Report of the

Committee on Real Estate Investment Market Strategy

December 2010

Committee on Real Estate Investment Market Strategy

Report of the Committee on Real Estate Investment Market Strategy
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Member List

Committee on Real Estate Investment Market Strategy

Member List

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Report (Summary)

Report of the Committee on Real Estate Investment Market Strategy (Summary)

This report recommends, based on the discussions that transcend the vertical divisions of administration, industry and market, the strategy (grand design) that experts from the public and private sectors shall pursue together so that the real estate investment market in Japan, which has one of the largest financial assets and real estate stock in the world, can pull out of the circumstances prevailing in the wake of the financial crisis and build the function to appropriately connect “real estate and finance” together (build a win-win relationship).

Challenges and Countermeasures of the Real Estate and Financial Markets

[Present State] Assets securitized in the form of J-REITs and private funds amount to approximately 33 trillion yen (real estate assets: approximately 2,286 trillion yen; revenue-generating real estate: at least approximately 99 trillion).

[Action] **Countermeasures shall be studied for establishment as a real estate investment market that facilitates application in the revival and effective utilization of real estate, as well as contributes to the affluence of citizens through revitalization of both the real estate and financial markets.**

1. Challenges of the Debt Market

- ○Lending stance easing in times when real estate prices are rising, and tightening when declining.
- ○Lenders of non-recourse and other loans are limited to specific major banks.
- ○“Credit for SPCs that own real estate,” which is classified into other types of business if owned by originators, is being posted to “real estate business” (formal increase in financing for real estate).

<Countermeasures>

- ➢ Declaration by real estate and financial authorities of their commitment to sound market development

- Study of long-term debt products with the involvement of public institutions (Flat 10)
- Detailing of classification of the types of business of financing for real estate securitization at financial institutions …etc.

2. Challenges of J-REITs

○Mismatch arising between the long-term capital demand of J-REITs and the financing period of banks, etc.

○Capital procurement means are restricted, making it difficult to address refinancing risks.

<Countermeasures>

- Diversification of capital procurement means (issuance of convertible bonds, purchase of own shares etc.)
- Enhancement of internal reserves …etc.

3. Challenges of Private Funds (Framework of Real Estate Securitization Other than J-REITs)

○Investment-grade real estate not being distributed sufficiently to the market.

○There are no buyers of existing unsuitable properties that do not comply with the new building standards though they are not categorized as illegal structures, residential real estate in regional areas, etc., even if these generate stable revenue, and securitization of these is thus stagnant.

<Countermeasures>

- Introduction of framework for bankruptcy remoteness in the Real Estate Specified Joint Enterprise Act
- Improvement of application of the Act on Securitization of Assets in real estate development and revival projects

4. Challenges Specific to the Real Estate Market

○There is a lack of real estate transaction information that are required for Japanese and overseas investors to make investment decisions.

○Lease contract periods are as short as two to three years, causing cash flows to be unstable.

○Real estate appraisal needs to be enhanced.

<Countermeasures>

- ➢ Promotion of provision of real estate transaction information and establishment of indices from the perspective of improving the transparency of the real estate investment market
- ➢ Study of fixed leasehold contracts that feature incentives for tenants
- ➢ Improvement of appraisal techniques, and enhancement of provision of information pertaining to public notice of land prices

5. Challenges in Taxation and Accounting (Taxation and Accounting Stability for Investment Vehicles)

<Countermeasures>

- ➢ Establishment of system for vehicles that is less susceptible to tax and accounting system reforms
- ➢ Study of creation of system for reduction entry of J-REIT shares (Japanese version of "UP-REIT")

6. Challenges of the Real Estate Investment Market and Financial Cycle System (Improvement of Vertically-Divided Initiatives)

<Countermeasures>

- ➢ Establishment of forum for policy coordination by the Ministry of Land, Infrastructure, Transport and Tourism (real estate administration) and Financial Services Agency (finance administration)

7. Countermeasures for Other Challenges

- ➢ Introduction of pension funds, etc. (public pension and other marketing by leaders)
- ➢ Promotion of investment by investors outside Japan (clarification of requirements for domestic offering of J-REIT shares)

<Attachment> Image of Concrete Measures
(*Please refer to the attachments to the Report)

①Development of long-term capital supply measures (detailing of classification of the types of business of bank financing, etc.)

②Creation of new securitization techniques for revival of real estate (revision of the Real Estate Specified Joint Enterprise Act)

③Creation of system for reporting transactions of investment properties

④Study of ideal form of long-term fixed leasehold contracts that feature incentives for tenants

⑤Creation of Japanese version of UP-REIT structure (structure corresponding to U.S.'s UP-REIT structure, etc.)

⑥Promotion of investment of public pension, etc. (marketing to relevant organizations by leaders, etc.)

⑦Holding of joint study sessions by the Ministry of Land, Infrastructure, Transport and Tourism and Financial Services Agency

Report (Body)

Report of the Committee on Real Estate Investment Market Strategy

1. Challenges of "Real Estate and Finance" in Japan and Positioning of the Committee on Real Estate Investment Market Strategy

(1) Challenges of Real Estate and Finance

The real estate investment market is essentially expected to play a major role in Japan's economy and society as the "field" for appropriately connecting the real estate market – Japan's largest asset market – and the Japanese and overseas financial market.

The real estate investment market pulling out of the circumstances prevailing in the wake of the financial crisis and playing its essential role by appropriately connecting "real estate and finance" will lead to the effective utilization of private funds and support renewal of the public and private real estate stock accumulated through the postwar high-growth period to today. Urban renaissance as a cluster of such will indirectly back transformation of the domestic industrial structure for the future of Japan and attempts to tap the growth of Asia, as well as facilitate an array of initiatives for improvement of the living and lifestyle environment and other aspects of the "New Growth Strategy." On the other hand, the real estate investment market is one that shall, through consistent provision of opportunities for the people to invest in financial assets that are said to be some 1,400 trillion yen, revitalize the domestic financial industry and serve as a source that produces affluence in the lifestyle of the people.

However, although the real estate investment market in Japan has grown largely from zero over the about ten years since its launch at the efforts of market participants, its size cannot be said to have reached an adequate level by any financial market or real estate market standard. Consequently, while there are repeated calls for "fusion of real estate and finance," standstill persists. The countless "market measures" to date, too, have failed to be any more than "support measures" and change into a "growth strategy." Moreover, they do not feature the breadth or depth to draw on the many possibilities of Japan and its 2,300 trillion yen of real estate stock or to address the many challenges for the real estate industry and the financial industry to grow.

Real estate and finance are both closely tied to a broad field that can be said to encompass almost all aspects of the national economy and the relationship between the two in terms of the Japanese economy may even be described as "mutually-dependent twin siblings." Ordinarily, many corporate finance and personal finance rely on the value of real estate as collateral directly or indirectly. On the other hand, finance is obviously indispensable to maintain the value and renew the functions of real estate or the city. Finance is like blood to real estate's metabolism; without it, urban competitiveness cannot be maintained and real estate and the city could become a "burden" on the economy. Furthermore, sharp declines in real estate prices could become a factor of instability in the financial system.

Such relationship between real estate and finance was not clearly recognized among the people throughout the Japanese economy's high-growth period, bubble years and the economic recession that followed for twenty years. That is because there was seamless supply of short-term funds for real estate based on an indirect financial system through corporate finance during the high-growth period and bubble years, and support measures for real estate liquidation were implemented as an economic measure during the twenty-year economic recession in the past. At the same time, these led to the bubble economy and its collapse, as well as increase in public debt.

Japan is now suddenly, so to speak, faced with response to aging of the public and private urban infrastructure, etc. that were developed throughout the high-growth period and the bubble years, call for more compact cities in correlation with demographic changes, renewal of urban functions to cope with the new international economic environment that includes the rise of Asian developing countries, and other needs. At the same time, Japan is under severe financial constraints in that the intermediate function of long-term funds in the financial system is deteriorating and support measures to deal with such like those implemented to date can no longer be taken.

On the other hand, national financial assets that were accumulated during that period have grown to an unprecedented large amount with the bank loan/deposit balance reaching 145 trillion yen as at October 2010. As exemplified by the outcries of chronic difficulty in managing pension and other assets under the prolonged low interest rate environment, the effective utilization of national financial assets has become a bigger challenge than ever before. In addition, in view of enhancing the international competitiveness of the financial industry as an urban information industry that sustains this nation, working toward establishment of a structure that facilitates attraction of capital from the world over is a pressing issue and the role that the real estate investment market is to play in revitalizing the real estate market and also revitalizing the financial market is said to be pivotal. There is a demand for moves to promote the "Growth Strategy" by resolving these challenges.

