
Japan Debates The Introduction of Real Estate Investment Trusts

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The Financial System Council, an advisory panel to Japan's finance minister, submitted proposals on 21 December 1999 for policy measures to support the securitization of real estate as one step in the government's promotion of collective investment schemes. These proposals recommended two broad measures: (1) revisions to the SPC Law (the Law on Securitization of Specified Assets by Special Purpose Companies), in effect since September 1998; (2) comprehensive revisions to the "Act Governing Securities Investment Trusts and Securities Investment Corporations." A draft bill is to be submitted to the regular session of the Diet at the beginning of 2000, which would come into force at the earliest sometime during 2000. The second proposal in particular, to expand the scope of permitted investments for investment companies from "mainly marketable securities" to the more comprehensive "general financial assets," would for the first time allow investment companies to acquire real estate assets. Further, there have been recent reports in the Japanese press that the Tokyo Stock Exchange plans to open a market for the trading of units in investment companies. It has raised expectations that Japan is finally going to establish an active market of securitized claims on real estate, and develop a Japanese version of the REIT (Real Estate Investment Trust) market.¹ This report will review the course of the debate over the current draft bill and consider possible future developments.

1. Collective Investment Schemes And Real Estate Securitization

The workings of the first committee of the Financial System Council (FSC) on the establishment of the legislative infrastructure for collective investment schemes has important implications for the future development of real estate securitization in Japan.

"Collective investment schemes," as termed by the committee in its interim report of 6 July 1999, are schemes where "a sponsor pools funds from a large number of investors, these funds being invested and managed by an investment professional (fund manager etc.)."

It divides collective investment schemes into two types - "asset securitization schemes" and "asset investment schemes." The former are based on the SPC Law or Specified Claims Law, whereby cash flows earned from specified assets are rearranged by professional arrangers, the purchase of the assets financed by the sale of securities to a large number of

1 For the history, structure and current state of the U.S. REIT market, see Y. Seki, "The Development of the REIT Market and Real Estate Finance in the U.S." (Capital Markets Quarterly, Summer 1999).

investors. Asset investment schemes on the other hand pool investors' funds and hand them over to be invested by a professional fund manager in various asset types, with the resultant cash flow being distributed among the investors (examples include securities investment trusts, commodities funds, and money management funds or MMF).

While the introduction of the SPC Law has opened the way to establishing "asset securitization schemes", the next goals regarding real estate securitization should be;

- (1) To enhance the flexibility of "asset securitization schemes" for originators, and
- (2) To establish "asset investment schemes" so that investment trusts and investment corporations can invest in real estate.

2. The Financial System Council Debate Over Legislative Revisions

Here we will examine the salient points of the debate on the proposed legislative revisions to the SPC Law (regarding securitization type collective investment schemes), and the Act Governing Securities Investment Trusts and Securities Investment Corporations (regarding asset investment type collective investment schemes).

1) SPC Law Revisions²

(1) Reduction of minimum capital requirement (currently ¥3 million)

While a minimum capital requirement is a fundamental financial obligation for regular companies, in the case of SPCs, whose purpose is merely to act as a vehicle for the securitization of assets, such a requirement is not particularly relevant. This measure is most probably a response to criticism from companies who have wanted to become originators.

(2) Flexible disposal / additional acquisition of specified assets

Under current legislation, an asset securitization plan must be submitted when establishing an SPC, and the assets obtained, managed and disposed of in accordance with this plan. This arrangement has been criticized as too rigid to allow companies to react to a dynamic market or to rapidly changing business conditions³. The Financial System Council is currently taking the position that permitting the free substitution of SPC assets will reduce the focus of the SPC Law itself as a special tax and legislative system for the liquidation of assets. They therefore thought that SPCs should not be allowed to acquire additional assets (particularly real estate), and instead the purpose of promoting investment in securitized real estate should be dealt with by revisions to the law on asset investment schemes. However it was also argued that, in the interests of allowing companies the freedom to devise their own asset

2 For an examination of the structure of the SPC Law and the background to its implementation, see M. Hashimoto, "Recent Developments in Securitization in Japan" (Capital Research Journal, Spring 1998)

3 For example, if a change in business conditions makes it necessary to securitize further assets, then it will be necessary to use further capital and draw up another plan in order to establish a separate SPC. It is because of this disadvantage that the industry was calling for a relaxation in the law regarding the replacement of assets.

purchase plans, the law should also be amended to allow SPCs to invest in the wider asset definition of “general property rights.” In which case, future debate concerning actual legislative revisions will likely centre around how the role of SPCs can be strictly distinguished from that of asset investment schemes.

