Ⅳ Significance of Real Estate Securitization

There are a number of reasons why real estate securitization has grown rapidly in the past few years while its fundamental structure and systems have remained unchanged. One of these has been the greater awareness of the risks of owning real estate. This has been amplified by the drop in land prices that began in the early 1990s and the major shift from indirect financing to direct financing in the financial and capital markets (Figure 2-8).

The drop in real estate prices and emergence of massive amounts of non-performing loans led to a significant weakening of many Japanese businesses and financial institutions and contributed to further asset deflation. The monetary authorities responded with an unprecedented period of ultra-low interest rates. With this economic backdrop, companies became more focused on financial performance and scrutinized their ownership of real estate. This scrutiny led many companies to seek to separate the responsibility for real estate ownership and management. Concurrently financial institutions began to be more cautious in extending loans to the real estate business, which resulted in fewer companies looking to acquire real estate from the mid-nineties, and the real estate market began to shrink.

New business models were developed around the same time focused particularly on the disposal of non-performing loans; many of these participants in this new market were backed by foreign capital, which led to a major revolution of financial control and management methods. These market developments combined with the regulatory changes associated with the financial big bang led to a shift in the financial system from indirect finance to direct finance, and companies with poor credit began to focus on asset financing rather than traditional borrowing.

During this period real estate securitization in Japan grew significantly and matured from merely investment real estate to financial products. This all occurred following the collapse of the "land myth and land standard system" that had been prevalent in Japan.

[1] Corporate Finance and Asset Finance

Historically in Japan corporate fund raising, or corporate finance, has depended on the credit strength of companies. Corporate finance can be further subdivided into loans from financial institutions, issuing of corporate bonds and other debt instruments to procure funds from the capital markets (debt finance) and equity finance where further equity or equity-linked instruments are issued to the capital markets. Put another way, corporate finance deals with activities that affect the right side of the balance sheet (equity and liabilities), and in many cases the assets from the left side of the balance sheet become assigned as collateral for the loans. In certain cases the personal assets of a guarantor may be subject to assignment if the owner becomes a guarantor of a loan.

By contrast, asset finance is capital raising that is dependent on the credit worthiness of a specific asset owned by a company or securitization vehicle. In asset financing the asset is separated from all other assets of the operating company (thus the credit of the operating company) and funds are procured based solely on the performance of the assets that have been separated. This process, sometimes referred to as "moving off balance sheet," can be applied to non-fixed assets such as accounts receivable as well as fixed assets the company owns of which real estate securitization also is a subset.

The sale of an asset and receipt of sales proceeds would also be a form of asset finance under the definition above; however, with the changes in the real estate market it has become more difficult to simply sell real estate to another single purchaser. This makes securitization, which provides liquidity, an essential part of the real estate market (Figure 2-9).

[2] Objectives and Merits of Real Estate Securitization

The following is a compilation of the objectives and merits of real estate securitization.

A. Procuring Capital

As described previously, the main objective for the originator when embarking on a real estate securitization is to procure capital.

FIGURE 2-9 CORPORATE FINANCE AND ASSET FINANCE

	Corporate finance based on company's credibility (corporate finance)	Asset financing based on asset credibility (asset finance)	
			Real estate finance
Indirect finance	Borrowings	Non-recourse loans, etc.	Non-recourse real estate loans
Market finance (indirect)		Asset monetization	Real estate securitization
Direct finance	Issuing of standard corporate bonds Increasing of capital (issuing of shares) Issuing of convertible bonds Issuing of warrant bonds	Asset disposal	Simple sale of real estate

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Unlike real estate financing for an operating company, real estate securitization does not depend on the creditworthiness of the originator. This is of material advantage in many situations as funds can be procured for the originator without reducing the asset efficiency. Plus securitization is a real option for companies with poor credit standings to raise capital on advantageous terms provided that the real estate being securitized is of good quality.

B. Providing Liquidity to the Real Estate Market

With fewer companies willing to purchase real estate in the real estate market, liquidity has fallen and made selling real estate in the traditional manner more difficult. However, securitization opens up real estate investing to a whole new pool of investors who view real estate as an investment asset class rather than from the perspective of direct ownership. This increases the liquidity in the real estate market through the application of securitization.

C. Transfer of Real Estate Risk

Ownership of real estate carries various risks in addition to the unpredictability of earnings (Figure 2-10).

Many companies are not interested in bearing these risks; therefore, it is beneficial to originators if they can transfer these risks to a third-party investor via securitization.

The securitization process transfers some or all of the risks of ownership from the owner to the investors. The securitization vehicle is structured to re-apportion the risks to various investors, insurers and other related parties depending on the level of risk they are each willing to assume.

From the investor perspective, real estate securitization expands the range of investment choices and opportunities, and with increasing numbers of investors the efficiency of the market improves.

D. Improved Financial Standing

When assets are monetized through securitization, the assets are moved off the balance sheet of the originator and the funds received can be utilized to repay debt, which in turn reduces the originator's interest-bearing liabilities. When the securitization of the real estate realizes latent profits from the real estate, this will expand the capital of the originator and any latent losses will reduce the originator's capital.

If a company obtained assets during the bubble period of the Japanese economy and thus increased their gross assets on its balance sheet, securitization will help the company improve its return on assets ratio, as the assets will be valued at market prices. In the late 1990s there were many examples of real estate securitization being used to improve the financial standing of companies.

E. Fee Business

Many developers, construction companies, real estate management companies and others aggressively purchased real estate during the bubble era; however, many of these companies returned to their core business after the collapse of the bubble so that they were not exposed to excessive real estate risk. Many of these companies also began providing real estate related fee businesses.