(2) Positioning of the Committee on Real Estate Investment Market Strategy

The Committee on Real Estate Investment Market Strategy was inaugurated as a private advisory panel to the Minister of Land, Infrastructure, Transport and Tourism in November 2010 in recognition of the foregoing issues. In the ten intensive discussions held to date, while reflecting interviews with a broad range of experts and other factors, the real estate investment market was re-examined as a key intermediate channel of capital from such angles as "debt and equity," "short-term funds and medium- to long-term funds" and "domestic funds and overseas funds" with respect to public and private sector challenges and countermeasures, along with also studying securitization techniques, challenges in taxation and accounting, etc. and drawing up independent proposals as a strategy committee with respect to the vision and policy responses that are required of Japan's real estate investment market. In the study, discussions were held in terms of strengthening the function as a "field" for connecting "real estate and finance" together in mind, without being particular on "vertical divisions of policy fields and industry" as in the past.

It is vital that Japan, which boasts one of the largest financial asset and real estate stock markets in the world, has a strategy for adequately utilizing such and for the real estate investment market to perform its essential role, and there are now calls for restructuring of the real estate investment market as a "reliable system" that can bring out the vitality of the Japanese economy and is closely tied to the Japanese and overseas financial system. Strong expectations are being placed on the Report to serve as basic guidelines for various real estate investment market initiatives as a "grand design for the real estate investment market" that is capable of responding to the ever-changing market environment, as well as serve to generate sharing of recognition among a broad range of experts – whether public or private, and Japanese or overseas – of the significance of Japan's urban renaissance and regional revitalization by utilizing private funds through the real estate investment market and of the importance of initiatives for building a new win-win relationship between real estate and finance.

2. Present State of the Real Estate and Financial Markets

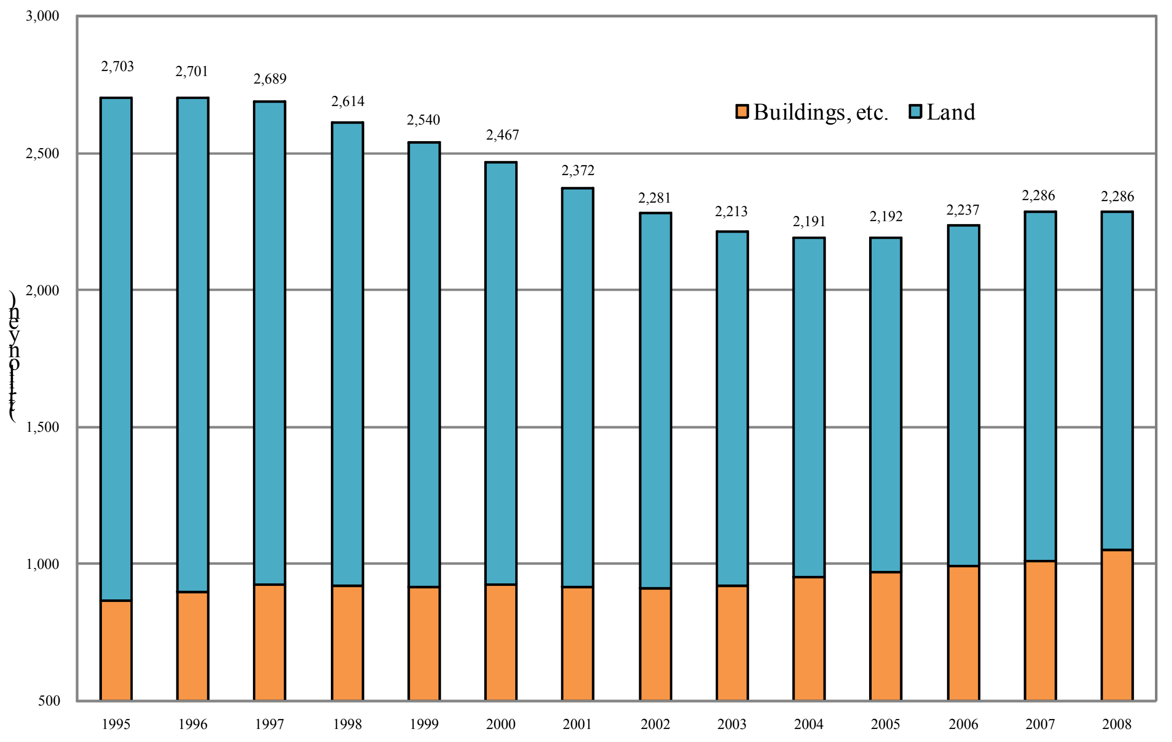
(1) Size of the Real Estate Market and Real Estate Securitization Market

Japan's real estate assets were a size of 2,500 trillion yen at the end of 2000 when the system for real estate securitization was fully established, but decreased due to nationwide falls in land prices and shrunk to a size of approximately 2,300 trillion yen by the end of 2008 (refer to [Figure 1]). On the contrary, a look at the amount of securitized real estate assets shows that it began in 1997 with only 61.6 billion yen at the time, but the flow reached 46.7 trillion yen in cumulative total by fiscal 2009 (Source: MLIT's Fiscal 2009 Fact-Finding Study on Real Estate Securitization). That cumulative total is broken down by fund procurement method into four typical types: ① J-REIT (cumulative total amount of 9 trillion yen in fiscal 2009 according to the above; hereinafter the same), ② TMK (*tokutei mokuteki kaisha*; specific purpose company prescribed by the Act on Securitization of Assets) (11.4 trillion yen), ③ GK-TK structure, whereby funds are procured in the form of a TK (*tokumei kumiai*; silent partnership) investment using an ordinary GK (*godo kaisha*; limited liability company) (24.3 trillion yen), and ④ In the form of TK investment, etc. under the Real Estate Specified Joint Enterprise Act (1.9 trillion yen) (refer to [Figure 2]).

As a result of such progress in securitization, the amount of real estate securitized asset stock, which was no more than approximately 1.5 trillion yen in 2000, is estimated to have grown to approximately 33 trillion yen by 2008. However, this is said to be inadequate yet when compared to the size of Japan's real estate asset amount, which is estimated to be approximately 2,300 trillion yen, or the size of revenue-generating real estate that generate revenue from leasing, which is estimated to be approximately 99 trillion yen at the least.

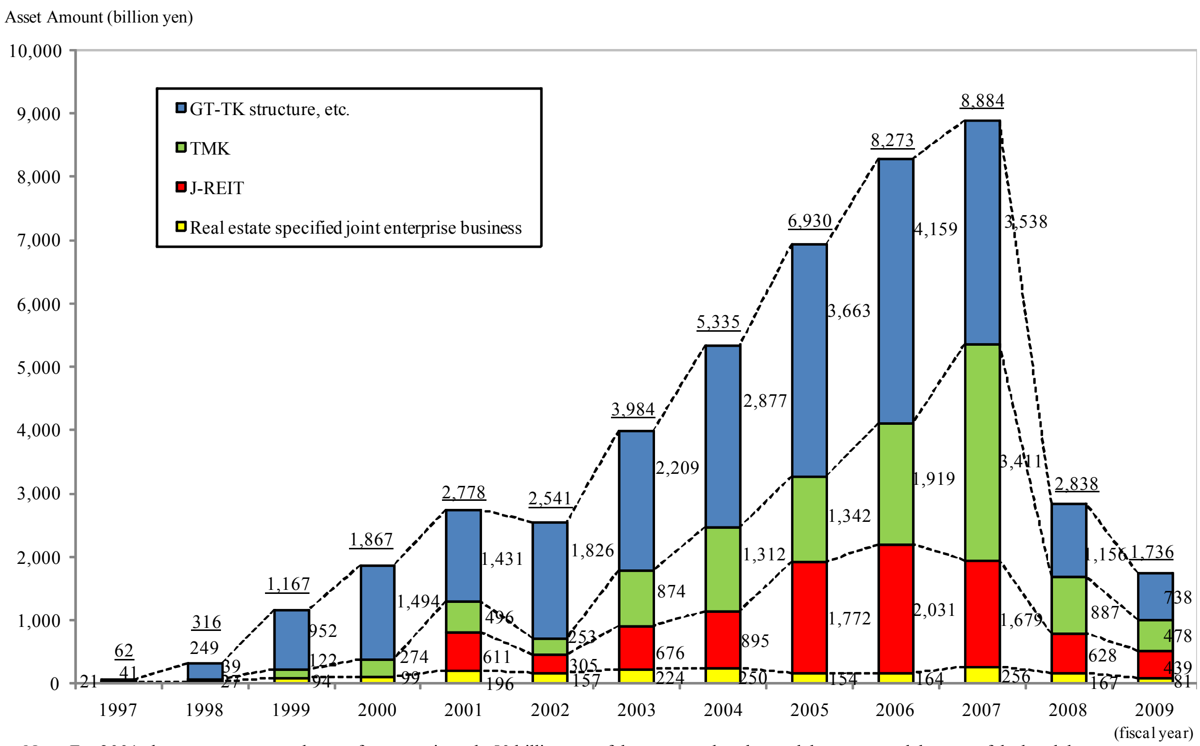
Having said that, let's next take a look at how funds flow from the financial side that underlies real estate securitization.

