and condominiums). The properties auctioned are foreclosed properties by financial institutions. Forty-nine properties were sold through the auctions and the auction prices for these properties were approximately 10% of the original collateral value⁷. The buyers of these properties include both individual and corporate investors. Financial institutions often hesitate to foreclose their collateral since they know that they can only get back a small portion of the money they lent to borrowers. Furthermore, if properties held as collateral are liquidated on a substantial scale to mitigate the problem of non-performing loans, the value of collateral held by financial institutions would be clarified publicly and real estate prices may fall further⁸. Because of these situations, financial institutions tend to keep their non-performing loans since doing nothing seems better than realizing a huge loss from selling their loan collateral. This problem also

⁷ NLI Research Institute Homepage, The Commercial Investment Real Estate Market in Tokyo, (Tokyo, February 1998), p8

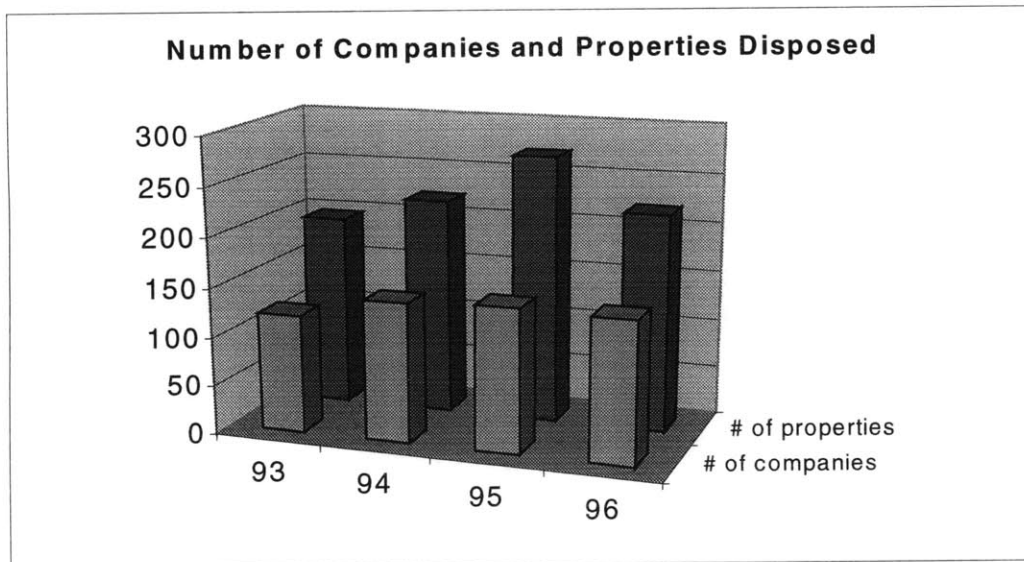
⁸ NLI Research Institute Homepage, The Commercial Investment Real Estate Market in Tokyo, (Tokyo, February 1998), p8

links to the problem of the Cooperative Credit Purchasing Corporation (CCPC) referred to in chapter 1. CCPC can not sell mortgaged real estate at the current market price, which is dramatically lower than the original loan value, because CCPC can not realize such a huge loss from the sale of mortgaged real estate.

5. Real Estate Disposal by Companies

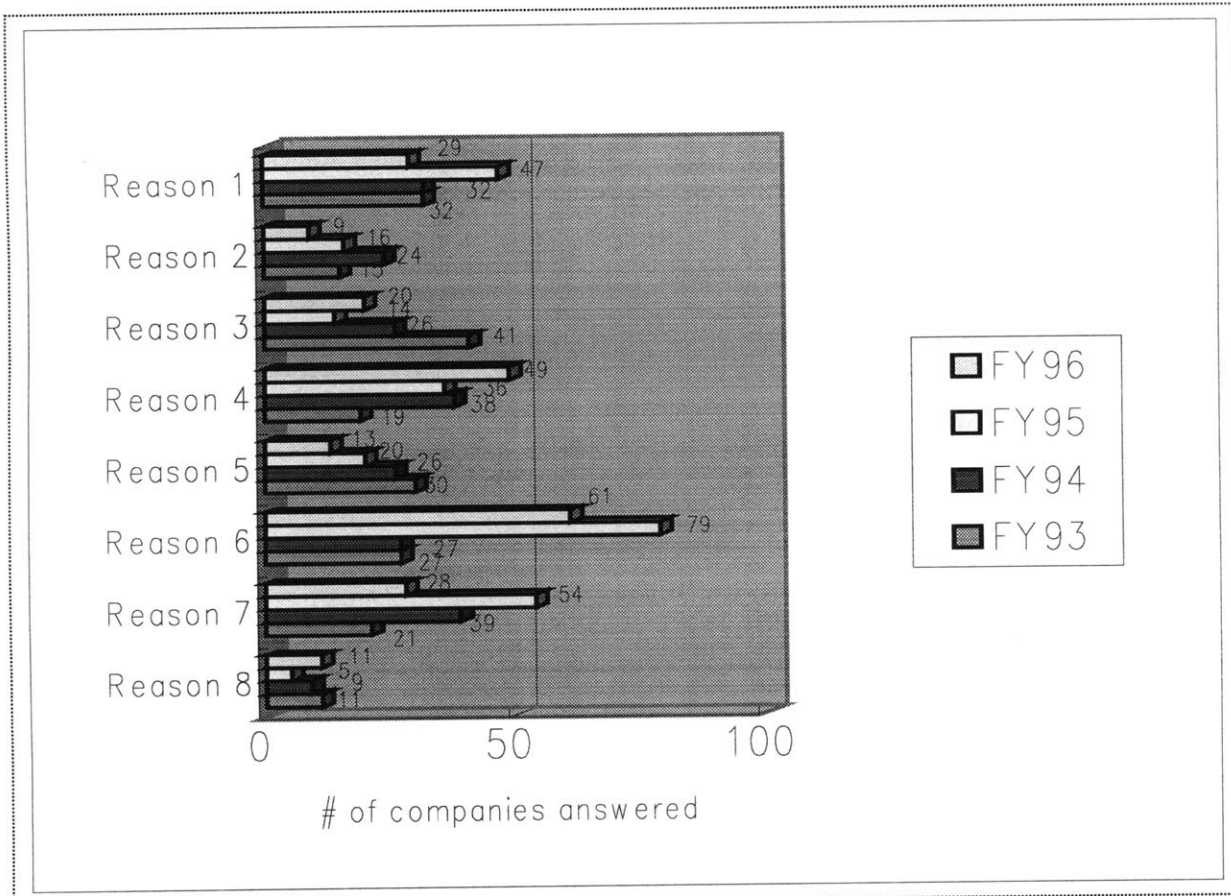
According to the trend of real estate transactions of Tokyo Stock Exchange listed companies between 1993 and 1996, a significant increase in the number of transactions can be seen for three years after 1994 <Exhibit 9>. These companies which are selling their properties include financial institutions and insurance companies that invested in real estate exclusively during the Bubble Economy. The supporting reason for the increase in selling their properties is companies' effort to reduce debt and pursue restructuring <Exhibit 10>. Public agencies account for 10%-20% of the purchases while most of the purchasers were affiliated companies of the seller and other companies in the private sector such as foreign investment banks. They seem to be buying these properties because of the much lower price in relation to the Bubble Economy years, and because of the potential profit that they will be able to earn by securitizing these properties in the near future. It is expected that the disposal of real estate holdings will stay at a high level for the time being because financial institutions especially continue to sell their non-performing loans.

