

Minutes: 5th Forum for Building Up the Real Estate Investment Market that is Trusted by Investors

Date: June 2, 2009 (Tuesday) 13:30 ~ 15:30

Venue: Kazan Kaikan Building (Kasumigaseki Common Gate West Tower 37F),
"Koubai no Ma" (Room)

Attendees: [Member]

Shinsaku Iwahara (Chair), Yuichiro Kawaguchi (Acting Chair), Toshihiko Okino, Yasuki Kaibori, Masao Shibuya, Kohtaro Tamura, Hiroshi Danno, Shohei Harada

[Observer]

Hideki Kono (Director, Listing Department, Tokyo Stock Exchange, Inc.), Tokio Morita (Director, Securities Business Division, Supervisory Bureau, Financial Services Agency)

Absentees: [Member]

Noriyoshi Ichikawa, Daisuke Hamaguchi, Kumi Fujisawa, Ryosuke Homma

Opening of the meeting

Greeting from Mr. Ozawa, Deputy Vice-Minister for Construction, Engineering and Real Estate Industry, Ministry of Land, Infrastructure, Transport and Tourism

<From this point onwards, the Chair led the meeting>

Explanation from the Chair regarding the purpose of holding this Forum

Mr. Harada, the chair of the Working Group, remarks on the report on discussion results by the Working Group

Explanation on the Report on Discussion Results by the Working Group (from Mr. Takuya Ishikawa, Director, Real Estate Investment Market Office, Real Estate Industry Division, Policy Bureau, Ministry of Land, Infrastructure, Transport and Tourism)

Free discussion

[Mr. Shibuya, Member]

- The progress in addressing systems for reorganizations/mergers of J-REITs through Forum discussions and Working Group tasks is an achievement. While there are no case examples yet, support in terms of systems for mergers and other reorganizations will be crucially important hereafter in the course of normalization of the market.
- A newspaper the other day featured a comment from Acting Chair Mr. Kawaguchi in it being time for J-REITs to change its model. Indeed. Where facility replacements and development investments are taken into account at general business corporations, no corresponding matters are being considered at J-REITs. J-REITs need to replace old assets with the new in the long run to keep its portfolio “fresh.” However, the income that is generated at that time must all go to dividends. On the other hand, even disposals of property for the purpose of reducing liabilities could result in cases where income generates at the time of sale if the property is one that has been owned for a long period of time and amortization has accumulated. In addition, there could also be cases in the future where financial restructuring is advanced as a set with a merger/reorganization. In light of these, shouldn't – while still imposing certain restrictions – some sort of allowance that would relax conduit requirements be considered?
- In the previous Forum, many members – including myself – voiced their opinion that the J-REIT financing problem requires immediate attention. The final report contained an array of considerations from the aspect of diversifying financing methods, but there are also many that have low practicality under the current so-called once-in-a-century financial environment. Of these, the distribution of treasury stocks as dividends (stock dividends) should be noted in that it has been introduced in the U.S., too, as a REIT market measure. As pointed out also in the report, while due caution must be paid to the demerits, the restructuring approach of lowering LTV by reducing liabilities in order to avoid bankruptcy – even if that means slightly decreasing dividends temporarily – is popular also among general corporations. For example, if there were support similar to the U.S. where there is a measure in place for a limited time frame of two years, plus allowances made for investor protection such as making it mandatory to reduce liabilities by limiting it to a certain percentage, then would it not be worth considering?
- Although it lacks immediate results, steady promotional activities aimed at increasing investors ought to be continued throughout the industry.

[Mr. Harada, Member]

- Member Mr. Shibuya's views perhaps translate to the thinking that the gain on sales of properties should be excluded from distributable income from the perspective of relaxing conduit requirements and to the consideration of stock dividends from the perspective of minimizing refinancing risks. Key to such would be to what extent J-REITs should be given authority over the various means to procure funds, dividend policy and decision-making, but even the Working Group has yet to delve fully into discussions on this matter.
- Under the Investment Trusts and Investment Corporations Law, J-REITs are given the two options – the contract type or the corporation type. A contract-type J-REIT is a vehicle based on contracts and is unavoidably characterized by a relatively rigid organization with merchantability established in advance. Meanwhile, in the case of a corporation-type J-REIT, although limited compared to general business corporations, unitholders are given powers of governance. In light of this, could not such various means of procuring funds and dividend policy flexibility be given solely to corporation-type J-REITs under certain restrictions?