[Figure 1]　Changes in Japan's Real Estate Asset Amount



Source: Cabinet Office's "National Accounts"

[Figure 2]　Changes in Real Estate Securitization Performance

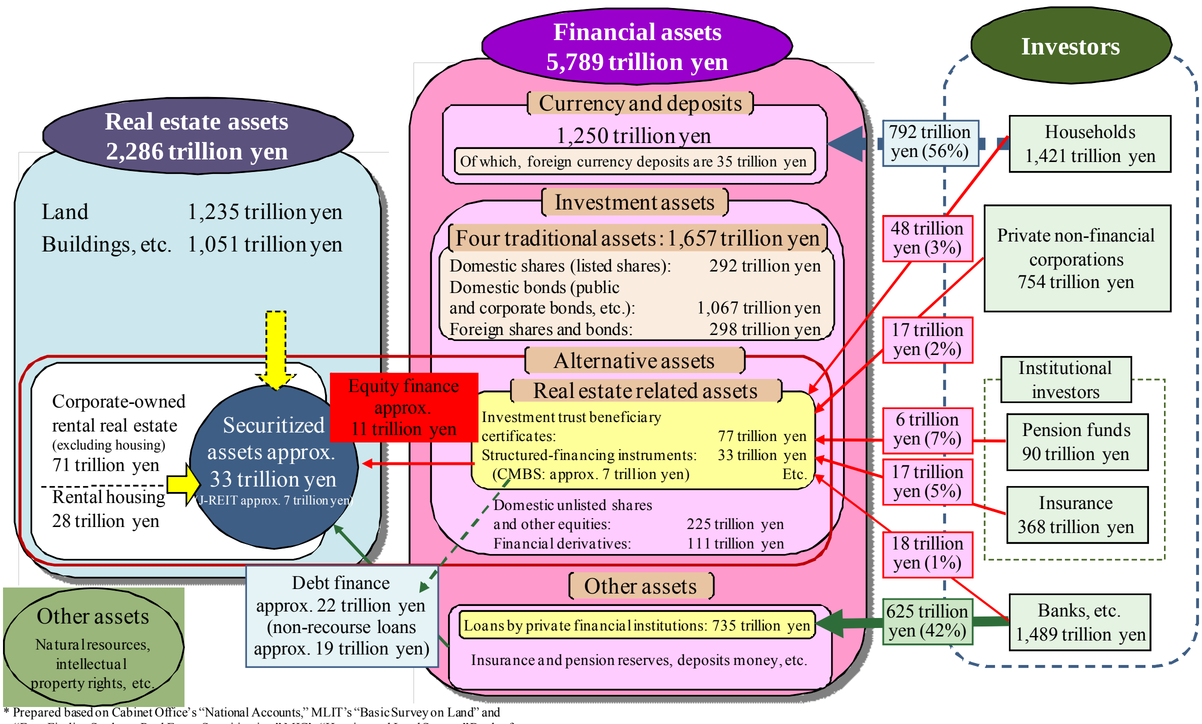


Note: For 2001, the structures are not known for approximately 50 billion yen of the assets and so the total does not equal the sum of the breakdowns.
Source: MLIT's "Fact-Finding Study on Real Estate Securitization"

(2) The Real Estate Market and Financial Market

Of the approximately 33 trillion yen in securitized assets in 2008, 11 trillion yen is estimated to have been financed by equity funds and 22 trillion yen by debt funds. This does not even account for 1% of the 5,789 trillion yen in total amount of financial assets. While 77 trillion yen of the financial assets is investment trust beneficiary certificates that are considered real estate related assets and 33 trillion yen is structured-financing instruments, CMBS is thought to account for approximately 7 trillion yen of the structured-financing instruments. Moreover, at approximately 19 trillion yen, the percentage that non-recourse loans account for the amount lent out by financial institutions is also small. An analysis by type of investor also shows that investments into real estate related assets account for only several percent. This shows that the size of the real estate investment market is not only extremely small relative to real estate asset size, but can also be said to be inadequate relative to financial asset size (refer to [Figure 3]).

[Figure 3] Overview of Japan's Real Estate and Financial Assets, and Real Estate Investment Market (2008)



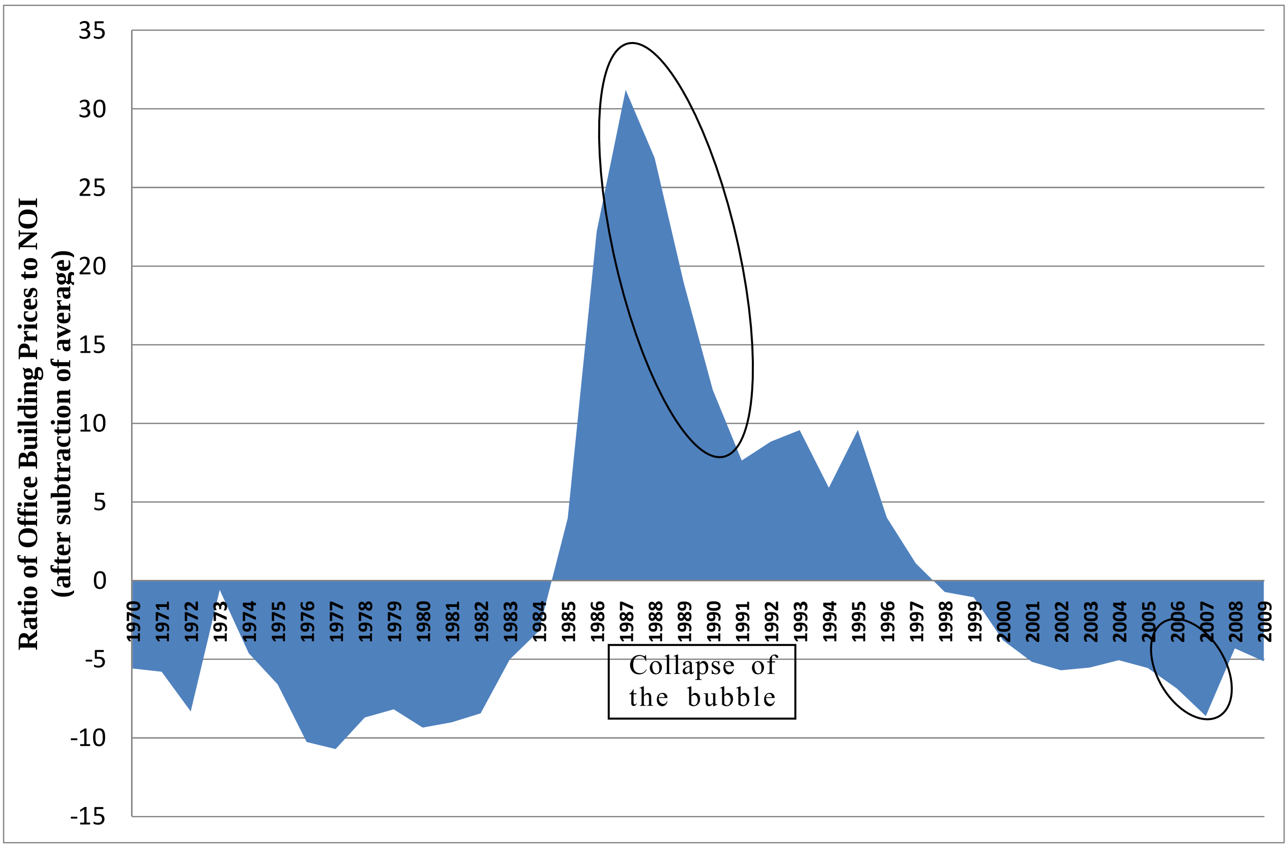
* Prepared based on Cabinet Office's "National Accounts," MLIT's "Basic Survey on Land" and "Fact-Finding Study on Real Estate Securitization," MIC's "Housing and Land Survey," Bank of Japan's "Flow of Funds Accounts," and Trust Companies Association of Japan's "Overview of Trust Contracts"

(3) Pulling Out of the Deflationary Mind-Set

The creation of opportunities for finance and real estate, which comprise 20% of Japan's GDP, to pull out of the deflationary mind-set is an extremely big challenge for the Japanese economy. For example, there are many people with the recognition that there was a "real estate fund bubble" or "mini bubble" in the real estate investment market in downtown Tokyo just before the Lehman Shock (from 2004 to 2007). However, sufficient examination on whether that was true or not cannot be said to have been conducted in the past.

[Figure 4] presents changes (from 1970 to 2009) in the value arrived at when the ratio of office building prices to net operating income (NOI) from leasing of office buildings in the Tokyo Central 3 Wards is calculated and its average subtracted. As shown, changes in the ratio of price to NOI from 2004 to 2007 resemble the pattern after the first and second oil shocks in the 1970s. The pattern at least differs completely to the pattern of the bubble years from 1985 to 1990.