Exhibit 9: Sale of Properties by Companies



Source: Ministry of Finance

Exhibit 10: Reasons for Selling Properties



Reason 1: Complying with request from public development project, etc.

Reason 2: Relocation factory or business site

Reason 3: Transferring idle land to affiliated company

Reason 4: Transferring idle land to another company

Reason 5: Covering term loss

Reason 6: Improving financial condition by repaying loan, etc.

Reason 7: Restructuring by consolidating operations, raising funds for severance pay, etc.

Reason 8: Unclear

Source: NLI Research Institute

6. Recent Trend of Securitization⁹

There is a growing interest in the Japanese real estate market among both domestic and foreign financial institutions since the government's latest economic stimulus package worth \$195 billion (24 trillion yen) includes measures to activate trading in real estate held as collateral by Japanese banks which wish to dispose of non-performing loans. While bulk sales of real estate backed claims to specialized investors overseas have been practiced in Japan, the securitization of real estate, including condominiums and commercial buildings owned by construction companies and realtors, is increasing rapidly. According to the survey done by Daiwa Securities Co., the market value of real estate subject to liquidation is equivalent to \$19 billion (2.3 trillion yen) and approximately \$8.3 billion (1 trillion yen) of real estate has already been liquidated. Daiwa expects the size of such a market to expand to \$664 billion (80 trillion yen) in three years, if infrastructure for distribution of securitized products and reliable credit rating system are well organized.

Foreign institutions provide real estate-related financing in the following three ways: 1) division of real estate into smaller lots for revenue generating development; 2) pursuit of revenues from tenants' security deposits and lease payments; and 3) loans to investors of collateral backed real estate. In Japan, foreign investment banks are particularly promoting the third type of service in conjunction with securitization. Even though securitization has so far been made for non-performing loans of Japanese financial institutions, the practice has recently begun to involve healthy properties. For instance, Goldman Sachs has securitized the building of Yamato Mutual Life Insurance in one of the most expensive areas in downtown Tokyo. In this deal, Credit Suisse First Boston Securities Japan Ltd. created real estate trusts on the properties and

⁹ Jiji Press Ltd., Tokyo Report, (Tokyo, May 11, 1998)

Goldman Sachs bought the entire trust beneficiary rights for \$36 million (43.2 billion yen). The vacancy rate is 0% and it is expected that the building on the property will generate 5% annual return¹⁰. Other foreign investment banks are following suit in handling both performing and non-performing assets.

The Government's stimulus package is expected to fuel securitization of real estate, using know-how obtained by foreign investment banks. However, it is pointed out by investment banks that securitization of non-performing loans without much cash flow has a limit. Healthy properties that generate greater cash flows should be securitized at a more significant level. Furthermore, current system of securitization does not offer liquidity of real estate at a required level and does not allow individual investors to enter because of the high investment principal required.

7. Implications of the Present Demands Made by Foreign Investment Banks for the Demand of the Japanese Real Estate Market

The recent trend of foreign investment banks to purchase collateralized real estate implies that there exists a demand in the real estate market. However, it is important to know that foreign investment banks are not buying collateralized real estate in order to develop the property, but buying as an investment. The reasons are follow:

- 1) Foreign investment banks see that this is a good time to buy Japanese real estate, especially, properties that generate an income stream. They believe that the land prices have nearly hit the bottom. Since the property has a potential "high market value", it is worth buying since they can sell it at a higher price in the future.

¹⁰ Masato Tanaka, A New Approach to Solving Japan's Real Estate Crisis, (MIT, August 1998)

2) Foreign investment banks see great potential in real estate as a financial product.

Therefore, they buy these properties at current low prices to prepare for securitization.

Clearly, for foreign investment banks, this is an excellent moment for them to buy Japanese real estate and enter the real estate industry, even though the domestic demand for Japanese real estate is low. The domestic demand is low because many Japanese investors currently do not have enough funds to invest in real estate. It is true that the price of real estate is nearly at the bottom; even so, many developers cannot afford to buy property of good quality (properties that generates great cash flow) and they cannot even borrow money because of the current credit crunch. Therefore, foreign investment banks seem very active in the Japanese real estate investment market.

THE REAL ESTATE MARKET NEEDS MORE LIQUIDITY¹¹

When the real estate market soured in the late 1980s, many people claimed that strict regulation and the legal system of land were deterring the efficient use of land, and requested relaxing plot ratios, allowing development and agricultural land in urban areas, and revising the Land Lease and Building Lease Acts. However, the plummeted land prices in 1991 changed the real meaning of the “efficient use of land,” and the fact that the land price is still at the bottom has changed the direction of the debate over land use policy.

Property prices reached the highest in the late 1980s, taking advantage of the internationalization of the Japanese economy, which led to an extreme concentration of people in Tokyo. At that time, it was generally believed that land prices were going up because of an

¹¹ Yukiko Suzuki, NRI Quarterly, (Tokyo, October 1997), p11

inefficient use of land, and this belief gave impetus for to aforementioned revision of the Productive Green Belt Law and the Land Lease and Building Lease Acts. These policies all aimed at increasing the overall supply of available land. However, since land prices fell drastically in 1991, “efficient land use” began to imply increasing the liquidity of real estate used as collateral against non-performing loans. Current owners, who cannot obtain the financing source necessary for development of unused plots of urban land that they currently own, should transfer the land as quickly as possible to people able to develop the property for more efficient and productive use. However, increasing the liquidity of real estate used as loan collateral could lead to bankruptcies and requires careful consideration of the circumstances of each property.

If real estate used as loan collateral is to be more liquid, property prices have to go down even further and have to reflect the market mechanism. According to the survey held by the Japan Food Service Association and the Central Bank for Agriculture and Forestry, in 1995, 50% of respondents said it is easier to open a restaurant than three or four yeas ago. The percentage of respondents who think it is easy to own a restaurant used to be 3.8% in 1991, and 33.3% in 1993. There is no doubt that it is now easier to own restaurants and retail stores, etc. since land prices and rents have fallen. Although further depreciation of land prices would cause more serious problems for people who bought land by borrowing money from banks as well as for these banks that lent their money to the borrowers, lower land prices would lead to stimulating business and incorporating liquidity into the system, both of which are vital for normalization of the real estate market.

