I Basic Structure of Real Estate Securitization

[ 1 ] Securitization and Monetization

Asset securitization is where a financial institution or other business that owns assets places those assets in a structure so that the risk and rewards of owning the asset are transferred to a third party. More specifically this is done by placing cash generating assets in a bankruptcy remote vehicle and implementing control functions on the asset in order to maintain its creditworthiness. Investment products that possess greater liquidity characteristics than the underlying assets, such as negotiable securities, are then issued backed by the securitized assets and cash flows those assets generate.

Ordinarily, “asset monetization” is used when transforming assets with low liquidity into a structure where investors can have greater liquidity. Usually this is where someone owning assets establishes an entity solely for the purpose of owning these assets (that entity is commonly called a special purpose entity or SPE) and transfers the assets to the SPE. Investment into the SPE and borrowings by the SPE, backed by future cash flow generated by the assets, can be secured and these funds flow back to the original owner. In a case like this the issuing of negotiable securities is not of particular importance. This is also called broad asset securitization.

Structured finance is often interpreted to be more sophisticated than broad asset securitization and used to indicate financial methods that involve unique structures (Figure 2-1). In this book, the term “real estate securitization” is used to indicate a broad form of asset securitization, and the book focuses on the securitization of real estate and assets derived from real estate (real estate backed debt, etc.).

[ 2 ] Basic Securitization Structure

Securitization is the process that links the economic performance of any asset with the financial and capital markets. The book “Corpus Juris Finance: Part 2” edited by the law firm Nishimura & Partners describes it in the following manner: “A technique for re-structuring the cash flow of assets for which there is limited liquidity or cash flows generated by combinations of assets that, after the restructuring, creates investment products worthy of investment in accordance with the demand of investors and participants in the capital markets.”

Generally there are four basic elements to securitization: (1) Assets generating the cash flow that are to be securitized (underlying asset), (2) Investors that invest in the cash flows generated by the underlying asset, (3) An SPE that functions as the conduit linking the underlying asset and investors (often referred to as a special purpose vehicle (SPV)), and (4) The securitization product which represents the rights the investor will purchase and does not necessarily have to be an investment security.

The transaction that combines these elements and makes the underlying asset bankruptcy remote from the previous owner of the underlying asset (originator) and any of the new investors and techniques for controlling various other risks are referred to as securitization.

Among the various forms of asset securitization, real estate securitization is where investment is solicited by pledging the distribution of cash flows generated by the real estate to investors, or a means for securing greater liquidity for real estate assets that are generally considered to have low liquidity due to high transaction costs. The liquidity is secured by issuing equity interests in small denomination

FIGURE 2-1 OVERVIEW OF SECURITIZATION AND MONETIZATION CONCEPTS

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and these have various rights for receiving cash flows generated by the securitized real estate.

Figure 2-2 outlines the basic structure of real estate securitization, but securitization is not limited to the very simple model indicated here. Many variations have been developed that show both great diversification and increasingly complex structures.

[ 3 ] Basic Requirements for Real Estate Securitization

Real estate securitization needs to fulfill a number of basic requirements. The following summarizes these.

(1) Bankruptcy Remoteness

Bankruptcy remoteness in real estate securitization is a term that represents the measures that are taken to prevent the underlying asset from being impacted by the bankruptcy of the originator and will prevent the securitization vehicle itself from being impacted by any bankruptcy proceedings.

As mentioned previously, the originator transfers the underlying real estate asset into an SPE in the first stage of the securitization process. However, if the originator were to go bankrupt after transferring the asset to the SPE and the bankruptcy administrator or creditors were to reject the validity of the transfer of said securitized asset or call for its cancellation, a very unstable situation would arise where investors would not receive the earnings they expected and the redemption of the principal would be impossible. Therefore, it is important to establish each SPE as bankruptcy remote from the originator so that investors do not suffer needless loss.

Even if the asset that is securitized is remote from any bankruptcy proceedings of the originator there is still the risk that the securitization vehicle goes bankrupt and a default occurs. Consequently, it is essential to have some bankruptcy prevention measure in place for the vehicle. (See Chapter 2 [1] Legal Considerations for bankruptcy remoteness.)