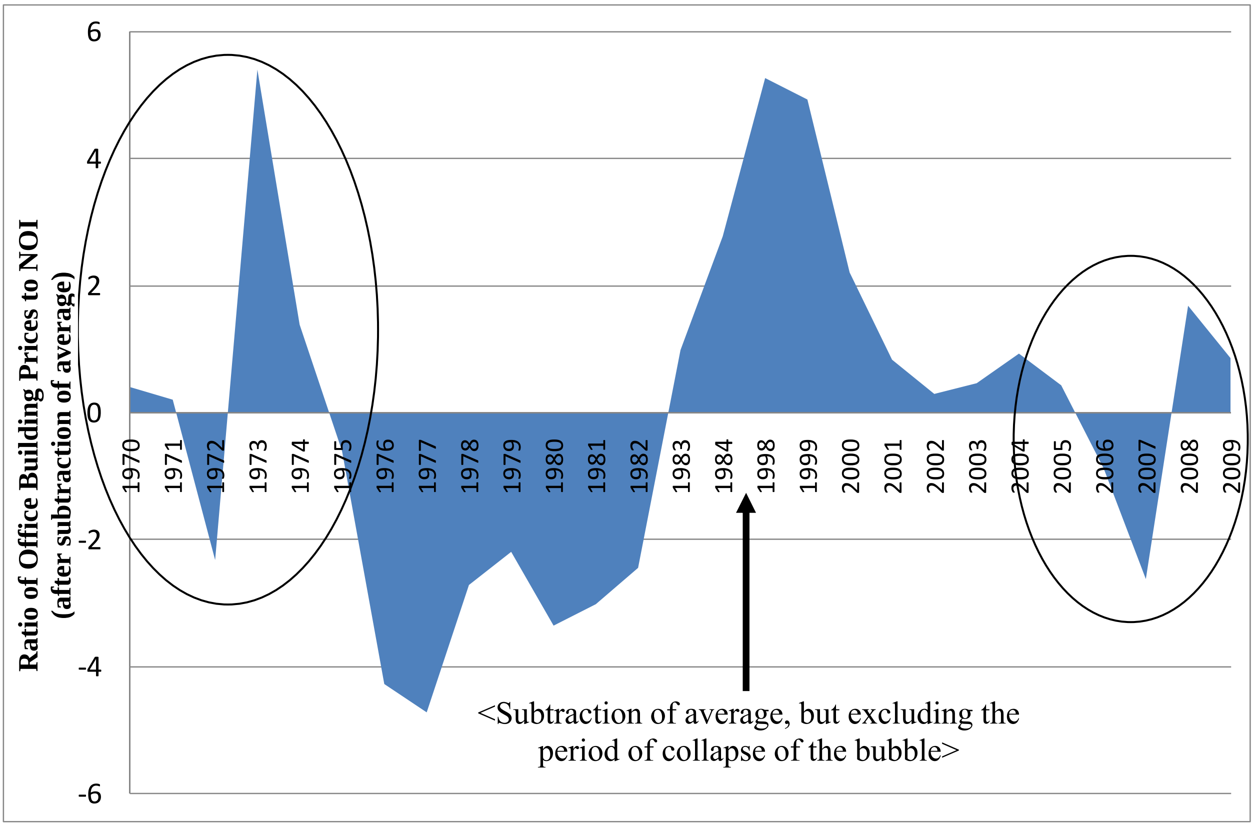
[Figure 4] Ratio of Office Building Prices to NOI (from 1970 to 2009)



This is a graph of the value arrived at when the ratio of prices to NOI of office buildings in the Tokyo Central 3 Wards is calculated and its average (29.9) subtracted (calculated by Committee member Kawaguchi using the MU-CBex office investment index developed by CB Richard Ellis K.K. and Mitsubishi UFJ Trust and Banking Corporation).

Moreover, even when the bubble years in the latter half of the 1980s and its collapse in the 1990s (from 1985 to 1997) are excluded as presented in [Figure 5], the pattern of changes in the ratio of office building prices to NOI from 2004 to 2009 (after subtraction of average for that period) (plus → minus → plus) shows a similar pattern to that from 1970 to 1975. This rules out there being a marked sharp rise in office building prices relative to the growth of its fundamentals (NOI) (a bubble taking place) during this period.

[Figure 5] Ratio of Office Building Prices to NOI (from 1970 to 2009 (but excluding from 1985 to 1997))



This is a graph of the value arrived at when the ratio of prices to NOI of office buildings in the Tokyo Central 3 Wards from 1970 to 2009 (excluding from 1985 to 1997) is calculated and its average (23.9) subtracted (calculated by Committee member Kawaguchi using the MU-CBex office investment index developed by CB Richard Ellis K.K. and Mitsubishi UFJ Trust and Banking Corporation).

Notably, from 2005 to 2007, the growth of office building prices could not catch up with the growth of its fundamentals (NOI) as was the case from 1971 to 1972. Although showing a rise in price to the extent that many people would mistake it for a mini bubble, there was found to have been an increase in NOI that surpassed such. For this reason, it is only natural to think that the office building investment market temporarily pulled out of deflation and entered a stage of mild inflation during this period.

Amid circumstances in which it was difficult for Japan to pull out of the deflationary mind-set due in part to the declining birthrate combined with aging population and fall in potential growth rate, it was good in a sense that the real estate investment market managed to pull out of deflation between 2005 and 2007 even if it was only temporarily. Yet, the negative mind-set of the past twenty years caused this to be mistaken for a real estate bubble and financial regulations may have been imposed as a measure to prevent a recurrence of the 1980s. As a consequence, it is undeniable that the risk money supply process was nipped in the bud just when it was showing signs of growth. As a result, while risk money supply for real estate investment was recovering globally, Japan finds itself lagging behind alone in this respect.

3. Challenges and Countermeasures of the Real Estate and Financial Markets

(1) Challenges and Countermeasures of the Debt Market

Having only relatively simple securitization cases, Japan was thought to be immune from the global financial crunch and financial system malfunction stemming from the subprime mortgage crisis and Lehman Shock, but investors hauling up risk money from the market became a reality for Japan, too. Refinancing problems arose for each of the means of providing debt financing to real estate investment vehicles – real estate non-recourse loans, CMBSs, loans for J-REITs, and J-REIT investment corporation bonds – and these were identified as big challenges.

Considering the size of Japan's real estate market, an urgent challenge of the refinancing problems is to broaden the fund lender base in the debt market and expand the volume of debt. This also underlies the challenges facing the regional economy, such as the grant of non-recourse loans not being likely for buildings around train stations and other properties sufficiently generating revenue in regional areas. There must be a clear recognition of sound growth of the real estate securitization market and real estate investment market being also important from the standpoint of the national economy and the need for quantitative combined with qualitative expansion of the debt market that can be described to be the blood circulation supporting such growth.

① Pro-Cyclical Issues

On a study of debt market issues in greater detail, firstly there is a trend of easing of the lending stance during the period of rising real estate prices causing the rise in prices to accelerate, and tightening of lending during the period of falling prices causing larger fluctuation in real estate prices. Central players and market participants thus need to take action against this by containing the market's pro-cyclical nature (nature of amplifying moves excessively), and establishment of a framework for regulating and systematizing support of such moves of market participants.

Specifically, from also the perspective of sound development of the real estate investment market and greater international competitiveness of the financial market, real estate and financial authorities need to closely monitor the real estate market and the underlying financial market and clearly assume a stance of commitment to contribute to sound market development together with related government departments.

② Lender Diversity Issues

Concerning lenders of non-recourse loans and other debt, there was a concentration on specific major banks and a lack of range to date. Concerning the percentage of total interest-bearing liabilities at even J-REITs, which have relatively low loan-to-value

(LTV), major banks account for a main portion, while regional financial institutions account for only about 5% in the case of lending of loans and only about 16% even in the case of the investment size of investment corporation bonds.

A market form in which CMBS, investment corporation bonds and other bond certificates are supported by a range of investors, rather than just leading banks and some foreign players, shall be aimed. In addition, there is a need to promote increase in syndicated loans that are not particular on the type of bond certificate, as well as promote new entry and greater investment by life/non-life insurance, pension and other fund management institutions.

In these respects, development shall be advanced that shall include strengthening the system through support measures for raising the capacity of regional financial institutions to provide non-recourse loans and initiatives to increase flexibility in such regulatory aspects as expanding the scope of institutional investors in taxation that are allowed to provide debt funds to TMKs and enabling handling of notification procedures all year round, as well as through matching of debt and equity in the real estate field by studying utilization of the Organization for Promoting Urban Development, etc. for stable supply of mezzanine loans and acquisition of real estate debt and CMBSs that meet certain requirements by J-REITs (mortgage REIT).

Concerning CMBSs and investment corporation bonds, there is a need to promote a market form suitable for enabling “CMBS and investment corporation bond” that meet certain requirements to fall within the scope of bond certificates that can be purchased by the Bank of Japan for the purpose of supporting revival and growth of the CMBS and investment corporation bond issuance market. If a sense of security can be fostered among a wide range of market participants through such policy, new entry and re-entry of a wider range of debt investors, including regional financial institutions, can also be anticipated.