STRUCTURAL CHANGES ARE ON THE WAY¹²

The value of property held as loan collateral has declined greatly. The decline of the value of real estate held as loan collateral is a healthy consequence when viewed from a long-term perspective since it reflects a shift to the new appraisal method of property that is based on the amount of cash flow the property can generate.

A major difficulty in increasing the liquidity of the real estate market is that many properties in Japan have multiple liens that transcend the property's collateral value and competing claims greatly complicate the foreclosure process. As I mentioned in Chapter 1, in the late 1980's, Japanese financial institutions in the late 1980s accepted the "land myth" which assumed that land prices would increase forever, and they kept on lending beyond the capacity of collateralized real estate value. They even allowed the same piece of property to be used as collateral for loans from different financial institutions. This practice is one of the reasons the foreclosure process is very complicated.

It should also be noted that lending practice in Japan is made through corporate financing. In Japan, project financing which is widely accepted in the U.S. does not exist. Under corporate financing, the failure of a project in a company affects another project very negatively. **<Exhibit 11>** On the other hand, under project financing, the failure of a project and foreclosure on its underlying collateralized real estate would not affect the operation of other properties.

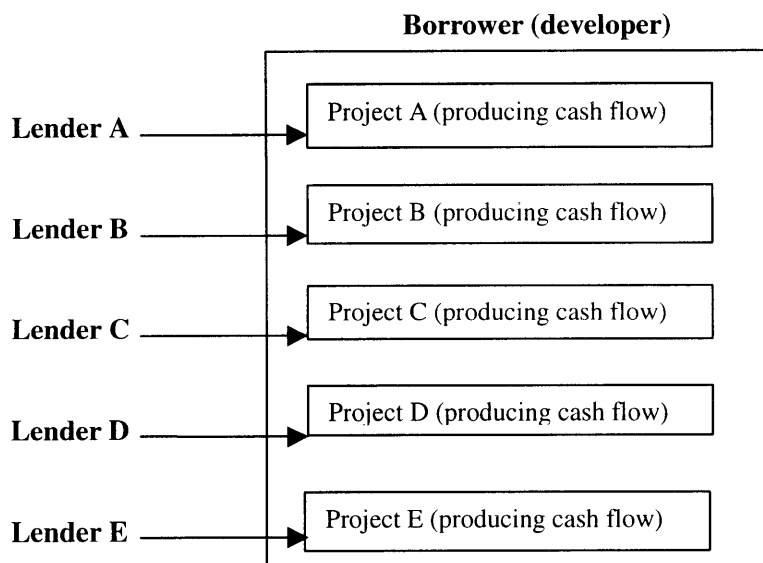
The market of real estate collateral can be more liquid if 1) the lender forgives some of the debts, ;2) the borrower sells the property voluntarily at a loss if necessary, and 3) the real estate collateral is auctioned off at a district court after being foreclosed. If the lender and borrower don't agree on either 1 or 2 above, it is almost impossible to achieve 3 if the borrower is using the property for business.

¹² Yukiko Suzuki, NRI Quarterly, (Tokyo, October 1997), p12

Exhibit 11: Use of Corporate Financing, Instead of Project Financing, Impedes Real

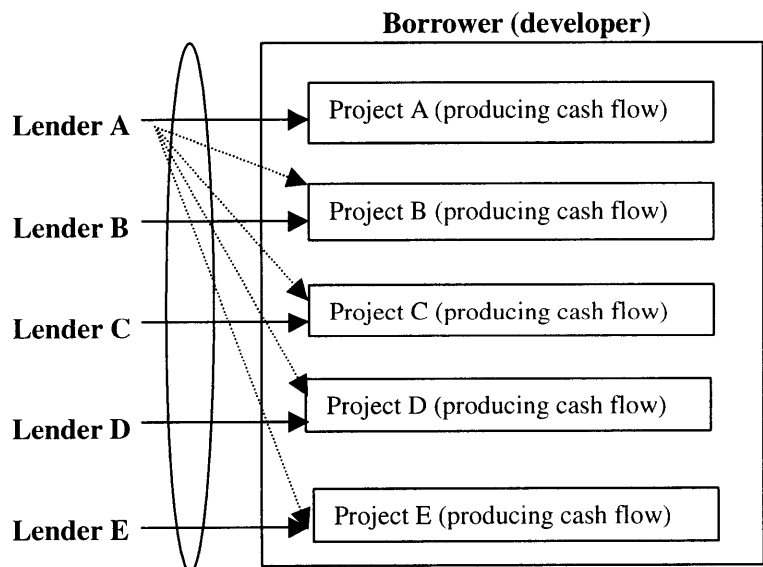
Estate Liquidity

Project Finance (widely used in U.S)



- Lending decisions made on basis of one specific project
- Even if one project fails, other projects can proceed

Corporate Finance (widely used in Japan)



- Foreclosure difficult due to multiple claims on same property
- Liquidity possible if lenders agree to forgive some or all of loan, if the borrower decides to sell, or if an auction is held; however, it is often difficult to sell the property if it is being used for business or residences. According to the Japanese real estate customs, an owner or a bank foreclosing the property is supposed to compensate tenants and residents for moving out of the property. To sell the property, the seller should have funds for this compensation.

Source: Nomura Financial Research Center

FALLING LAND PRICES DO NOT NECESSARILY IMPLY LOW EXPECTATIONS OF REAL ESTATE INVESTMENT¹³

The most effective way to increase the liquidity of the collateralized real estate market is not necessarily through the imposition of further laws and regulations. The complicated lending-borrowing issues of non-performing loans have to be solved first. However, for the time being, land value held as collateral will continue to fall.

This continued decline in land prices does not imply that the entire real estate market must suffer from diminishing expectations. Rather, the recent trend of falling land prices reflects the diminishing expectation of conventional reasons for real estate investment in which the returns of investment are earned merely by the appreciation of land value. Since the driving force behind real estate investment is no longer capital gains but income, the value of those properties that can generate significant cash flows will soon rebound. In fact, rents of new buildings in convenient locations in central Tokyo have been rising since mid 1996. The majority of properties in Tokyo continue to fall to the point when most investors start to invest in real estate. Once many investors start to buy discounted properties, a part of current non-performing loans may perform better.

DUAL STRUCTURE OF THE REAL ESTATE MARKET¹⁴

As we have seen, there are reasons for being both optimistic and pessimistic about the Japanese real estate investment market. This is because the real estate market is still in an adjustment phase, and market conditions cannot be precisely captured by average values because the market has a dual structure. That is, some investors think that it is a very good time for real

¹³ Yukiko Suzuki, *NRI Quarterly*, (Tokyo, October 1997), p13

¹⁴ NLI Research Institute Homepage, *The commercial Investment Real Estate Market in Tokyo*, (Tokyo, February 1998), p12

estate investment while others think that it is one of the worst time for real estate investments. Therefore, there are factors that drive the real estate market both positively and negatively.