(2) Double Taxation

Each vehicle used in securitization has different tax characteristics. Trusts and Nipponi Kumiai (NK, voluntary partnership) do not pay tax themselves but the investors are liable for tax payments. However, if a Kabushiki Kaisha (KK, joint stock company) or Yugen Kaisha (YK, limited company) is used as the securitization vehicle the revenues are taxed twice before the investor receives any return as the profits are taxed once at the corporate level by the deduction of corporate taxes and then the dividends are taxed when distributed to the investors. This is called double taxation.

In order to avoid double taxation a system has been developed where securitization vehicles based on specific securitization laws enable dividends to be recognized as expenses provided certain conduit criteria are met. However, this does not mean that double taxation is avoided unconditionally so there is a need for operational awareness. (See Chapter 2 [2] Tax Points for details on avoiding double taxation.)

(3) Credit Enhancement for Controlling Risk

Real estate securitization also confers the risks of owning the assets from the originator to the investors. In

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Figure 2-2  Basic Structure of Real Estate Securitization
exchange for bearing these risks the investors receive the profits generated by the real estate, therefore the asset owner must control the risks and reflect these controls in the product design after considering the risk-return characteristics the investors expect. Where there are uncertain risks in the future for securitized assets it is necessary to structure the investment so that the investors are not hit with catastrophic losses if such an event occurs.

When structuring a real estate securitization product it is common to include a form of credit enhancement to increase the credit worthiness of the security and to better meet the demands of investors. Internal credit enhancement features that use the cash flow of the securitized asset include creating a split capital structure that will include preferred and subordinated securities that will have different rights to the asset’s cash flow and may also include a seller reserve whereby the seller will leave a cash reserve from the sales proceeds in the securitization vehicle. External credit enhancement measures include cash collateral and guarantees provided by third parties.

A. Preferred/Subordinated Structures
This structure divides capital structure so that the securities that are issued have different rights to the asset’s cash flows, the preferred securities will have first priority on the cash flows and assets of the asset in the securitization vehicle and only once the obligations to the preferred securities have been fulfilled will the subordinated securities receive any payments from the vehicle. Thus when cash flow fails to meet projections the first investment loss will be taken by the investors who own the subordinated securities, which provides greater certainty of the performance of the preferred security investors. The existence of a subordinated tranche of securities in any capital structure enhances the creditworthiness of the preferred securities.

Ordinarily, equity investors are subordinated to debt creditors, but equity investments in the forms of Tokumei Kumiai (TK, silent partnership) investments and preferred investments often assume more complex preferred/subordinated structures. The preferred debt credits may be further divided into several segments and corporate bonds with varying credit ratings are issued, this is commonly referred to as tranching and refers to the division of the credit portion of the investment according to their respective risks and each portion is called a tranche.

B. Seller Reserve
When the originator (seller) transfers the asset to the securitization vehicle, credit enhancement of the real estate securitization product is achieved by reserving a portion of the sales proceeds in the securitization vehicle. The seller reserve will be in the position to take the first loss should the cash flow from the securitized asset be inadequate. The Japanese Institute of Certified Public Accountants has published guidelines that stipulate that the maximum economic interest an originator may maintain in a securitization structure for the asset to be accounted for as off the balance sheet of the originator is 5%; this is thus the de facto limit on the size of the seller reserve.

C. Cash Collateral
Cash collateral is used in a similar manner to the sellers reserve in case the asset cash flow is insufficient for operations. There are different approaches but most commonly either the originator provides the collateral or the collateral is withheld from funds generated by financing from financial institutions.

D. Guarantees from a Third Party
This refers to guarantees from a third party, and may take the form of an insurance policy, that non-life insurance companies and banks may provide. This field of guarantees and insurance has not developed in Japan as far as it has in the U.S. and the UK but has recently become a new field of operation for a number of participants with the expansion of the securitization market.

(4) Providing Liquidity
Investors in real estate securitizations do not necessarily want to own or use the real estate themselves and usually do not intend to become the main management body of the property. Their emphasis is on the potential of the investment product to generate returns and see that potential converted into money through the receipt of cash flows from the underlying real estate. The key point is how to provide liquidity for real estate securitization products so that it is easier to participate as an investor. Liquidity is established for the investment product from the product design stage and at the market level by preparing a market for the investment products and a system for distributing products to it.