Figure 2-11 is a compilation of application needs and solutions concerning real estate securitization.

FIGURE 2-10 EXAMPLE OF VARIOUS RISKS RELATED TO REAL ESTATE

Risk Factors	Examples of Risk	Assumable Condition
Disaster risk	Damage to buildings caused by earthquakes, fires, etc. Subsidence, etc.	Need recovery expenses, etc.
Management and operation risk	Reduced functionality due to aging Claims from neighbors, etc.	Need function renewal, repair/maintenance costs, etc. Need funds for neighborhood measures, etc.
Profitability risk	Drop in lease rates and occupancy Increase in management costs Drop in real estate prices, etc.	Drop in earnings Need to provide additional collateral
Liquidity risk	Cannot sell when desired Cannot sell at desired price, etc.	Inability to sell Booking of losses
Real estate development risk	Found soil contamination Cannot build Delay in construction Cost overruns, etc.	Need countermeasure fees Earnings cannot be realized Drop in profitability

Prepared by ARES

The solutions that securitization offers can be divided into two patterns: 1) Using securitization vehicles primarily to dispose of real estate, and 2) Using securitization vehicles primarily to acquire real estate exposure.

V History of Real Estate Securitization

The following is an overview of the history of real estate securitization in Japan.

[1] The Budding of Real Estate Securitization

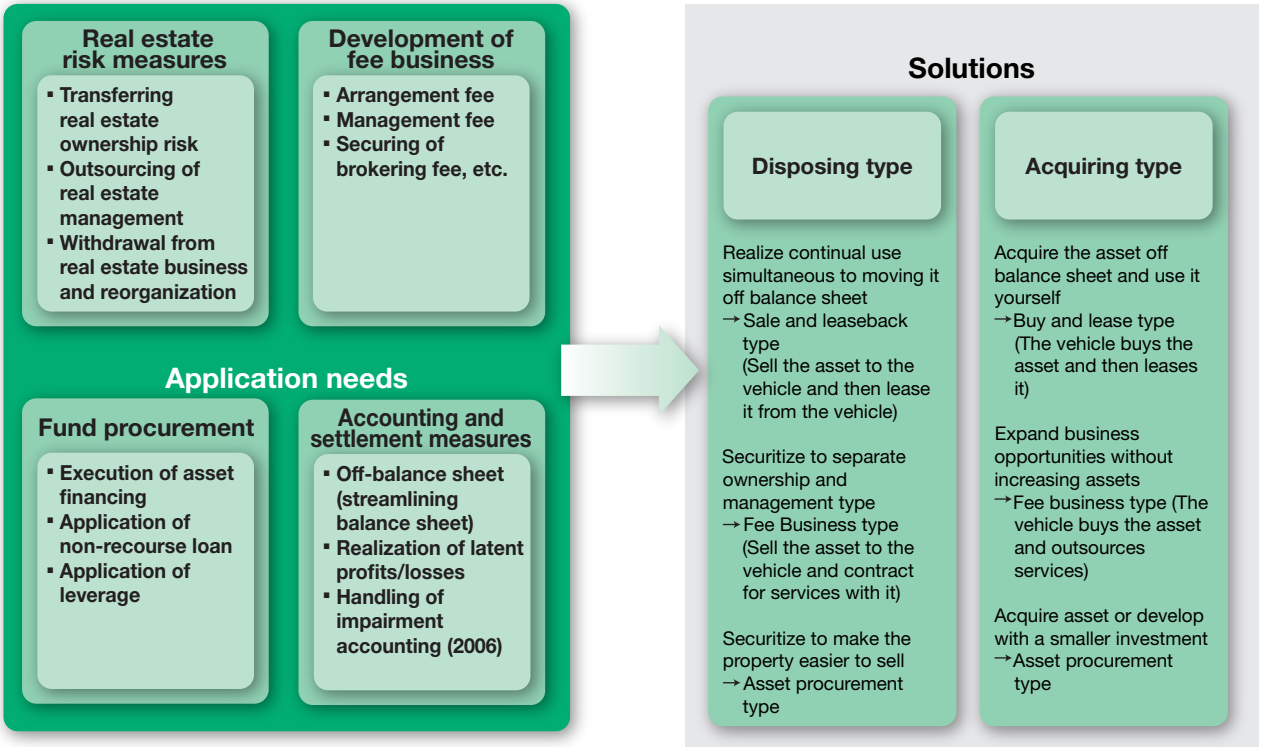
Some people trace the start of present day real estate securitization back to mortgage securities that appeared in 1931 or the housing loan debt trusts of 1973, but generally securitization, in its present form, started in 1987 with the formation of small lot real estate beneficiary interest in trust and the real estate conversion loans of JNR Settlement Corporation in 1990.

Either way, the history of real estate securitization follows the first attempts to transform real estate from being an expensive real asset with a fixed location into small assets that can be easily traded on the securitization markets as they exist today.

[2] Small Lot Real Estate Investment Products

The small lot real estate investment products that appeared in 1987 were basically real estate divided into small ownership units and sold in units small enough for retail investors to purchase. The small units were developed because the generally large investment size required for real estate and its low liquidity made it difficult for retail investors to invest. These investments differed from traditional, direct real estate investment because the operator controlled the equity of each investor so that it was effectively a collective investment structure for real estate. However, it lacked any measures to protect the interests of the investors and so many investors suffered large losses after the collapse of the bubble. As a result of these losses there were calls for a legal system to be established to protect investors, and the "Real Estate Syndication Act" (see Chapter 4 I.) was enacted in April 1995 with this aim

FIGURE 2-11 APPLICATION NEEDS AND SOLUTIONS FOR REAL ESTATE SECURITIZATION



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