If the demise of the Bubble Economy were seen simply as a cyclical event, I would say that prices would go up again once the adjustment period ends. However, an increasing population and a growing economy supported the increase in real estate prices during the Bubble Economy. In the future, both population and economic growth are expected to decline, giving no support for a real estate bubble as seen in the past.

Because of structural changes in the real estate market, the basis of price formation in the real estate investment market is changing from a belief in rising land prices to a rational approach based on use value. In 1995, the release of official land values finally paid attention to the discount cash flow method, and in 1997, the new overall land policy promotion outline altered the objective of land policy from the suppression of land prices to the effective utilization of land.

Once the real estate investment market in Japan begins to function efficiently, rents for superior properties should rise because they fell too far in the confusion after the collapse of the Bubble Economy. In this kind of market, older buildings can also regain high prices once alternations for earthquake resistance and facilities are enhanced. On the other hand, when the price of a particular land or building rises, surrounding land prices will no longer rise also.

FACTORS THAT BLOCKED SECURITIZATION¹⁵

In an efficient real estate market, it is totally normal for property prices to be different according to the cash flow that the property can bring. This is finally occurring in the Japanese real estate market, although slowly.

However for real estate to be securitized and for securitized products to be circulated at arbitrated rates with other financial products, the investment environment will need to change through measures such as constructing an information infrastructure and revising tax laws that impedes transactions. At this moment, there are many factors that block securitization real estate and those need to be developed to make securitization successful.

Absence of Proper Infrastructure Necessary for Securitization

➤ Leasing Code

In the U.S., lease agreements on trade buildings are comparatively long term (around ten years) and since the lessee must pay any lease fees on the period remaining if it withdraws, long-term cash flow is secured. In contrast, under the Japanese Leasing Code, lease agreements on office buildings are in principle renewed every two years and withdrawal is possible without penalty if a six-month notice is given. This complicates long-term profit predictions and does not guarantee fee payment, thereby, making an evaluation of capitalized value very difficult. This clearly blocks the creation of securitized products with a redemption term of more than 5 years.

➤ Too Many Real Estate Regulations

An inordinately large number of local and prefectural regulations apply to real estate. There are

¹⁵ Goldman Sachs (Japan) Ltd., Japan Research, (Tokyo April 1998), p10-12

strict regulations pertaining to floor area ratios, a strict Building Standards Law, very harsh environmental assessments, and a counterproductive law that requires the attachment of residential dwellings to commercial developments. These strict regulations are deterrents to the smooth cash flow necessary for securitization.

➤ Tax System

The frequent amendment of real estate tax laws such as acquisition taxes, ownership taxes, or taxes on transfer profits, is a deterrent to estimating cash flow.

➤ Separation of Real Estate and Finance

In Japan, a policy that deliberately separates real estate and finance has been in place since the first oil crisis. Separate government bodies supervise the two sectors: the Ministry of Finance and the Ministry of Construction. Without changing such an environment, it will be difficult to enhance liquidity of securitized real estate.

➤ Servicers (collection agents)

Especially in the case of real estate collateral, servicers (special agents responsible for collecting loans) are indispensable. In the United States, there are 26 major servicer companies, which have contributed to the disposal of the bad debts of savings and loan institutions in the early 1990s. Under the Attorneys' Law until now, only lawyers have been permitted to perform collection work until now. However, Servicers Law, which will allow private institutions to do collection work as well as lawyers, is going to be enacted in Japan by the end of 1998.

FACTORS THAT ARE CURRENTLY BLOCKING SECURITIZATION

SPC Law¹⁶

The Special Purpose Company Law was planned and implemented to promote securitization permitted under the Specified Credit Law, especially to include receivables and other assets. However, the law seems not to be functioning effectively since it was implemented on September 1, 1998. Reasons are explained later in this section.

The government intends this law to encourage asset securitization in Japan. The assets targeted are: 1) non-performing loans of financial institutions; 2) leasing and credit loans; 3) real estate; and 4) trust beneficiary rights of non-performing loans, leasing and credit loans, and real estate. These assets are placed with an SPC to protect the management risks of the company, which created the SPC. Then, these assets are securitized and sold to investors. Through securitizing its assets through the SPC, the company can get direct financing from investors, which is a new practice in Japan. Securities include preferred stocks, corporate bonds, and commercial papers (CP). It is expected that if securitization of real estate is once achieved by SPCs, it will become possible to sell properties easily and to utilize currently vacant land more efficiently.

However, even after two months have passed since the law was implemented, almost no companies have registered as SPCs. This is because realtors and other companies are fairly uncomfortable with the requirement for registering as SPCs. SPC Law requires all the registering companies disclose the information including the name of the tenants, rents, rent space, and the expiration date of the lease contracts. The private sector is opposed to the government in requirements for disclosure, and companies that consider registering as SPCs

¹⁶ Nikkei Newspaper, Delayed Securitization, (Tokyo, October 1998)

argue that if they disclosed all rents, it would accelerate the movement of tenants, and thus confuse the Japanese real estate market. On one hand, what companies think sounds rational. However, on the other hand, companies may be just showing discomfort with the possible higher level of disclosure imposed on real estate transaction, if their businesses take advantage of the low disclosure level.

One of the greatest advantages for the companies that register as SPCs is that the companies can get direct financing from a wide range of investors in the market by securitizing their assets. For all the Japanese companies facing the credit crunch, securitizing their assets is a wonderful alternative to borrowing money from banks. Ministry of Finance argues that it is necessary for SPCs to disclose their information thoroughly to make the deals transparent in the capital market. The Ministry is particularly concerned about the much lower level of disclosure of the real estate market than that of stock and bond markets.

According to the senior management director of the Real Estate Syndication Consortia, the level of disclosure in the real estate market is not low compared to that in France and Australia, both of which have a high level of real estate securitization. The United States is the only country where the real estate market has a higher level of disclosure than that of Japan does.

The private sector's discomfort with the current SPC Law goes beyond the issue of disclosure. Companies that consider registering an SPC often complain that the income taxes imposed on SPCs are very high. <Exhibit 12>

SPCs have advantages in acquisition taxes and registration license taxes when a company places its real estate ownership with its SPC, compared to the case where a company places its real estate ownership with its joint stock companies. However, there is a growing demand for SPCs to have full-scale tax exemption. The government imposed acquisition and registration license

taxes on SPCs because if it did not impose taxes on SPCs, the government thought that there would be many companies that register as SPCs only to obtain full-scale tax exemption without any plan to securitize their assets. The government has a good point. However, judging from the fact that almost no companies have registered as SPCs, the government tax imposition on SPCs may be too rigorous. There is a need to relax the law to promote securitization of real estate.