(5) Information Disclosure for Investors
In any securitization the funds invested by investors are the foundation for the deal and sufficient information is necessary for investors to make an informed decision. Therefore, for the real estate securitization market to grow there must be a robust system that ensures sufficient information is provided to the investor to make an informed investment judgment, as well as provides protection to the investor against unjust losses.
There are already regulations provided for in various laws that protect investors in real estate securitization products. However, it is important that not only legal requirements are met but also that information disclosure be consistently maintained so that investors can continually make informed decisions and take responsibility for their investments.

[4] Real Estate Securitization Market Participants

One characteristic of real estate securitization is that it fuses the real estate business and finance but makes a clear distinction between the various functions and has created a further division of functions.

In response to this trend for clear distinction between the functions there is a need for increasingly greater specialization or unbundling of the various services that is driven principally by the diversity of laws and ordinances that are relevant to each transaction and the differing structures utilized in each securitization project. Thus the greater division of roles now compared to earlier real estate transactions has led to an increasing number of participants in each transaction.

We have compiled an overview of the market participants, their roles in real estate securitization and finance aspects to real estate securitization to serve as an introduction and assist in the understanding of the roles of participants (Figure 2-3).

A. Originator
The term “Originator” commonly refers to the original owner of the real estate that is being securitized. The first step is that the real estate that is to be securitized is transferred from the originator to the securitization vehicle. An originator can be anyone who owns real estate and typically includes developers, ordinary companies and financial institutions.

B. Investors
In exchange for receiving the investment returns from the securitized real estate, the investor accepts the economic risks of owning the real estate.

Investors can be subdivided into debt investors and equity investors and each investor group has specific risk-return characteristics they aim for when investing in real estate securitization products.

C. Lender
Lenders fall under the category of debt investor and are primarily financial institutions that provide non-recourse loans to securitization vehicles. Individual institutions may provide loans or a number of financial institutions
may together provide the loan through a syndicated loan. Non-recourse loans can be subdivided into various tranches that have varying rights with regard to receiving principal and interest, which are called senior and subordinated tranches.

**D. Arranger**
The arranger assumes overall responsibility for the overall structure of the real estate securitization and provides the knowledge and administrative functions needed to create the securitization framework and implement the securitization, which includes liaison between the originator, investors, lenders and other related parties. The arranger has to be able to accurately understand the needs of each party of the transaction as well as have the skill to coordinate the logistics of the securitization and specialist knowledge to negotiate effectively with lawyers, tax attorneys and accountants when necessary.

The arranger is responsible for supporting and coordinating with third party consultants and contractors for preparing due diligence reports, engineering reports etc. and advises in the selection of various professional service providers including accountants, lawyers, real estate appraisers, trust banks and securities firms. After the asset is in the securitization vehicle the arranger may select the underwriter for the sale of public securities, if applicable, as well as the financing counterpart who will provide the non-recourse loan and finally provide advice when considering disposing of the real estate.

Generally, arrangers are securities firms, city banks, trust banks, other financial institutions, real estate companies and consultants.

**E. Underwriter**
Underwriters are most commonly securities firms. They underwrite the securities derived from real estate securitization, handle the public issuance of securities in the capital markets and also conduct investor surveys to determine how receptive investors will be to various products. Their primary responsibility to the investors is to ensure that the investors understand the concerned securitization products. There are cases where securities firms have acted both as arranger and underwriter.

**F. Trust Banks**
One of the most common real estate securitization structures in Japan involves the originator entrusting the real estate to a trust bank and then transferring the beneficiary interest in trust to the securitization vehicle. Establishing the beneficiary interest in trust enables the trust bank to apply its knowledge of the management, operation and sale of real estate assets to improving the performance of the securitization as well as reducing the real estate acquisition tax that is payable on the transfer of the asset.

The trust bank is a specialized institution that can handle a variety of functions for a real estate securitization; a trust bank can act as the arranger, lender, bond manager and asset custodian when the securitization vehicle issues corporate bonds, and it can handle administrative duties.

**G. Rating Agencies**
Ratings are a simple method of assessing the creditworthiness of the debt instruments issued by a securitization vehicle (corporate bonds, commercial paper, borrowings, etc.). An independent third party assesses the ability of the securitization structure to meet its principal and interest obligations, which are then made available to investors by the ratings agencies.