[Mr. Danno, Member]

- The J-REIT market was under extremely severe circumstances at the time of the ad interim report by the Working Group in February 2009 as well. Under such circumstances, there were talks of wanting to make funds assistance utilizing the crisis response facilitation operations of the Japan Finance Corporation into one that is effective. This was because views that the use of the system was not going too smoothly were being heard. While challenges still remain, I have heard since that it is progressing smoothly for the time being.
- The J-REIT market does not allow for premature conclusions, but wouldn't you say that it has managed to avoid an immediate serious crisis for now? Going forward, we, too, must strive towards revitalizing the sluggish J-REIT market by effectively leveraging the market infrastructure and funds pipeline that have been established by the efforts of authorities.
- The economic stagnation due to the global financial crisis is perceived to continue also on a global scale for the time being. Even during this time, however, international intercity competition continues and initiatives aimed at urban and regional renaissance must continue to be carried out as to date. For such, stable and lasting funds that are not overly susceptible to international financial trends are required. We have thus far been discussing and working, and the government

has also been helping out through various environment improvement efforts, all so that retail investors and pension funds, which are the typical suppliers of such funds, will be able to supply funds in earnest to the J-REIT and other Japanese real estate investment markets, but further efforts need to be made.

- The recent J-REIT crisis was triggered by financing risks. An array of equity financing methods is studied by the Working Group, but there is debate over the immediate introduction of new methods and it is also systematically difficult. Accordingly, stable supply of debt is indispensable to stabilizing J-REITs at this point in time. Without smooth refinancing, J-REITs are forced to unreasonably sell portfolio assets even if the assets are generating stable cash flows and, in the worst case scenario, it could cause such situations as bankruptcies or liquidations. Such leads to concerns that the drop in real estate prices will be accelerated and, through decreases in collateral values, there would be grave impacts on the financial system and real economy. While there was a time when refinancing was rather difficult and that caused also a J-REIT crisis, most J-REITs have now managed to avoid loan refinancing risks due in part to the appropriate response of financial institutions. The desire is for financial institutions to continue to check the asset management situation and appropriately embrace refinancing based on that, with the recognition that they are key players underlying the J-REIT market.
- A joint public-private fund, the establishment of which is being considered, is extremely crucial as a safety net for the J-REIT market. In particular, its role in the aspect of redemption of investment corporation bonds can be anticipated. Proactive undertakings as an industry are desired as well. In addition, the hopes are to see the participation of as many market players as possible and that is the way it should be. Growth to the extent that it will have actual effects – namely, lending – and participation by many players will convey to the market the strong message that the public and private sectors will jointly proceed to support J-REITs in name and in reality.
- When ARES held the J-REIT Fair in March 2009, numerous retail investors took part in the event. The ongoing implementation of industry initiatives for similar activities is desired. Also desired is for financial institutions to proactively carry out initiatives to diversify sales channels for retail investors, with the motivation to capture new investors.
- Concerning pension funds, there has been much dialogue from before. While both sides are hopeful, realization has been difficult in reality. The desire remains to be to proceed to develop the environment for full-fledged introduction by continuing to

pursue broader discussions among the concerned parties.

- As for the establishment of an array of business methods, although a longstanding problem, it is a highly effective means as an approach for urban area renaissance. Proactive consideration is definitely desired in the future.