Exhibit 12: SPC Taxation

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

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

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

And if both of the following are also true:

- The SPC is conducting business activities in accordance with its asset liquidation plan and no other than business activities.

- The SPC is disbursing as dividends 90% or more of its income available for dividends to parties not constituting its family companies under the Corporation Tax Law (excluding cases in which the SPC issues at least \$714,000 (¥100 million) in public special bonds or special bonds limited to eligible financial institutions).

Source: Goldman Sachs (Japan) Ltd.

CHAPTER 4: HOW TO CARRY OUT TRUE SECURITIZATION

Chapter will discuss: 1) political factors that blocked securitization; 2) desired full- scale securitization; 3) things needed to carry out true securitization; and 4) merits of securitization.

FACTORS THAT BLOCKED SECURITIZATION POLITICALLY

If the government thinks that securitization is a great idea for disposing non-performing loans, and for reviving financial market, why wouldn't the government consider securitization earlier? In the previous chapter, I have described various factors that blocked securitization of real estate in view of real estate laws, regulations, and infrastructure. Here, I would like to talk about the factors hampering securitization politically.¹ There has been a certain resistance to securitization because of the disadvantages to certain parties such as real estate owners, investors, and developers.

➤ Disadvantages for Real Estate Owners

For most of the Japanese owners of real estate, owning a property allows them to hope that eventual appreciation of land would benefit them if they were to sell the property. They are particularly attached to the pride of ownership. Therefore, securitizing their ownership was not appealing to them even if they could have raised much more profit through securitizing their property.

➤ Disadvantages for Investors

For many Japanese investors who are currently extremely risk averse, buying securitized products is not attractive. For the time being, they may stay away from real estate investment

¹ Goldman Sachs (Japan) Ltd., Japan Research, (Tokyo, April 1998), p23

until the real estate market in Japan recovers.

Regarding real estate, as in the U.S., investing in property in Japan is a good way to reduce taxes. They can borrow money to buy real estate in Japan. However, once REITs are allowed in Japan, dividends paid out to REIT investors may be considered taxable. Therefore, Japanese investors who know about REITs in the U.S. may not think that investing their money on REITs is a good way to reduce tax.

➤ Disadvantages for Developers²

Once securitization is accelerated in Japan, the need for large sums of real estate equity and mortgage funds would be demanded in the form of REITs. However, since REITs have the same effect as public stock offerings, developers have to disclose a lot of information regarding their management when establishing REITs. If a developer's business is not going well, investors won't buy shares in the developer's REITs. Therefore, establishing REITs requires investors' constant supervision on the developer's business.

The political factors that blocked securitization seem reasonable. However, the government's efforts over the past year to develop a securization scheme are noteworthy and many investors are now aware of the benefits for new investment products. Therefore, the future of securitization is still full of hope. As was noted in the *Japan Research*, 'The situation is like a fabulous new sports car that has been built when almost the entire road remains to be paved. But that is the situation we must begin from, and, after all, even an unpaved road gets smoother with each passing car.'³

² Goldman Sachs (Japan) Ltd., *Japan Research*, (Tokyo, April 1998), p23

³ Goldman Sachs (Japan) Ltd., *Japan Research*, (Tokyo, April 1998), p23

DESIRED FULL-SCALE SECURITIZED PRODUCTS⁴

The three conditions that make full-scale property security products attractive to regular investors are as given below.

- The advantages of property investment that can be obtained at a relatively low investment price.
- Liquidity is maintained
- The investment climate assures reasonable methods for risk evaluation.

The advantages of investing in real estate are conventionally listed as the capital gains to be earned through tax advantages thanks to its rising land prices. However, ever since the Bubble Economy burst, investment in anticipation of rising land prices has become less likely. Traditionally, capital gain does not refer to unearned revenue gained from land resale or holding on to buildings that are not profitable, but to earnings derived from the value of managing and using the land appropriately (rent, leases). This type of property income and the actual value of the asset itself which creates this income (property value) are expected to rise with projected long-term economic growth and are seen as a hedge to inflation where fixed income bonds and savings deposits cannot be. It is for these reasons that good quality real estate still offers attractive investment opportunities.

The property investment market is in disarray due to falling land prices for the first time since World War II. Moreover, it appears that any investments that rely on land price rises for returns are being absolutely ignored. However, while investments that do not consider earnings gained from holding empty land and expecting land prices to rise are being refused, preservation of the

⁴ Masanori Oka, NLI Research Reports, (Tokyo, November 1997),p5

value of the asset through effective usage or investment that accrues capital gains should not be ignored.

Until recently, compared to other financial commodities, real estate was not an object for regular investors due to the high investment prices (or large investment denominations required), uniqueness of each property, and low liquidity. The purpose of true securitization of real estate is thus to offer investment opportunities in real estate that ordinary investors can access in relatively small denominations in a mixed portfolio of properties that can hedge risks.

While the goal of true securitization of real estate is to offer more investment opportunities to small investors, its greatest advantage is to provide an opportunity to obtain all the benefits of property investment. It makes sense to preserve secondary liquidity, as it is essential that financial commodities can be easily sold when required. The establishment of an investment climate that allows rational assessment of investment risks clarifies the relationship between risks and returns, provides information that allows comparison with other financial assets, and provides for financial bodies and investment consultants who can rate and evaluate circumstances for investors. In this respect, the U.S. already has REITs (Real Estate Investment Trusts) and MBS (Mortgage Backed Securities) as securitized real estate. REITs are real estate investment trusts that collect small-lot capital funds from multiple investors, and with the recent establishment of minimum investment amounts of \$830 approximately, these have also become popular with individual investors. An MBS is a bond backed by residential mortgages or properties.

The securitization market in the U.S. was not always large. While REITs have been threatened twice in the past in connection to market crises, the market has currently grown to a healthy

trading size with individual investors, in particular baby boomers who are managing their assets in preparation for retirement.

The process of developing securitized products in the U.S. was the refinement of different experiences that eventually showed these products to be attractive to investors. In addition, these securitized products are monitored by the Securities and Exchange Commission which is strict in instructing corporate bodies to provide investors with information regarding the tenant agreement conditions for real estate and predicted returns and this system means that investors are well informed.

THINGS NEEDED TO CARRY OUT TRUE SECURITIZATION⁵

Many things need to be done to carry out true securitization of real estate.

❖ Revising Real Estate Appraisal Method

The Real Estate appraisal method should take into greater account a discount cash flow model to make land value reflect income it can generate. To securitize real estate, what matters most is the possible income gain of the property. Therefore, property appraisal should be based mainly on the cash flow it can produce. This will encourage investors to figure out the risks and returns associated with the securitized products that they buy.

❖ Revising the Leasing Code

It is important to make lease agreements long-term (about 10 years) to secure long-term profit, which makes it possible to estimate risks and returns on the property. Without long term income gain, it is impossible to securitize properties.