③ Issues of Mismatch between Period of Procurement of Portfolio Assets and Funds in the Real Estate Investment Market

Essentially, real estate is a long-term investment target (revenue projected over the long term). However, many of the loans, centering on bank loans, provided in the present market are for two years or three years and are no more than five years at the longest. Even in terms of the permanent investment vehicle J-REITs, its weighted-average loan period being merely less than three years cannot be said to be sound. Japan’s CMBSs have also been criticized for its short investment period from the beginning. In this manner, the lack of entry of lenders of long-term funds for which there are essentially needs among borrowers is a challenge.

Concerning lengthening of debt periods, using securitization of the home loan Flat 35 as a case example, the establishment of an environment for promoting investment by long-term investors through the provision of products from the standpoint of long-term investors by developing long-term debt products involving public institutions that will serve as a benchmark for the capital market (Flat 10) is needed.

④ Establishment of Thorough Thinking on Asset Financing

Despite it being financing for bankruptcy remote vehicles, it is viewed widely as having a corporate link in that the shareholders, etc. of management companies are emphasized, and this is one aspect that is hindering sound growth of the real estate non-recourse loan market as an asset finance market. For J-REITs, too, the present situation is similar in that it is viewed as being linked to the sponsors of asset management companies. With listed companies owning lease real estate and J-REITs existing side by side, how financing should be viewed for each can be cited as a challenge.

In addition, it is pointed out that developments in the real estate securitization market cause a shift, which is overlooked, in the classification of credit, etc. for SPCs that own real estate that were removed from the balance sheets of business corporations, etc. as part of a CRE strategy (owns assets that would have been classified into "other types of business" in the past) to "real estate business." If real estate securitization financing is treated within the framework of lending to the real estate business as conventional corporate financing and each financial institution and financial authorities continue to uphold the thinking that credit for the real estate business is within the same framework as conventional real estate business, then it is nothing short of it limiting itself from the growth of the real estate securitization market that would essentially be achieved by incorporating assets of a wide range of business types other than real estate business.

On that note, for example, promotion of a review of financial institutions' classification of business types and risk control for SPCs that own real estate that were removed from balance sheets (setting of "investment real estate financing" or other new classification, reviewing of maximum limit on credit for types of business, streamlining of risk control against falls in the price of revenue-generating real estate, etc.) is an agenda to be studied by each financial institution, and development of a regulatory/institutional environment that would urge such is demanded.

*Reference Material 1: Changes in CMBS Issuance Amount
Status of Financing for the Real Estate Business

(2) Challenges and Countermeasures of the J-REIT Market

Japan's real estate investment trust (J-REIT) system started in September 2001 with the investment units of investment corporations based on the Act on Investment Trusts and

Investment Corporations (Investment Trusts Act) being listed on the Tokyo Stock Exchange. J-REITs assume the role of a leading indicator of the real estate market due to the high transparency of its transactions and there is a sense of reliability over disclosed information due to the involvement of many regulators (investment management companies, securities companies, stock exchanges, lending financial institutions, trust companies, etc.). As such, J-REITs now have a large presence in the real estate investment market. In this manner, J-REITs are the ideological form of real estate securitization that binds the capital market and real estate investment market, and are premised on the fusion of finance and real estate. In Japan, however, it is criticized for not functioning fully in terms of its purpose of providing real estate investment products that are valuable to middle-risk and middle-return investors – in other words, a range of investors, including individual and pension investors – and injecting stable funds into the real estate market, and thereby contributing to real estate liquidity, real estate development and advancement of urban functions.

By the end of May 2007, the market capitalization of investment unit prices grew to 6.8 trillion yen. Today (end of November 2010), however, market capitalization decreased to 3.4 trillion yen as a result of the credit crunch before and after the Lehman Shock, and remains stagnant as its steps toward recovery are slow in the wake of the global financial crisis not only compared to the U.S. and other REIT markets that were launched earlier than Japan but also compared to REIT markets that were launched later than Japan.

*Reference Material 1: Market Capitalization of and Number of Listed J-REITs
Comparison of Market Capitalization of REIT Markets of Different Countries

Since 2009, the Forum for Building Up the Real Estate Investment Market that is Trusted by Investors has held intensive discussions for revitalization of Japan's real estate investment market, centering on J-REITs, and presented measures for improvement of refinancing issues, restructuring issues, governance issues, etc., which have proved effective in several respects. The Bank of Japan has also been undertaking initiatives, such as making investment corporation bonds, etc. eligible for collateral (January 2009) and establishing the Asset Purchase Program that includes the investment units of J-REITs as a target of purchase (October 2010).

Along with continuing to spread and raise awareness of J-REITs among individual investors, in order to make J-REITs a target of proactive investment by institutional investors of overseas funds, pension, insurance, etc., it is indispensable that the market grow in size to a certain level. To that end, the setting of goals, such as to aim to increase the market capitalization of investment unit prices to 10 trillion yen, is one possible example.

① Fund Procurement Capacity Challenges

The global financial crisis caused problems in that it was difficult to refinance loans even in the case of J-REITs, a vehicle that generates stable revenue. Owing to the global credit crunch that had already started from 2007, financial institutions adopted a stricter stance on lending to J-REITs. Refinancing risks and investment corporation bond redemption risks thus began to surface in 2009. While the situation is now relatively stable as a result of initiatives, such as establishment of the Real Estate Market Stabilization Fund, and change in the refinancing stance of financial institutions, there is essentially no change in the fact that the period of debt funds provided to J-REITs by financial institutions is still the same relatively short period as private funds and a mismatch continues to exist with the fund demand of J-REITs that is premised on holding real estate for a long term. At banks, too, there is not necessarily a common understanding established on whether lending to investment corporations is to be positioned as asset financing or positioned as corporate financing in light of its relationship with sponsors. There, the challenge would be to enhance the attractiveness of J-REITs from the standpoint of pension, life/non-life insurance funds and other long-term fund lenders and thereby procure long-term stable funds from such investors.

In addition, the system is structured in a way that financial techniques are limited for investment corporations as the only means for it to procure debt funds is to borrow funds or issue investment corporation bonds, making it difficult to flexibly respond to refinancing risks for borrowings from financial institutions and redemption risks for investment corporation bonds. While there is room for improvement in also the professional financial management abilities of management companies, there are criticisms over not being able to set aside internal reserves and other structural limitations preventing improvement in financial composition and flexible response to financing risks.

In terms of capital policy also, while it can increase capital by way of third-party allotment and split investment units, it cannot implement a retirement by purchase of its own investment units, which would be effective in dealing with a slump in investment unit prices when investment unit prices are hovering at low levels in the market or to make improvements for dilution.

Policy inducement is required for the above points at issue in order to ensure a smooth supply of funds to J-REITs, etc. (clarification of the types of business and risk control by financial institutions, and streamlining of risk control against falls in the price of revenue-generating real estate) and flow of long-term funds from pension and life/non-life insurance to investment in and lending to J-REITs.

Moreover, efforts to optimize the period for lending from financial institutions and ways to optimize leverage are actions required of management companies.

Furthermore, measures need to be taken to facilitate diversified response with respect to financing techniques of J-REITs. Specific examples include allowing issuance of convertible bonds, acquisition of own investment units, investment unit distributions and internal reserves.

② Governance Challenges

A J-REIT governance challenge that has been pointed out is the need to align the interests of management companies and investment corporations and thereby enhance the trust of investors. In addition, under the present situation in which management companies and investment corporations adopt the form of external management but are substantially integrated, how to structure avoidance of transactions involving conflicts of interest with management companies is in question. In regard to this point, there are many cases where the internal rules of management companies set forth provisions that transactions with interested parties, such as sponsor companies, shall be subject to mandatory check of an external expert committee member (for example, an attorney, accountant or real estate appraiser) and that purchases/sales with interested parties shall be at or below the appraisal price when J-REITs are to purchase real estate from interested parties and at or above the appraisal price when J-REITs are to sell real estate to interested parties. However, it is difficult to judge whether or not conflicts of interest are in fact being avoided with such formal criteria alone. On the other hand, there are cases where sustaining good relations with sponsors are rated highly by investors and the market in terms of acquiring investment-grade real estate and managing and maintaining properties. It appears that acquiring economic results and sustaining business relations to a certain degree may be accepted in Japanese business practices more so than the prevention of conflicts of interest.

J-REITs disclose a substantial volume of real estate transaction information with transparency through not only disclosure at its IPO, but also through timely disclosure. In spite of this, overseas investors have frequently indicated issues over the transparency of real estate transaction information. Some have pointed out that underlying this is in fact the complicated nature of Japan-specific real estate transaction practices that are not noticed by players that have engaged in real estate transactions in Japan from before. If the J-REIT system continues to be an atypical one unique to Japan, it will be increasingly harder for overseas funds to enter, meaning the arrangement of a fund for real estate located in Japan will need to lean towards taking place in overseas markets. This will lead to concerns of hollowing progressing in the Japanese market and market size shrinking further. In light of such factors as REITs, too, having entered an era of international competition and many investment units being held by overseas investors, there is a need to make the system one that will size up adequately to also investors abroad, which would include governance issues concerning investment corporations and management companies.