[Mr. Kawaguchi, Acting Chair]

- One large question clouds the current J-REIT problem. That is, why J-REITs failed to be countercyclical. In other words, J-REIT is a product that was launched at a time when the real estate market conditions were deteriorating in anticipation of J-REITs supporting such a real estate market and the system was meant to have been designed for that, but why did it not function that way? The answer to that is provided in the recent Working Group report.
- Failure in regulations is one of the causes of the recent financial crisis in Europe and the U.S. and the global economic crisis. Capital adequacy regulations on banks, which were enforced twice – once with the real estate bubble in Japan in the 1980s and another with the recent financial bubble in Europe and the U.S., had procyclical effects and, today, this is being viewed as a problem at financial institutions worldwide. In that sense, if J-REITs are to be defined again, then it would be a stable real estate leasing business based on refinancing of principal backed by the capacity to make interest payments semi-permanently. In addition, it exhibits a conduit nature and is structured to distribute at least 90% of residual profits. Why it is that such J-REITs, which were designed to be a system based on being able to make interest payments semi-permanently – had difficulty refinancing principal poses as a problem.
- The first reason is because it was a once-in-a-century crisis. REITs not only in Japan but also across the globe are designed as products that serve as alternatives to national bonds and deposits, and this was the first time that an equity REIT went bankrupt. In other words, it was because the recent crisis was so big that the myth of REITs not being subject to downfall was disproved. Now that the downfall myth has been disproved, the restructuring of J-REITs should then be considered within the entire cycle. This time, until a new funds supplier is found, some sort of DIP financing must be conducted and it is said that the government will provide that link. It is one form of DIP financing that addresses the crisis and not the government supporting the real estate industry as criticized. If this does not facilitate an exit, then the crisis will be overcome through the public-private fund and mergers. As a result of such political measures and Working Group

discussions from February onwards, one structure for the restructuring of J-REITs has begun to surface and this will possibly enable the trust of investors to be regained.

- The second reason is the sense of mistrust some investors and media have regarding J-REITs' property acquisition moves. As a result, rather than retail investors and pension funds supporting the countercyclical, they pulled back. This is a matter of governance. An experimental study in the U.S. shows that there is no better governance of REITs than internal asset management, but the historical background of the Japanese system and the individuality of the Japanese real estate market must be taken into account. In addition, it would be time consuming and there are also difficult aspects to change from external asset management to internal asset management. Accordingly, the mistrust of investors and the views of some investors must be changed within the framework of the present conditions. Specifically, this would likely take the form of events and such.
- The third and primary reason is that refinancing of principal has stopped. Refinancing of principal no longer being a premise for J-REITs, which must depend entirely on external funds, is probably something that no one had envisaged. In addition to increasing flexibility of financing for more stable debt, a structure should be created for J-REITs again so that refinancing of principal with domestic funds will not stop even if there is a break in the flow of foreign funds. This does not mean the uncritical support of funds, but to reaffirm J-REITs as stable funds that can make interest payment semi-permanently.
- The last is information disclosure. That is, having doubts about real estate appraisals or in other words having doubts about the fair values of the physical real estate market in contrast with stock prices. Presently, the J-REIT cap rate is around 4% on average. On the other hand, stock prices indicate an implied cap rate of 6.6%. This difference is generating a disparity of PBR0.4-0.6. Under such circumstances, what investors will trust is probably price indices based on contract prices. This statement receives great counterargument in that such price drops and REIT bankruptcies took place in the U.S. even with the contract price index the S&P/Case-Shiller Index. However, on a comparison of the Japan indices and U.S. indices, it is clearly obvious whether or not there were bubble-like elements to existing residences in Japan at the very least. For banks to bear a certain level of real estate risks at their own discretion as a firm was the goal of market-oriented indirect financing in such a financial crisis. But both sides ended up freezing. While information disclosure has progressed substantially at the efforts of the

industry, having such an infrastructure that is one step ahead developed may have served as one countercyclical brake.

- Concerning real estate appraisals, the yield issue is also being pointed out. However, even if appraisals are requested from ten appraisers given the same information, it is the limits of human valuation that there are bound to be disparities of plus or minus 10% and so it is quite difficult. Rather, particularly in the case of J-REITs, presentation of costs of replacement and slightly more detailed cash flow situation as indices may likely improve the trust of the lender side and investor side.