⁵ Goldman Sachs (Japan) Ltd., Japan Research, (Tokyo, April 1998), p10-12

❖ **Relaxing Real Estate Regulations**

It is necessary to abolish or relax some of the complicated real estate regulations to achieve smooth securitization.

❖ **Revising Real Estate Taxation System**

Whereas in the U.S. and Europe, real estate sales profits (transfer profits) are normally included in corporate income, and are taxed at operating corporate tax rates, in Japan these profits are calculated at long-term corporate tax rates of 5% (5 years or more), short-term rates at 10% (over 2 years and under 5), or ultra-short-term rates at 15% (under 2 years), lowering the rate of return after tax. Therefore, taxation on real estate sales profits should be revised to be fairer.

Also, the Real Estate Acquisition Tax and the Registration and License Tax, which impose higher transaction taxes than in the U.S. and Europe, should be revised so as to reduce real estate taxation costs related to property transactions in Japan.

❖ **Developing a Secondary Market**

Without a secondary market, the liquidity of securitized products is extremely limited. Therefore, developing a secondary market is indispensable to allow investors to buy and sell securitized products freely. The Government should set proper laws and regulations to allow companies to list real estate securities in the Tokyo Stock Exchange. Once infrastructure for the secondary market is well prepared, it is the job of investment banks and real estate related companies to create attractive securitized products for investors.

❖ **Considering the Real Estate Market as a Part of the Capital Market**

Currently the real estate market and the capital market in Japan are supervised under different government bodies since the two markets are considered to be separate. However, securitization of real estate is involved in the capital market exclusively. Therefore, the government should consider the strong link between the two markets.

❖ **Adopting Non-Recourse Financing**

As mentioned in the previous chapter, with-recourse financing is the form typically used in Japan. However, in the U.S., the majority of mortgage properties are financed by non-recourse finance. Under non-recourse financing, a failure of a project and foreclosure on its underlying collateralized real estate do not affect the operation of other property, which ensures liquidity of collateralized real estate.

❖ **Revising the SPC Law**

The SPC Law's strict requirement that all the registering companies disclose detailed information regarding the property they are to securitize should be relaxed. Acquisition and registration license taxes on SPCs should also be relaxed to encourage companies to register as SPCs, thus promoting securitization of real estate.

As long as there is no revision in the aforementioned areas, even if the ban on property investment trusts such as REITs were lifted, the real estate securities market would not expand. If we are to undertake true securitization of real estate, we must carry out reforms so that the

basic conditions of the capital market are incorporated in the normal real estate investment market⁶.

❖ **The Use of Public Funds to Augment the Financial System**

Without stability, the financial market would remain inactive, regardless of reforms mentioned earlier. In such a market, it is impossible to carry out successful securitization. Therefore, it is important for the Japanese Government to augment the capital market. The government should use public funds to restructure financial institutions, which is currently hampering the capital market to work efficiently. One of the most recent government plans to use public funds is the Financial Revitalization Plan, announced in July 1998. One of the main objectives of this plan includes stabilizing the financial system and augmenting the function of the system. One hundred and one billion dollars (13 trillion yen) are to be allocated to private financial institutions to tackle the current credit crunch and 250 billion dollars (30 trillion yen) are to be used to restructure financial institutions: this means covering the loss from disposing non-performing loans, taking care of the assets of failed financial institutions, and compensating for the loss arising from the failed financial institutions.

I mentioned earlier in this thesis that many financial institutions could not easily sell the loan collateral because of the possible large loss from the sale. Because of this, the government's decision to use public funds in this way is a right move. However, it remains to be seen if public money allocated to these financial institutions are managed efficiently to promote liquidation of loan collateral.

⁶ Masanori Oka, NLI Research Reports, (Tokyo, April 1998) p1-10.

MERITS OF SECURITIZATION

As I mentioned earlier, true securitization cannot be achieved without reform of the real estate investment market's practices and systems. The Japanese government is already aware of the securitization of real estate as a way to dispose of non-performing loans, and as a measure of financial market stimuli. As I have seen, many financial institutions have started to liquidate their assets, mainly non-performing loans with major foreign investment banks, although most of the deals are not profitable to the Japanese banks. Even though there are still many difficulties such as long-established Japanese real estate customs, low infrastructure for MBS, and a quite high tax rate, Japanese real estate securitization has a large potential to be further developed. Here is a list of benefits of securitization of real estate in Japan⁷.

Merits for Fundraiser (Business)

- Diversifying financing methods
- Enabling diverse development projects and arrangements

Merits for Investors

- Expansion of investment opportunities
- Diversification of investment instruments
- Reduction of liquidity risk of real estate
- More information obtainable in the real estate market

⁷ Masanori Oka, NLI Research Reports, (Tokyo, April 1998), p9

Merits for Real Estate Markets

- Encouragement of a sound and active market
- Wide product variety that allows arbitration with other financial products
- Encouragement of entry by domestic and foreign investors
- Market expansion through formation of securitization market
- Emphasis on returns and use value of real estate
- Progress in disposal of non-performing loans and collateral real estate

Changes in the real estate market can be accelerated by the emergence of attractive real estate securitized products, such as securitization of a famous high-rise building or a large-scale development project located in the center of a city. Considering the possibility that the revised foreign exchange law could cause funds to shift to REITs in the U.S., work needs to be started immediately on securitization by fundraisers, investors, government agencies, and other market participants.

CHAPTER 5: CONCLUSION: REALISTIC EXPECTATION OF WHAT SECURITIZATION CAN DO FOR THE JAPANESE REAL ESTATE MARKET AND THE ECONOMY

This chapter will conclude with realistic goals of securitization for the Japanese economy and the real estate market. It will also analyze the impact of securitization to the Japanese market.

THE JAPANESE GOVERNMENT'S EXPECTATION OF SECURITIZATION

Securitization is often mistakenly considered to be a panacea for non-performing loans. However, it will not erase the damage caused by the real estate bubble, nor will it suddenly improve the performance of assets. It is risky to expect too much of securitization as a solution to non-performing loans. Right now in Japan, the government puts a high expectation on what securitization can do for non-performing loans, as can be seen from the ruling party's interim report on their Financial Revitalization Total Plan. In this plan, the ruling party, the Liberal Democratic Party, expresses its firm intention to set up an environment that facilitates securitization of assets, especially, non-performing assets.