The focus falls on conflicts of interest matters when it comes to governance, but it could also be said to be a demand for transparency in the decision-making of investment decisions. Possible measures are to appoint an independent director at the management company (*for example, from fiscal 2010, the Tokyo Stock Exchange created a system in its Securities Listing Regulations for a listed company to designate an outside director or outside auditor (who is unlikely to have conflicts of interest with general shareholders of the listed company) as an independent officer who is to notify to the Tokyo Stock Exchange), devise ways to ensure transparency by keeping a record of the degree of supervisory function input made by the directors of an investment corporation in the investment decisions of a management company, and devise other ways to build a solid structure for preventing conflicts of interest in transactions with interested parties. There is also a need to consider whether or not to stipulate regulations against insider trading that arise with transactions of investment units on the securities market. Moreover, in terms of overseas investors, governance issues are often discussed from the perspective of accountability in real estate transactions or business practices and so there is likely to be a need to improve the ability of management companies to explain its transactions with interested parties or transactions with third parties.

③ Volatility

Concerning the volatility of J-REITs, with large volatility in the TSE REIT Index (May 2007: 2,613 (high); October 2008: 704 (low)), there is a need to work at gaining more value investors and other participants that engage in long-term investment.

④ Institutional Stability as a Vehicle

There are also challenges in taxation and accounting in the context of ensuring the institutional stability of J-REITs (refer to "(5) Challenges and Countermeasures in Taxation and Accounting"). From the taxation and accounting perspective, policies for ensuring the stability of J-REITs as an investment vehicle are demanded.

(3) Challenges and Countermeasures of Private Funds

It was real estate securitization and monetization based on a fund system that led to a paradigm shift in the land collateral financing relationship between real estate and finance that had existed up until the 1990s. The fund system is a system of establishing a special purpose company (SPC) engaging exclusively in the real estate business that specializes in the target real estate and outsources its management. It is designed to enable fund procurement that is separate from an indirect financial system centering on banks.

In terms of legal system, the Act on Liquidation of Special Assets by Special Purpose Companies (the "SPC Act") that was enacted in 1998 played a large role. Moreover, a system for a YK (*yugen kaisha*; limited liability company; now, GK) to procure equity funds through TK investments and debt funds through non-recourse loans was established in 1997 amid failures of financial institutions and accelerated disposal of non-performing loans at the time, and such is still of a certain size.

The emergence of such systems facilitated real estate transactions that are based on market mechanisms and played a significant role in subsequent developments in the real estate investment market. In terms of increasing the supply of investment-grade real estate to J-REITs, the role of private funds is pivotal not only in the aspect of fund flow but also in creating J-REIT investment-grade real estate through real estate revival, development and management. In that sense, there is a need to work at reviving and enhancing the private fund market.

① Fund Procurement Challenges

As the large number of products that have high leverage based on short-term non-recourse loans suggest, there being many products that are likely to fail the test of LTV against fluctuations in real estate prices (loan principal amount as a percentage of real estate value) and heavily dependent on the lending stance of financial institutions is cited as one challenge with private funds. Consequently, it is not fulfilling its intended purpose of fund procurement that is separate from an indirect financial system.

For the above challenge, a system for acquiring target real estate through equity investment alone by gathering small pension funds shall be considered as a product that has fluctuations in real estate prices less susceptible to impact from the indirect financial system, and establishment of an environment that facilitates borrowing of long-term life/non-life insurance funds shall be considered.

Concerning medium- to long-term funds, whether debt or equity, many depend on the creditworthiness of real estate investment management companies in addition to real estate value. Therefore, there is a need to also enhance the creditworthiness and management ability or product development ability of the real estate investment management company itself.

② Real Estate Revival and Development Challenges

Next, there is the problem of limited volume of supply of real estate that could be positioned as being of investment grade. This leads to the point that the volume of supply of real estate that is suitable for real estate securitization is small to begin with relative to the size of Japan's real estate market on the whole and to the concern that there thus exist all-too-easy securitization that places emphasis on the intentions of the arranger and disregards the risk appetite of investors. Furthermore, there are criticisms in terms of trust custody. In many cases with private funds, target real estate needs to be converted into trust beneficiary rights. At the point of the trust custody on which that is based, however, *kizon futekikaku* real estate (real estate that no longer conform to the law but are not categorized as illegal structures), residential real estate in regional areas where there is a limit to credibility research and management of tenants, etc. tend to be avoided, resulting in it not being placed in trust and securitization falling behind. The handling of those thought to have high development risks like urban renaissance and *kizon futekikaku* buildings are now recognized as problems in that it is the gap that prevents the fusion of real estate and finance. It is understandable from the standpoint of financial institutions not placing *kizon futekikaku* properties and illegal structures in trust as they cannot take the risks of such structures. From the standpoint of real estate and the national economy, however, having to respond to the needs for revival and effective utilization of such real estate is a major challenge.

As a measure to fuel investment by conducting real estate development, revival and management altogether, there is a need to introduce a bankruptcy remoteness structure to the real estate specified joint enterprise business (engaging in real estate transactions through partnership investments, etc.) and bring about a change towards accepting SPCs as a subject of transactions in the real estate specified joint enterprise business. Establishment of an SPC as a so-called bankruptcy remote vehicle and performance of its duties by an approved real estate specified joint enterprise business operator based on a general assignment from such SPC will enable the aim of protecting investors to be accomplished.

③ Legal System Challenges

As a legal system challenge, application of the Financial Instruments and Exchange Act (the "FIEA") from the fall of 2007 made SPC business (private funds' investment vehicle) other than the real estate specified joint enterprise business constitute an investment management business, management company entrusted with asset management by an SPC constitute an investment advisory business or investment management business and sales agency business in the course of distribution of trust beneficiary rights or TK investment constitute a type II financial instruments business, resulting in investor protection being followed through under the FIEA. Complicated interpretations of FIEA provisions are in demand in terms of trust beneficiary right transactions that in essence exhibit real estate transaction aspects and the various management of private funds centering on such under the FIEA, and the stability of the structure for distributing revenue from real estate management to investors is also affected.

On that note, there are demands for experts to work at bridging the gap between the actual state of real estate transactions and consistency with FIEA regulations, and draw up and enhance Q&A for legal interpretations, procedures and other inquiries made with related ministries and agencies. There is also a need to improve application, such as strengthening the capacity to address real estate development projects and revival projects by TMKs under the SPC Act.

(4) Challenges and Countermeasures Specific to the Real Estate Market

Of the challenges that are pointed out with respect to Japan's real estate investment market, there are challenges deriving from the characteristics of Japan's real estate market.

The investment environment of Japan's real estate market is assessed to be comparable to European and U.S. countries in terms of market size, stability and risk level, but is assessed harshly when it comes to growth, rate of return, ease of fund procurement, extensiveness of information and transparency. The same trend is found in the assessment even in comparison with Singapore and Hong Kong (Source: MLIT's Fiscal 2009 Survey on International Comparison of Real Estate Markets). For investors (especially, investors abroad), low extensiveness of information and low transparency not only reduces motivation to invest, but are also causes of increase in the risk premium for Japan's real estate.

Amongst these harsh assessments are also matters that cannot be resolved by the efforts of the real estate market alone, such as growth of the Japanese economy and rate of return. On the other hand, extensiveness of information and transparency can be resolved by proactively tackling it as issues specific to the real estate market.

① Extensiveness of Information, and Transparency

In Japan, an extremely large volume of real estate market information is disclosed in each of the public and private sectors. In spite of this, the international assessment of the extensiveness of information is harsh. One reason for this is there being little information provided in the international language English. It also represents the dissatisfaction of the market in that the existing flood of various information is not useful as it fails to appropriately reach investors as information that helps them make investment decisions.

The MLIT already provides real estate transaction information, but that information provision is limited in that properties are not identified and such and so the information is not sufficient from the perspective of use of the information for the purpose of making investment decisions. For this reason, private real estate fund management business operators are taking their own initiative to grasp the bottom line of the properties under investment consideration and to grasp and gather transaction information, etc. provided by private media, etc. with their own know-how and effort to use as materials that will serve as the basis for making investment decisions. However, as these are not publicly disclosed information, the situation cannot be described as one in which sufficient information is available to investors who are considering newly entering the market.

On that note, at present, the content of disclosure of real estate information provided by the MLIT is being implemented in a limited manner in that properties are not identified, etc. in consideration of it being easier for the general public to understand. However, the provision of information with the properties identified should probably be studied in the case of transactions of revenue-generating real estate for investment purposes.

The consideration taken in the current provision of information is based on the judgment that it is necessary from the perspective of privacy protection in transactions involving individuals. At the same time, there are many cases of proactive disclosure of transactions in real estate investment and such consideration seems to lack significance.