Obtaining a rating from a ratings agency increases the transparency of the securitization structure and improves the marketability of the securities that are issued, thus the fund raising becomes easier.

**H. Asset Manager**
The asset manager specializes in the management and operation of the securitized real estate. The asset manager is responsible for developing the financial strategy of the asset and providing advice on its purchase and sale at the end of the securitization period. The asset manager is also responsible for providing direction to the property manager in regard to attracting tenants and general property management policy, as well as supervising the property manager’s performance managing and operating the property. The asset manager is ultimately responsible for the performance of the asset and has a fiduciary duty to maximize the value of the asset.

In situations where investors invest in an asset-management securitization, the asset manager is responsible for investing the funds invested by investors in real estate related assets and in such a case the asset manager may be referred to as the fund manager.

**I. Property Manager**
The property manager is responsible for the day-to-day management of the real estate asset and is focused on maximizing the earnings of the real estate asset. The property manager is usually a third party contractor chosen by the asset manager and contracted with the real estate owner or asset manager. The property manager’s duties include tenant management (tenant attraction and leasing management) and building
management work (maintenance). The property manager also provides detailed reports on its work to the client.

There are cases where the asset manager also acts as the property manager or building and facility management firms that manage other buildings locally provide these services under contract.

J. Servicer
The source of the cash flow generated by real estate is the rent paid by the tenants and the servicer is responsible for the collection and accounting of these monies. Generally in Japan a servicer is considered to be someone who collects and manages loans and other debts and is certified under the Debt Servicer Law; however, a broader definition is used here. Although the property manager often collects rents in real estate securitization, in certain cases the originator handles the collection of rents to maintain the tenant relationship that existed prior to the securitization.

K. Business Affairs Manager
The business affairs manager is responsible for the operation and maintenance of the securitization vehicle, including communication with investors at the behest of the directors of the securitization vehicle. This function is required outside of the securitization vehicle because the operations that a securitization vehicle may perform are very limited; this is to avoid additional bankruptcy risks such as liabilities connected with employees. In a case where a business affairs manager is required, the vehicle will contract with a third party to handle its business affairs. There are also many cases where the business affairs manager assigns personnel as officers of the vehicle.

L. Lawyer
The many participants in a real estate securitization transaction make it necessary to prepare many contracts to clearly define the relationship of each participant along with their respective responsibilities, duties and liabilities. This task is best handled by a lawyer. The lawyer also handles legal due diligence; specifically the lawyer prepares opinions on true sale, bankruptcy remoteness, validity of contracts, compatibility with related laws and other material legal aspects that can become vital issues with the structure at a later date.

M. Certified Public Accountant and Auditor
The real estate securitization vehicle ordinarily prepares a balance sheet, profit and loss statement, financial statement of change in shareholders’ equity and annotation table at the end of every fiscal period. Not all vehicles are obligated to have audits conducted by auditors, but it is desirable to have an audit conducted by a certified public accounting firm in order to provide an additional level of protection to investors. The accounting office not only provides accounting services for the securitization vehicle but also provides advice on accounting issues the originator may face.

N. Tax Attorney and Tax Attorney Corporation
Certain legal vehicles used for real estate securitization purposes can deduct profit distributions as an expense, thus reducing the tax liability of the securitization structure, while others may be eligible for reduced real estate acquisition taxes. However, many requirements must be satisfied to qualify for these tax advantages. These requirements are detailed and intricate and require the filing of many reports with the tax authorities that must reflect the individual circumstances of each securitization to ensure the tax benefits can be enjoyed. Therefore, the advice of tax attorneys is regularly sought and the attorneys are usually asked to submit tax opinions as well as supervise the filing of tax reports.

O. Due Diligence Vendors
Due diligence is the detailed examination of the real estate by a potential buyer and/or an investor considering investing in a real estate securitization. The process is used to accurately assess the investment value and risks of the real estate under investigation. Due diligence is ordinarily focused in three specific areas: studies on the physical condition of the property, legal studies and economic studies, which are compiled into reports (engineering report, real estate appraisal, etc.) by construction firms, environmental study firms, real estate appraisers, judicial scriveners, land and building investigators, lawyers, consultants and other specialists.