[Mr. Tamura, Member]

- Without thinking about how to keep improving the governance of J-REITs, it would be difficult to draw an ideal picture of the future. Then, what should be done to enhance governance? Governance, or more simply the presence or absence of failures in asset management, is not something that concerned us too much. Although discussions on the supervision of the asset management company by the officers of the investment corporation and the appointment of outside directors are also important, discussions should be on whether or not it will work in terms of the future. On top of that, what state the asset management capacity of the asset management company and the due diligence and fiduciary duties in the course of asset management ought to be should be discussed more in the future. What I first wondered when I read the Investment Trusts and Investment Corporations Law was that there were provisions on the means to procure funds of issuing investment corporation bonds, but there were no stipulations stating that investment corporations can conduct acts of borrowing. Of course, the provisions that the borrowing situation shall be stated in the articles of incorporation can be read to mean that investment corporations can borrow, but it does not state that borrowing acts are asset management acts. It is truly at this point in time that we now know that, within asset management, borrowing or financing is an extremely important place to demonstrate asset management capacity. In light of the current state of Japan that could arguably be said to have content on the asset management company's process for making financing decisions missing from the composition of the Investment Trusts and Investment Corporations Law, I would like to discuss how to enhance capacity in the future.

[Mr. Okino, Member]

- I agree with Member Mr. Tamura's view. As it turned out, it is true that there was a J-REIT that went bankrupt and, while there may have also been systematic problems, the qualifications and responsibilities of the asset management company must be questioned. In that sense, the process towards future rehabilitation of the failed J-REIT must proceed to be examined. Although it has gone bankrupt, there are still lenders and shareholders whose interests it is still closely involved with and so that needs to be followed.
- In the previous Forum, many members – including myself – voiced their views on the refinancing problem and it is a great pleasure to see such take shape as political measures. Stock markets have also begun to settle down a little and have been hovering at relatively robust levels between April and May. On the other hand, the problem of moral hazards requires some thought. Concerning the joint public-private fund, the impact of announcements and other impact has been extremely large. It is essential that it proceeds to be actually established and managed in the future. Meanwhile, there is talk that J-REITs can just rely on this public-private fund in the end. I do not suppose that there are any asset management companies thinking that, but if there is even a bit of such anticipation on the investor side, then the market cannot be said to be really sound.
- However, it is also true that there are restrictions on the corporate management methods that asset management companies of J-REITs may take. While there may be some among the array of financing methods studied by the Working Group that may have no immediate results, stock markets are constantly changing phases and to have an available means prepared is highly ideal. I would like to see further studies be advanced going forward towards its realization.
- With the basis being that asset management be carried out by the asset management company with responsibility by valuing the trust of investors, the self-responsibility of asset management companies must be the first to be questioned. The role of the government is to serve as a safety net and I think it is good to also keep discussing the necessities of amendment and such within this Forum, but it is critical that we keep focusing on discussions on the governance of asset management companies.

[Mr. Kaibori, Member]

- For the public-private fund to be a safety net is of paramount importance as a response to the recent crisis, but the prevention of moral hazards is the matter that should be noted foremost and fair operations must be conducted under proper rules.

In the previous Forum, I commented (on the crises response operations of the Development Bank of Japan) that it does not provide cash like an ATM and the same goes for this fund. This is a fund intended to respond to crises and is not permanent. The system design must be thought out thoroughly, coupled with the fact that it will eventually return to orderly market rules.

[Mr. Kono, Observer]

- Concerning the J-REIT market, the impact of announcements of system measures was extremely large. In addition, the governance problem and strengthening of financial strategy functions are also of paramount importance. Diversified refinancing methods were concluded to have no immediate results and require prudent examination for their introduction. Among them, increase of capital through rights issue seems to relatively have potential. In view of the merchantability of J-REITs, capital increase through shareholders in the form of offering all shareholders the opportunity to invest is worth considering. Notably, it would be good if the ways for issuing at a discount could be devised.
- Several points were made on information disclosure. The timely disclosures required by exchanges are made promptly by investment corporations in a way that is easy-to-understand for general investors. The *yuuka shouken houkokusho* (securities report) serves the role of exhaustive, accurate and in-depth disclosure as legal disclosure. In addition, there are ways of disclosure addressed to the public in financial results briefings and IR activities as well. Each information disclosure is being enhanced for better disclosure in line with their respective characteristics and, from that standpoint, it would be good for us, too, to cooperate.
- Promotions targeting retail investors were touched upon at the J-REIT Fair. The TSE IR Festa also saw the participation of several J-REITs and sponsorship of ARES, too. In light of such, backup continues to be desired. Speaking of investment trusts, ETFs linked to the TSE REIT Index listed on the TSE in the fall of 2008. Through ETF, diversified investments in small amounts can be made into the forty J-REITs listed on the TSE. Such will probably make retail investors more familiarized with J-REITs. Ongoing PR is desired from such aspects.