The current method of gathering transaction information is based on change of registration provided by the Ministry of Justice and is conducted via a questionnaire of the parties involved in transactions. For transactions of investment real estate, reporting of transactions of all assets under management that are disclosed ought to be made mandatory. Of this, information should be provided to market participants at the level required in making investment decisions by utilizing the current real estate transaction information system.

The establishment of real estate indices and establishment of an environment that facilitates verification of the information provided by clients in appraisals, etc. are believed to progress as a result of such information provision.

② Challenges Arising from Lease Contracts

With both the debt loan period and equity investment period being a short three to five years in Japan, the securing of long-term stable funds, which essentially ought to be supporting the real estate investment market, poses difficulties in Japan.

The underlying circumstances specific to the real estate market include (1) The standard lease contract in Japan’s real estate market is a lease term of two to three years, and (2) There are many regular leasehold contracts that accept mid-term contract terminations and exercise of the right to claim reductions in amount, which cause cash flows to be unstable. The above is one factor that is increasing the volatility of investment real estate and hindering the inflow of long-term stable debt and equity funds.

The fixed-term leasehold system is a structure that can stabilize cash flows. A decade has already passed since the system was introduced and is used for office buildings and rental housing that are supplied by major real estate companies. For other properties, however, a high percentage of the contracts are still regular leasehold contracts.

On that note, in view of attracting long-term stable funds to the real estate investment market, cash flows must be stabilized and volatility of real estate leasing lowered. To that end, in the case of anchor tenants, it would be effective to promote the signing of fixed-term leasehold contracts that are for the long term and do not accept mid-term contract terminations nor contain the claim for increases/reductions in the amount of rent.

However, under the present state where the system allows two choices of leasehold – regular leasehold or fixed-term leasehold, there is no incentive for tenants to select fixed-term leasehold. Past discussions over fixed-term leasehold were concentrated on the aspect of correcting leasehold relations, which used to be a system that was mainly focused on protecting tenants due to the historical background, and incentives for tenants to select fixed-term leasehold contracts was not much discussed.

Concerning fixed-term leasehold for the long term, there is a need to develop the ideal form of fixed-term leasehold contracts that provide incentives to also tenants, such as allowing transfers or sales of leasehold rights by right.

③ Enrichment of Real Estate Indices

The necessity for enrichment of real estate indices is a challenge that has been advocated repeatedly, but the initiatives for such are still insufficient and is a factor that is discouraging institutional investors in and out of Japan from investing into the Japanese real estate market.

On that point, early development of an appropriate housing price index based on information on real estate deals that have been closed and start of its delivery on a trial basis at the Tokyo Stock Exchange (targeted for around the spring of 2011) are being studied. There is a need for ongoing initiatives toward its steady implementation.

On the other hand, plans are underway to draw up international guidelines on real estate price indices at the United Nations, etc. In correlation, there will be a need steadily implement initiatives to create and announce official real estate price indices in Japan.

④ Enrichment of Real Estate Appraisal

With developments in the real estate securitization market, the role of real estate appraisal is growing significantly in weight. In particular, in light of the Japanese real estate securitization market's characteristic of there being many related-party transactions, further enrichment of the real estate appraisal is desired.

In securitization, as information required in appraisals is predominantly held by clients, it is vital that the information provided be verified by appraisers. The DCF method that is required in appraisals of securitized real estate is a method involving many elements of projection. Therefore, greater accountability is demanded for the employed discount rate and cap rate on the assumption that the real estate is sold, as well as the rent scenario during the investment period.

In this regard, appraisal is indispensable to the implementation of securitization projects. As there are various challenges with appraisals upon securitization, such as actual real estate sale prices varying depending on seller and buyer needs and appraisals of even real estate based on stable revenue fluctuating depending on investors' expected return, there is a need to keep working at enriching real estate appraisal that is trusted by a broad range of investors. The direction of concrete initiatives shall be a study of appraisal techniques that take into account the actual state of the real estate investment market, response to internationalization of appraisals and enhancement of the provision of information pertaining to public notice of land prices.

(5) Challenges and Countermeasures in Taxation and Accounting

The foundation of the current taxation system for investment corporations (J-REITs, etc.) and TMKs, which are frequently used as real estate investment vehicles, was established in fiscal 2000 with the Act on Special Measures Concerning Taxation stipulating special provisions (conduit) for including distributions of pretax earnings in the amount of deductible expenses. Universal vehicle conduits are designed to be subject to single taxation by eliminating double taxation at the vehicle through investor levels as long as almost all earnings generating from investment assets are distributed (in Japan, the requirement is distribution of at least 90%). If this function at the basis of the system is unstable, investors not only in Japan but also abroad will be compelled to think twice about seriously embarking on investment.

European and other REIT systems that were launched later than Japan made appropriate allowances for the above point by reflecting the experience of Japanese and other earlier REIT systems. However, Japan's system still resembles the early stages of U.S. REITs. While various improvements have been made over the past decade, its presence has become one that is inferior to the international standard in terms of taxation and accounting. With Japan's system, various stipulations of different intent are imposed and this is raising criticism in that, even if the aim individually is secure management, etc., it instead hinders stability on the whole and evokes market pro-cyclicality.

① Taxation and Accounting Discrepancy Issues

There are criticisms over discrepancies arising between distributable earnings and pretax earnings, such as when there are discrepancies in the calculation of income in taxation and calculation of earnings in accounting (taxation and accounting discrepancies), causing failure to meet conduit requirements and this in turn hindering the security of investors. As similar problems arise also when inclusion in the amount of deductible expenses is rejected in tax inspections, there are also questions being raised that the conduit requirements, which were originally imposed on investment vehicles that are taxation risk intolerant, have become overly focused on distribution of earnings in taxation and accounting problems are subordinated. As a result, there are also criticisms over intolerance to discrepancies in the transaction amount and appraisal amount and such hindering the liberty of business transactions. Taking into consideration that increases in the degree of taxation and accounting discrepancies from convergence with international accounting standards, etc. and taxes being imposed as a result of tax reforms in the future will cause discrepancies to arise in distributable earnings and pretax earnings, it would be difficult to address this problem through future amendments of individual taxation calculation stipulations any more and would instead require a complete amendment.

On this point, while referring to the taxation system related to vehicles in Western countries, ongoing initiatives toward building a real estate securitization structure that is highly stable in that conduits are ensured will be required even after international accounting standards are adopted (establishment of a vehicle system that is less susceptible to tax and accounting system reforms (fundamental resolution of taxation and accounting discrepancy issues)).

② Treatment, Etc. of Impairment Losses and Scope of Required Distributions

In taxation, in principle, impairment losses that are not included in the amount of deductible expenses until sale and negative goodwill generating at the time of a merger, etc. are accounts for which large taxation and accounting discrepancy issues arise. Consequently, while allowances were made for some of these at the time of the fiscal 2009 tax reform, issues arising after the fiscal year of incurrence and other taxation and accounting discrepancy issues have not been resolved. In order to avoid taxation of impairment losses, REITs will likely sell properties when market prices fall.

With REITs of overseas countries, there are many cases that allow capital gains to be deducted from the required percentage of distributions and a corresponding amount set aside as internal reserves. Meanwhile, the Japanese system distributes almost all capital gains, too, making it easy to fall into a mess because maintaining net asset value becomes difficult when market prices fall and this is a cause of fire sales. The outflow of earnings that ought to be applied to capital expenditures making it difficult to boost net asset value is one of the points that should be studied.

With respect to the above issues, while retaining special taxation measures as a conduit, studies need to be underway on an institutional design that can cope with changes in the finance environment, etc. The direction of concrete initiatives could include enhancement of internal reserves (deferment of taxation on capital gains for reinvestment purposes) and deduction of impairment losses and capital expenditures from required distributions.

③ Creation of Japanese Version of UP-REIT and Promotion of Urban Renaissance

Whether or not there are mutual conflicts between policy objectives – including establishment of urban infrastructure, such as environmental issue and tourism policies, enhancement of the infrastructure business and PRE through PPP, PFI, etc., and enhancement of foreign direct investment and pension and other personal financial assets – and tax and other systems for real estate and other investment vehicles need to be re-examined across the boundaries of competent authorities from the standpoint of sustainability that takes into consideration tightening finances and based on the process of revision of the Japanese government's Basic Policies for Urban Renaissance. For example, some question whether taxing capital gains that arise from the extra FAR (floor area ratio), injection of subsidies, etc. when blue-chip real estate owners and developers transfer such property to REITs would be offsetting the effects of urban policy. In such cases, allowing reduction entry of investment units (as well as purchase of own investment units and investment in kind) would enable the same effects as U.S. umbrella partnership REIT (UP-REIT) to be achieved (Japanese version of UP-REIT). Introduction of such structures would likely particularly drive large blue-chip urban developments/redevelopments that involve the participation of several land lease right holders.

The direction of other concrete initiatives could be to develop special taxation provisions for vehicles that are linked to the real estate specified joint enterprise business system, etc. and requirements for vehicles that are suitable for J-REIT policy environment investment or infrastructure building projects and PPP/PFI programs.