SECURITIZING NON-PERFORMING LOANS IS NOT UNREALISTIC, BUT IT IS VERY DIFFICULT FOR JAPAN

It is true that it is possible to securitize any assets that generate cash flows. These assets include auto loans, leasing loans, credit loans, and credit receivables. However, the most non-performing loan collateral includes properties that currently do not generate enough cash flow or have great difficulties to securitize. These collateral include: 1) vacant lands; 2) designated farmlands which do not have permission to develop; 3) urbanization controlled areas and irregularly shaped lands which do not have construction permission; and 4) leased lands. Securitized products that are backed by such real estate are not attractive to investors since they

cannot provide much dividends or interests to investors. Therefore, buyers won't easily buy such asset backed securities. Furthermore, as often with the case of non-performing loans, there are many collateral lenders associated with the same property. In many cases, during the Bubble Economy, there were more than 6 financial institutions that lent money, collateralizing the same property. This fact greatly complicates the process securitization, let alone foreclosing the property.

Securitizing non-performing loans successfully requires super expertise in real estate management and finance, combined with knowledge of Japan's peculiar real estate regulations. As the vice president of a major leasing company, ORIX, Mr.Katsuaki Ishida, mentioned, "even in the U.S. where securitization is practiced generally, securitizing non-performing loans is not carried out in many cases now." Even though, in the past, the RTC successfully securitized non-performing loans, the agency was fortunate in that the U.S. had better infrastructure for secondary market and much less complexities in loan collateral, which helped to develop securitization.

The question remains whether securitization of non-performing loans can be successful in Japan, where the securitization business is in its infancy as compared to that of the U.S.

An investment banker working in Tokyo commented "once derivatives were treated as magical wands in the Japanese financial market. Now, it seems that the derivatives are replaced with securitization." Will securitization bring no significant benefits in the end or will it have a meaningful impact on the Japanese economy and financial market? The next section will address the real implications of securitization, realistic expectations for securitization and its effect on the Japanese economy.

REALISTIC EXPECTATION OF WHAT SECURITIZATION OF REAL ESTATE CAN DO FOR THE JAPANESE ECONOMY

1. A Shift From Indirect Financing to Direct Financing¹

Financial institutions are urged to reduce their assets such as loan credits to meet the required return over asset ratio known as ROA² which is determined by Bank for International Settlements (BIS) and to overcome increased competitions among financial institutions because of the Japanese financial deregulation, Big Bang. To reduce assets, what banks do is: 1) sell off their assets if they are of good quality; 2) sell or replace the assets to the Credit Cooperation Purchasing Corporation (CCPC) if the assets include non-performing loans, or; 3) securitize their assets such as properties with a strong income stream. By reducing their assets, banks can recover a “healthy looking balance sheet” that is necessary to receive a high grade by rating agencies. By the end of 1997, major Japanese banks reduced their risk assets including credit loans by \$ 283.3 billion (34 trillion yen), or a decrease of 7.7% comparing to 1996. Because of this, banks are very reluctant to lend money. As a result, many companies and individuals find it very hard to borrow money from banks currently. Even companies with good performance and sound credit history often can not rely on bank loans. It is the problem of financial institutions that make companies unable to obtain money from indirect financing. Consequently, it is inevitable for companies to get financing other than bank loans. Therefore, there will be a growing demand for direct financing: issuing bonds, stocks, and securities backed by their assets and getting funding from a wide range of investors in the market directly. The distinction between direct financing, namely, stocks, bonds, commercial papers, and

¹ East Asian Economic Weekly, (Tokyo June 13, 1998), p11-13

² Return over total asset = (net income + net tax or interest expense) / average total assets. A higher ROA indicates a better performance on the company's management and leads to higher stock price and higher bond rating of the company

securities backed by assets is that the first three ways of direct financing are based particularly on the company's creditworthiness. However, securities backed by assets such as real estate are different. One of the key merits of securitization is that companies can get direct financing using the creditworthiness of their assets such as income generating real estate<Exhibit 13>. This gives a great opportunity to obtain financing for not only large companies, but also middle- and small sized-companies, which face great difficulties in borrowing money from banks currently.

Exhibit 13: Corporate Financing and Asset Financing

	<i>Indirect Financing</i>	<i>Direct Financing</i>
<i>Corporate Financing</i>	Bank loan	Bonds, stocks, commercial papers
<i>Asset Financing</i>	Factoring, Project financing	Securitized products (trust beneficiary rights, asset backed securities, asset backed commercial paper)

* factoring: selling a company's accounts receivable (not securitizing them)

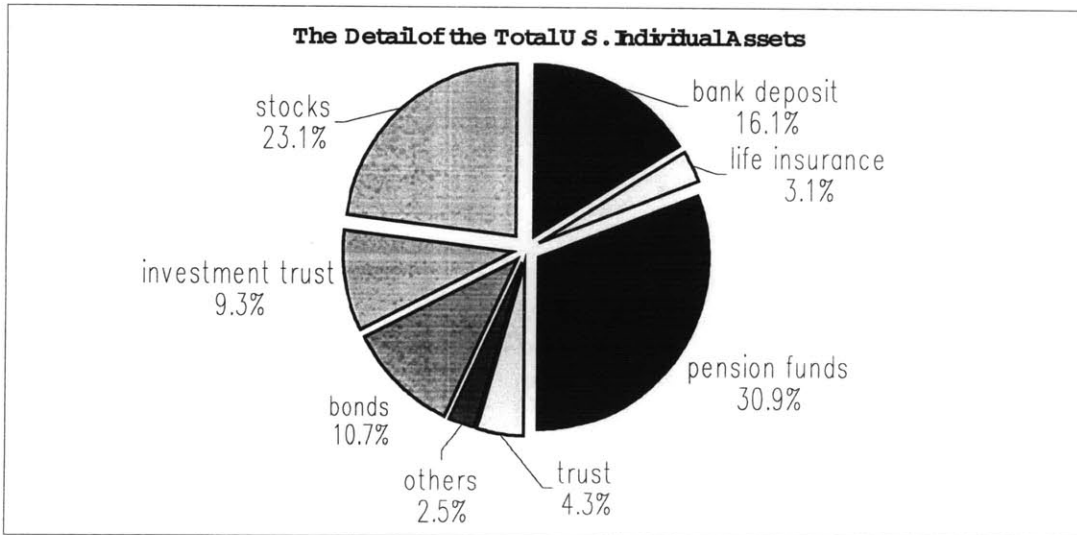
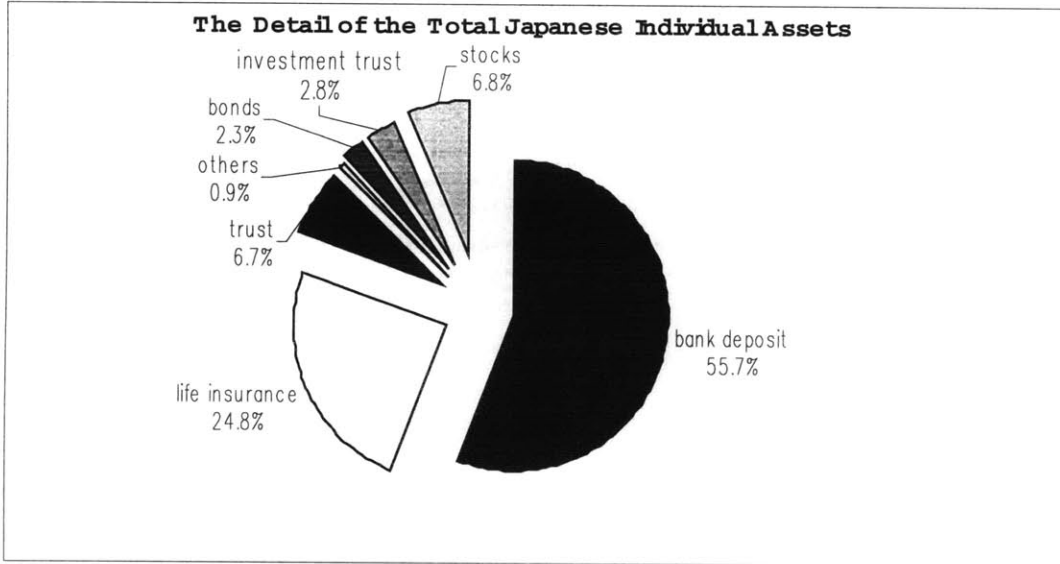
Source: East Asian Economic Weekly, June 13, 1998, P12