(3) Relaxation of restrictions on debt financing

In the FSC’s opinion, SPCs should be allowed to finance asset acquisition costs through debt assuming that this is included in the securitization plan. Some voices further called for allowing SPCs to raise funds above the value of the limit in the securitization plan when the property involved in a securitization scheme requires unforeseen and substantial repairs. On the grounds that this affects the interests of investors however, the FSC decided on requiring a majority vote by the investors to make changes to the securitization plan in order to finance such activities.

(4) Simplification of organization and operational procedures

In the view of some market professionals, since an SPC is “no more than a vehicle,” such items as the detailed specification of directors’ obligations and prohibitions, and the compulsory appointing of auditors are unnecessarily restrictive. However, the FSC is not inclined to either relax the terms of directors’ obligations (e.g. prohibitions on parallel and competitor employment) or to discontinue the requirement to have audited accounts due to concerns over investor protection. On the other hand, items for the articles of incorporation of the SPC at the time of its establishment are to be simplified.⁴ Detailed information regarding the asset-backed securities which is not known until right before the securities are issued, will no longer have to be included (while on the other hand the penalties for contravention of the terms of the securitization plan are to be strengthened). Further, a time-consuming registration system is to be replaced with a speedier notification system.

(5) Introduction of investment trust type schemes

In addition to existing securitization schemes, the new proposals also introduce a scheme whereby a trust is used as the investment vehicle, with beneficiary rights on trusts recognized as marketable securities under the Securities and Exchange Act. In fact, out of the total value of claims securitized under the Specified Claims Law (¥4.5 trillion in FY98 according to the Ministry of International Trade and Industry), 75% (¥3.3 trillion) were securitized using trusts as vehicle. This move is aimed at improving the liquidity of trust beneficiary rights and of increasing the range of originators’ choices available. From the investor protection point of view, it would be necessary to clarify the rights of the beneficiary rights holders, which details have yet to be worked out.

4 Until registration of the SPC is completed, it may not issue any securities. The normal time for completing registration inspection of an SPC will be 2 months.

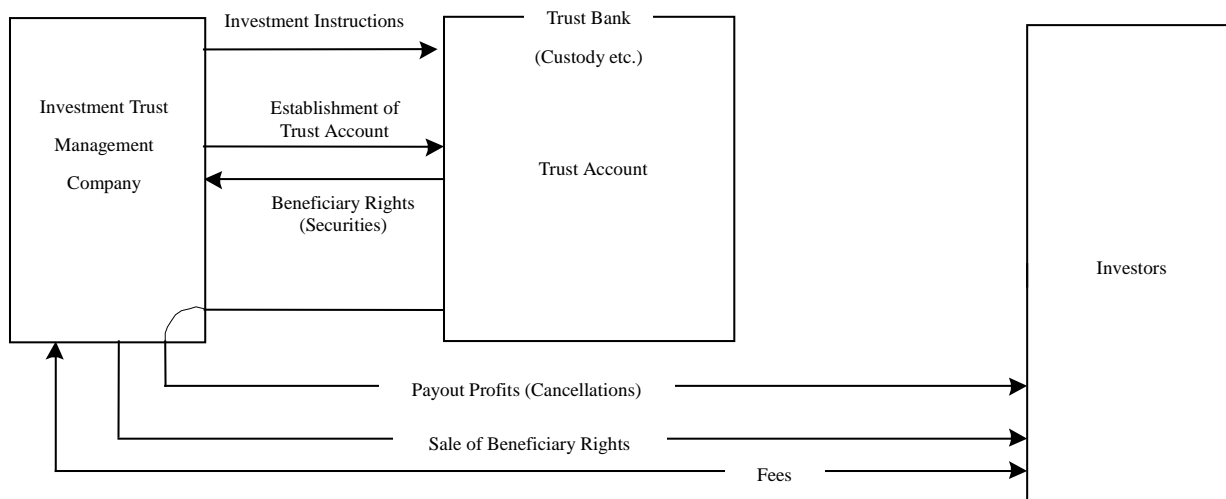
2) Expansion Of Investment Targets For Collective (Asset) Investment Schemes

(1) Overview of asset investment schemes

[1] Contract-type and company-type investment trusts

The expansion of the scope of asset investment schemes through revisions to the Act Governing Securities Investment Trusts and Securities Investment Corporations⁵ opens the way to investment in new products such as real estate funds, and develops the debate concerning the clarification of selling rules and investor governance. The schemes are as shown in the two figures below.