[Mr. Morita, Observer]

- The Securities Business Division of the Supervisory Bureau oversees operations directly related to J-REITs rather than system design. With the environment surrounding J-REITs being extremely severe, we have been working on it as one of

the top priority items of the Division particularly since the fall of 2008. We have been working together with the Ministry of Land, Infrastructure, Transport and Tourism that has been performing the role of leading J-REITs from before.

- In the series of studies, market problems have been highlighted to date. It is crucial that parties concerned – including ourselves – each be committed to doing what is in their capacity. As noted by Acting Chair Mr. Kawaguchi, today, reconstruction of the financial system based on reflecting on the procyclicality problem, governance, ideal form of compensation, absence of an incentives structure and such are underway also at international forums. At this Forum, it is essential that such matters be studied with the focus narrowed down to J-REITs. Seriously thinking about each of the matters discussed this time leads to the interesting point that raises the fundamental problem of what sort of system J-REITs should be in the first place. The desire is to take this point seriously by discussing thoroughly with system authorities and tax authorities.
- Speaking in relation to the overseen operations, the request is definitely for fast, fast response. Currently, not limited to REITs, the world's supervisory authorities are discussing the ideal form of liquidity management. Bear Stearns and Lehman Brothers stated that they had ample liquidity and that their capital adequacy ratio also adequately fulfilled the requirements, but once in action, they both went bankrupt in a week. In light of such events, the ideal form of liquidity management is being discussed. Concerning J-REITs as well, financing is in extremely severe circumstances and so the request is for fast, fast response.
- From the perspective of a J-REIT market that is trusted by investors over the medium and long term, the governance problem and unacceptable problems like moral hazards are also critically important. As the Securities Business Division, we intend to address such matters seriously as well.

[Mr. Iwahara, Chair]

- With the highly valuable opinions from everyone, I believe we accomplished truly productive discussions today. The Working Group has compiled a report that has a considerably good grasp of the points of concern and for that I would like to extend my appreciation to the Chair of the Working Group Mr. Harada and all other members of the Working Group.
- The report lists the respective tasks. These must be forged going forward. Looking at the respective tasks, there are those where the organization taking action to forge the tasks ahead is the Ministry of Land, Infrastructure, Transport

and Tourism, but there are also others that are not. I kindly ask for the dedicated efforts of each of the organizations in charge. For instance, the appraisal problem is among the problems that are extremely critical tasks requiring the efforts of the Ministry of Land, Infrastructure, Transport and Tourism. As for systematic aspects other than that, there are some that will require revisions to be made to the Investment Trusts and Investment Corporations Law and such for example. There are also points noted concerning tax laws. In order to forge these ahead, it is of utmost importance that the society's and the public's trust in J-REITs be heightened. To that end, there will be no progress unless the society's understanding and trust are properly earned concerning the governance problem that was pointed out earlier. For these matters, I would truly like to see improvements be achieved with the cooperation of each industry. Furthermore, the bigger problem of procyclicality is a major problem in finance overall and so I truly hope that the Financial Services Agency will consider it as a problem that concerns finance on the whole.

The following agenda were approved in regards to how to proceed with the Forum in the future:

- Concerning the summary of the Forum, the Report on Discussion Results by the Working Group shall be revised as appropriate in light of the opinions of each of the members presented today and, after receiving confirmation from each member, be subsequently officially published.
- The Chair shall be entrusted with making the final adjustments to the summary.

Closing of the meeting