Direct financing, especially securitization will contribute to many companies that suffer from the current credit crunch. By securitizing their assets such as real estate, these companies can get necessary funding to inject more capital in their businesses. Indeed, securitization has a key to stimulate the entire business sector.

2. Widened Techniques to Manage Japanese Individual Assets Equivalent to \$10 Trillion

Japanese individual assets amount to \$10 trillion approximately<Exhibit 14>.

Exhibit 14: The Detail of Total Individual Assets in Japan and the U.S.



Source: The Diamond Weekly, June 6, 1998

As the figure shows, low interest bank deposits account for 56% of all the individual assets approximately. This ratio of bank deposits is significantly higher than that of U.S., which is 16%. Therefore, by securitizing real estate, especially those that generate significant income,

and denominating the securities to make them available to individual investors, a higher portion of the entire individual assets will be managed more efficiently. At the same time, the techniques for managing the Japanese individual assets will be more diversified. Managing individual assets more efficiently and diversifying the techniques to manage them are very important to restructuring the Japanese capital market because the capital market needs more funds to be revitalized.

3. Increasing Real Estate Transaction

Since securitization allows a wide range of corporate and individual investors, securitization will dramatically increase real estate related transactions and promote more efficient use of land because many property owners will try to make their property to generate cash if they want to securitize their property. Also, there are many property owners, especially corporate property owners, interested in securitizing their property to obtain necessary funds for their businesses.

If the properties are used properly so as to generate enough cash flow, the property price will no longer fall. However, except for some properties in central Tokyo, this is not the case for most properties. Securitization is expected to spur property owners' attention to manage their property more efficiently, such as constructing a commercial, residential, or office building. This will have a positive effect on revitalizing real estate market and the Japanese economy.

4. New Business Opportunities³

Securitization of real estate brings great opportunities to “fee businesses” such as a real estate investment advisory business, and an asset management business. The real estate industry gives

³ The Diamond Weekly, (Tokyo, June 6, 1998), p41

the impression of being a “hard industry” which provides properties and buildings to users. However, the future real estate industry will become more of a “soft industry” which provides various know-how regarding real estate investment. There is especially great potential in the following new businesses:

- Planning and Development of Real Estate Investment Products
- Real Estate Investment Advisory and an Asset Management business

In 1997, Mitsui Real Estate, one of the largest real estate companies in Japan, established a real estate investment advisory company and other large-scale developers have established the same kind of advisory business. Since many banks are also trying to enter this business, there will be a high competition among them.

- Business That Manages Buildings and Tenants

Real estate companies that manage properties will need to enhance their know-how in generating more cash flow in order to enhance the value of their securitized products.

These new businesses will spur the demand of both corporate and individual investors interested in real estate investment. The new businesses will actively make these investors involved in the real estate market, which will contribute to revitalizing the market and, further, the Japanese economy.

5. Impact on the Real Estate Market

Securitization of real estate promotes the adoption of discount cash flow method for land evaluation and disclosure of information regarding securitized real estate. In the actual real estate market, transactions will be more open, fair in terms of pricing, and the market’s order will be enhanced. The Japanese real estate bubble comes partly from the Japanese conventional method of “sales comparison”, which determined land prices based on the surrounding land

property value. Therefore, with a real estate market in which property pricing is based on the income gain of the property, it becomes possible to prevent dramatic increases or decreases in real estate prices, which were seen during the bubble economy.

The second major impact of securitization on the real estate market is that the level of disclosure of real estate transactions will be enhanced. For example, when investors buy commercial mortgage backed securities, they need to know the vacancy rate of the building, the tenants' trend of moving in and out of the building, their type and term of leasing, and their trend of paying full rent without fail. At this moment, this information regarding properties is not disclosed in Japan. The third major impact of securitization is that the liquidity of real estate will be more enhanced. Securitization of real estate will lead to property owners' paying more attention to the cash flows that their property can generate. This is because investors, of course, want to buy securities backed by such income generating properties. Therefore, once various securitized products become available to a wide range of investors, the liquidity of real estate will improve.

The adoption of the discount cash flow method, enhanced level of disclosure, and improved liquidity level will certainly contribute to control of the Japanese real estate market of current stagnancy. Once the real estate market starts to be active again, the whole capital market will be revitalized, leading the entire Japanese economy to recover from the long lasting recession.

CONCLUSION

In this chapter, I have discussed various implications of what securitization can do for the Japanese real estate market and the Japanese economy. First, securitization will enable a shift from indirect financing to direct financing, which is particularly beneficial for many companies with difficulty in borrowing money from banks. Second, it will lead to managing the huge

Japanese individual assets more effectively. Third, it will increase real estate transactions. Fourth, it will bring new businesses to the real estate industry. And finally, it will help get out of the current real estate stagnancy.

It is expected that the creation of a healthy securitization market in Japan would facilitate necessary structural adjustments in Japan's financial economy and dramatically increase the liquidity available to Japanese companies including financial institutions. Financial institutions, especially, would in turn be able to raise their capital adequacy to international standards and spread the risks inherent in asset portfolios. This may work positively to solve the current credit crunch.

Whether real estate securitization can be successfully carried out relies on the motivation of the Japanese government and market participants. It is important for the Japanese government to look at securitization as more than merely a means to solve the bad debt problem. Securitization in Japan, which is in its infancy, can not offer much to solve this problem in a short run. However, it has a large potential to be a market stimulus to the currently ailing capital market and real estate market in a long run. Indeed, securitization of real estate would contribute significantly to the revival of these markets in Japan.

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