Figure 1 Contract Type Scheme
(this figure uses the example of a trust type arrangement)



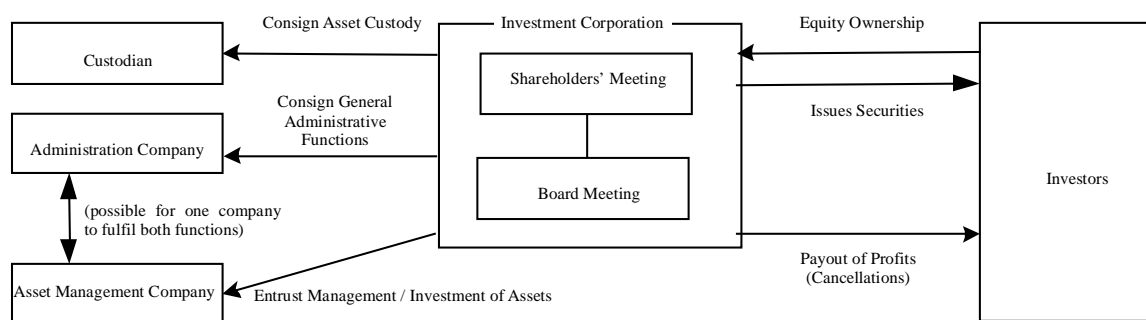
Notes (1) Trust type: an external asset management company (securities investment trust management company) issues investment instructions.

(2) Fiduciary type: a trust bank, rather than an investment trust management company, makes investment decisions on its own.

Source: NRI, from materials published by the Ministry of Finance

5 For an examination of the background to the introduction of company type investment trusts and an overview of the legislative infrastructure, see S. Osaki "Securities Investment Corporations: The Introduction of Company Type Investment Trusts" (Capital Markets Quarterly, Summer 1998).

Figure 2 Company Type Scheme



Source: NRI, from materials published by the Ministry of Finance

[2] Diversification of investment targets

With asset investment schemes the FSC’s aim is to create the legislative infrastructure for establishing comprehensive funds with the remit to invest in a wide and diverse range of property claims for the purpose of promoting financial innovation. While contract-type investment trusts and investment companies under the current legal framework are obliged to invest “predominantly in marketable securities” (Law Concerning Investment Trusts and Investment Corporations, Articles 1, 2), it appears the new proposals will allow investment in real estate by expanding the definition of “marketable securities.”

[3] Securities issuance and borrowing limits

In order to avoid creating investors with conflicting rights and interests, the investment trust may only issue one type of equity. It is still being debated whether to allow closed-end funds (where the total investment amount is fixed and there is no redemption of shares in the investment trust) to issue debt securities. In the case of open-ended funds (where redemption is possible on request), while the FSC recognizes the need to borrow funds in order to sustain fund growth, it is also recommending other measures to balance the interests of investors and creditors.

[4] Asset management companies

Asset management companies are to be approved on the basis of their financial condition, experience and personnel. Investment trust management companies and investment advisory firms are to continue to manage funds as before. It is expected that the activities of asset management companies should be limited to related jobs, for assuring risk minimization, the avoidance of conflicts of interest and the effectiveness of regulatory supervision. Clarification of fiduciary responsibility will probably become a major future issue of concern.

[5] Custodians

To avoid commingling of investor assets, asset management companies and custodians are to be separate. However, for fiduciary type investment schemes, the FSC is tending to the view that it should no longer be obligatory to appoint a custodian separate from the trust bank

as investment trust accounts are secured independently in the case of bankruptcy. In order to counter the risk of commingling, the custodians for highly liquid financial assets such as cash and securities might be limited to certain authorized institutions.

(2) Issues concerning real estate investment trusts

[1] Assessing suitability of assets

“Investment” in property by real estate investment trusts is taken to mean not simply the buying and selling of property, but also leasing, repairing, rebuilding and other property management operations. Based on the nature of real estate, it is difficult to assess fair market value for assets owned by real estate investment trusts in a timely fashion. Also owing to the low liquidity of underlying assets and the difficulty of large-scale substitution, it would be difficult for real estate investment trusts to cope with demands for additional investment or redemption. Therefore, the FSC is going to recommend real estate investment trusts to be set up as closed-end funds. In which case, in order for investors to be able to freely purchase or redeem their investments, the FSC deems it necessary for the units of real estate investment trusts to be listed on a stock exchange.

[2] Avoidance of fiduciary conflict of interest

In the case of real estate investment trusts there are cases where in order to improve the performance of the fund it would be to the advantage of the investment trust company to trade with affiliated companies. Therefore there have been calls to consider legislating to protect against conflicts of interest while at the same time differentiating between on the one hand distinct assets such as real estate and on the other volume-traded, liquid assets. Since real estate investment trust will mostly acquire assets already held by real estate businesses, the FSC is not to prohibit trading entirely but instead aims to increase the transparency of the actions of the fiduciary, by imposing higher standards of governance and information disclosure.

[3] Taxation

Present tax treatment on securities investment corporations was dealt with by revisions to the Special Tax Measures Law implemented in 1998 along with the revisions to the Investment Trust Law. Essentially these allowed for securities investment corporations to deduct dividends paid out to investors from taxable income for that particular fiscal year (Special Tax Law 67-15-1). However, in order to receive this special treatment, it must satisfy the criteria in Table 1 below:

Table 1 Securities investment corporations: criteria for having paid-out benefits counted as accounting losses

<p>1. The securities investment corporation :</p> <ol style="list-style-type: none">1. Must be a registered securities investment corporation (Act Governing Securities Investment Trusts and Securities Investment Corporations, Article 187)2. It must satisfy one of the following:<ol style="list-style-type: none">I. The total price of units issued at the time of establishment is ¥100 million or overII. Investment units are held by over 50 persons, or are owned by qualified institutional investors⁶ at the end of the relevant financial yearIII. Other criteria as laid down by government ordinance <p>2. Other</p> <ol style="list-style-type: none">1. It does not exceed the recognized function of a securities investment corporation (Act Governing Securities Investment Trusts and Securities Investment Corporations, Article 63)2. Its asset management business is being entrusted to an asset management company as prescribed in the Investment Trust Law (Act Governing Securities Investment Trusts and Securities Investment Corporations, Article 199)3. Custody of its assets is being entrusted to a custodian as prescribed in the Investment Trust Law (Act Governing Securities Investment Trusts and Securities Investment Corporations, Article 208-2)4. That at the end of that particular financial year, an affiliate may not also be operating as an investment corporation (Corporation Tax Law, Article 2-10)5. Dividend payouts for the financial year concerned exceed 90% of profits available for dividends^(*). Further, the amount of profits available for dividends for the financial year in question is set by government ordinance.6. Other criteria as laid down by government ordinance <p>(*) The value of inventories and marketable securities for calculating profits available for dividends is on a market value basis for open-end funds and book value basis for other securities investment corporations (Special Tax Law, Article 8-2-5).</p>

Source: NRI, from Akitoshi Takatsuki "The Amended Investment Trust Law"

In the U.S. an REIT is "exempt of tax if 95% or more of the taxable income excluding capital gains for each financial year is paid out in dividends." This makes the corporation tax treatment of real estate investment trusts in Japan, as detailed above, practically the same in concept as the U.S. with tax being charged only at the investor level.

On the other hand, one thing that has often aroused criticism concerning the securitization of real estate via an SPC is the high amounts⁷ that have to be paid in real estate acquisition tax

6 Qualified institutional investors are defined in Securities & Exchange Act, Article 2-3.

and registration and licence tax. Currently the acquisition of real estate by an investment company may also be subject to the same high tax charges. Incidentally, in order to pay less circulation tax, up to now schemes for the securitization of rent payments have often temporarily placed the property itself in trust and sold the beneficiary certificates to the SPC, with the trust acting as agent between the originator and the SPC. A similar level of complexity and awkwardness also occurs when using an investment company as a vehicle of real estate securitization. Examination of real estate tax legislation will be carried out by the relevant authorities and is not specifically within the remit of the Financial System Council.

3. Future Outlook ~ The Impact of Collective (Asset) Investment Schemes on Real Estate Investments Trusts

As we have seen it is unlikely that restrictions on SPCs acquiring additional assets are to be lifted completely. Here we will therefore examine current and future issues regarding real estate collective (asset) investment schemes.

1) Comparison with REITs ~ Asset Management Companies

Firstly, in terms of the scheme structure itself, the main difference between Japan's real estate (company-type) investment trusts and the REITs in the U.S. is the responsibility of asset management. The former are obliged by law to entrust the actual investment management to an asset management company (Act Governing Securities Investment Trusts and Securities Investment Corporations, Article 198), whereas investment operations of most REITs are internally managed.

We should note here that prior to legislative changes in 1986, the legal obligation for REITs to entrust the management of their investments to a third party was criticized due to the resultant lack of incentive to maximize investor returns (manager fees were obtained regardless of performance). Currently most major REITs are run by real estate investors or managers with a proven investment track record. In the U.S. it is generally thought that real estate investment requires its own particular expertise. The question as to who is going to be running Japan's real estate investment trusts is therefore an important issue.

As mentioned previously, requirements for eligibility as an asset manager acting on behalf of an investment company have not yet been decided. According to Article 199 of the "Act Governing Securities Investment Corporations," asset managers must be either (1) investment trust management companies, (2) investment advisory companies (Law Concerning Regulations on Securities Investment Advisory Firms, Article 24-1), or (3) other corporations as recognized by prime-ministerial or finance ministerial ordinance. We can expect trust banks or, depending on new legislation large real estate companies, to also be eligible due to their expertise in the real estate business.

7 Acquisition Tax and Registration and Licence Tax are respectively 2% and 2.5% of the property tax valuation amount. However, temporary measures in place until March 2000 allow for the reduction of the appraisal value of the land by 1/3 or 1/2.

Japanese real estate investment trusts will on the one hand be closed-end funds like their U.S. equivalents, with adequate liquidity ensured by listing the units on the exchange. One other notable scheme however is German real estate funds (immobilienfonds). The funds are contract type investment trusts with 80-95% of net assets invested in real estate, which are open-ended and whose unit prices are constantly quoted (typically by financial papers and banks) so that unit holders are able to redeem their investments at the day's unit price.

2) The Importance Of Asset Size and Sales Power

Asset size is likely to be one of the major determinants in the success of Japanese real estate investment trusts, since unless the fund can reach a certain size it will not be able to purchase attractive properties in Tokyo and other major cities that offer high-returns. Relevant here is the example provided by partnerships for real estate specified joint investment⁸. Since the enactment in April 1995 of the Specified Joint Investment Business Law total annual sales for all such products peaked at ¥24 billion in 1996 (according to the Council for Real Estate Syndication). Judging by Japan's past experiences however, there might be difficulties in collecting enough capital to create a diversified real estate portfolio. In 1999 however, the minimum amount for limited partnership was lowered from ¥10 million per unit to ¥5 million per unit, with one company actually selling over ¥25 billion with sales of over 5000 units (the Sumitomo-run real estate fund "SURF Fund").⁹ Most investors in the funds were retail investors, indicating perhaps that the demand of Japanese retail investors for real estate securities is increasing.

3) The Enhancement of Transparency of Commercial Real Estate Market

While looking at the U.S. REIT sector, which now has over 200 issues with a total market capitalization of nearly \$120 billion, some may predict a large amount of funds flowing into real estate investment trusts in Japan, which would vitalize property trading. The actual situation may not turn out to be so simple. Whereas the public U.S. REIT market has come into being since 1990, the TSE first and second sections already have a listed real estate sector (with a sector weighting of around 1%, as in the U.S). Since investors probably will compare fundamentals and performances between existing real estate shares and units of real estate investment trusts, we can expect to see information disclosure by originators and real estate owners improving and investor evaluation methodology also being refined. The one sure effect the new market will be to enhance the transparency of Japanese commercial real estate market, which tended to be criticized by outsiders and foreigners.

After regulatory reform is completed, attention will focus on the whether the new Japanese market in real estate investment trusts can stimulate the formation of a new market in securitization, and who will be the drivers of this new market.

8 Partnerships for real estate specified joint investment are formed as "tokumei kumiai" under the Japanese Civil Code, and are similar to limited partnerships in their role as moderators ("eigyosha") and investors.

9 On 27 September 1999 the Ministry of Construction partially revised the related regulations to allow additional purchase / replacement of real estate assets, making it possible for funds to be set up under this structure.