(6) Challenges and Countermeasures of the Real Estate Investment Market and Financial Cycle System

As pointed out heretofore, Japan's financial institutions, real estate business operators and other private business operators have implemented market expansion initiatives in an array of fields since the launch of the real estate investment market, but such attempts have not necessarily led to solid results. The fact that the initiatives were focused on those categorized by the type of financial product in the real estate investment market, or in other words vertically divided, can be cited as the source of many underlying causes.

For example, a large challenge faced by the J-REIT market that is still in fresh memory is the event of difficulty in refinancing investment corporation bonds that were issued by J-REITs. Behind this is that the market of real estate investment products of the debt type, such as non-recourse loans for corporate real estate, which was recognized at first to exist outside of the framework of equity-type real estate investment products of J-REITs, failed to fully function. Facing a crisis, in effect, led to the recognition for the first time that there are risks of the running of several J-REITs becoming impossible depending on debt market trends.

On the other hand, in the CMBS market, the fact of the matter is that improvement of the nature of products for introducing long-term funds (standardization of information disclosure and introduction of benchmark products) has been neglected as securities companies involved in arrangement only arranged products that are of a relatively short period (about three years) for banks with excess liquidity and other institutional investors belonging to the indirect financial system. As a result, the present state is an unstable CMBS market that finds itself fluctuating up and down depending on the trends of excess liquidity. In addition, note must be made that the awareness of investors of CMBS, too, that they contribute to raising the value of underlying real estate by investing into such products has to date been weak.

Concerning the system that ties real estate and finance, independent initiatives of the private sector to build it into a cycle system (refer to [Figure 6]) and appropriately function as one kind of ecosystem were rarely found in Japan in the past and this is a matter that must be seriously reflected upon. Some see this to be the product of a lack of awareness in both the banking and securities industries, which have been treating debt-type products like CMBS and non-recourse loans and equity-type products like J-REITs under the concept that they are not meant to complement one another but rather compete with one another.

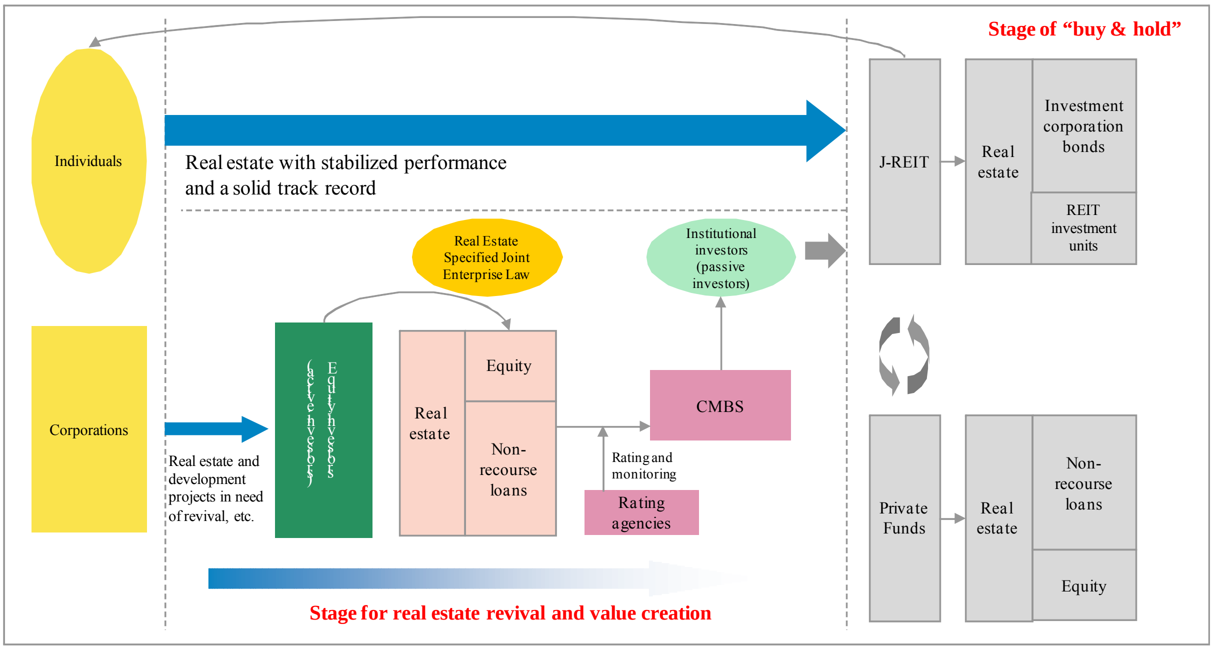
Moreover, a look over past policy discussions also shows that, after introduction of the J-REIT system, there was a focus on incorporating into J-REITs real estate that were already sufficiently generating revenue in an effort to expand that market. Such moves put off initiatives for reviving or raising the value of the large stock of so-called *kizon futekikaku* real estate that do not fit the above description and from there converting such into blue-chip real estate stock that would be considered to be of J-REIT grade. This is also said to have triggered a frequent fierce battle over the small portion of real estate that are of J-REIT grade.

Furthermore, little heed has been paid to date on institutional and policy initiatives for addressing the large challenges of strategically nurturing private real estate funds as an industry that is to lead the revival of real estate and, as the source of debt fund procurement for such, establishing a framework that properly positions the CMBS market and non-recourse loan market within the financial system, and thereby introduce diversified medium- to long-term funds into the real estate market. In that sense, Japan's real estate securitization market to date has been one that features a structure that is distorted as a system as a result of inadequate initiatives and fallacy of composition.

It is under such circumstances that the financial crisis stemming from the subprime mortgage crisis that originated in the U.S. took place, resulting in a decrease in the inflow of funds from the financial market into the real estate market and urban development field and bringing rise to a lack of supply of especially medium- to long-term funds, mezzanine funds, etc.　This is arguably the very time that Japan must go beyond structures and finance of individual investment product to respond to calls for establishment of a grand design for the real estate investment market to appropriately function as a real estate and financial cycle system and for policy collaboration that transcend the vertical divisions of ministries and agencies.

As countermeasures for such challenges, there must be stronger policy coordination between the MLIT (real estate administration) and Financial Services Agency (finance administration) by establishing a forum for study between the two and while appropriately discerning market conditions.　The forum for study needs to conduct regular discussions on the ideal form of J-REIT and other real estate securitization techniques, an appropriate vehicle taxation system and other challenges facing the real estate investment market, as well as establish a framework for reflecting budget, tax and institutional reforms, etc. into concrete initiatives.　In addition, upon discussions, there should be a framework in place for consistently transmitting information to the market, such as posting a summary of the studies (suggestions), etc. on the website, etc., as well as reflecting wide expert opinions.

[Figure 6]　Real Estate Investment Market as a Real Estate and Financial Cycle System



(7) Countermeasures for Other Challenges (Broadening of Investor Base, Etc.)

① Utilization of Pension Funds, Life/Non-Life Insurance Funds, Personal Assets, Etc.

While expectations are placed on pension, life/non-life insurance and other funds under management as lenders of long-term funds to the real estate investment market, such investment assets still account for a low percentage of real estate investment compared to overseas due in part to the size of the real estate investment market being insufficient yet and losses being incurred from real estate investment in the past.

Consequently, along with expanding the market size of J-REITs, etc. while taking into consideration investment needs for long-term and stable management, there is a need to encourage public pension and other funds that make little investment into real estate.

<Direction of Concrete Initiatives>

- Enhancement of management governance and clarification of diversified investment policy to ensure rational investment under appropriate risk controls
- Marketing to relevant organizations by leaders and other strategic encouragement
- Promotion of establishment of unlisted REITs

② Promotion of Real Estate Investment and Financing from Abroad

Promotion of real estate investment and financing from overseas investors will require announcement of a policy for attracting a wide range of smooth and stable funds from abroad.

<Direction of Concrete Initiatives>

- Clarification of domestic offering requirements under tax laws
- Acceleration of institutional investor authorization under tax laws

③ Promotion of Environment-Related Investment

CO_2 emissions in the business field dominate one-third of total CO_2 emissions in Japan. In order to accomplish the reduction target, there is a need to form stock of real estate that have high sustainable environmental value (environmental real estate) in the future.

To that end, clarification of standards and indicators and other studies will be made in order to promote real estate investment into the environment.

<Direction of Concrete Initiatives>

- Clarification of standards and indicators and grant of incentives for promoting investment

④ Creation of Growth Opportunities through Integration of Urban Policy and Monetary Policy

In Japan, with progress in the declining birthrate combined with aging population, the long-running increase in population changed to a decrease in population and the aging population increased sharply. Under such circumstances, a major challenge is to build a society in which the elderly can live and lead an active life with a sense of security and anyone can bear and raise children. In addition, amidst intensifying international competition fuelled by the rapid economic growth of developing countries, the Japanese economy has been in a prolonged slump and there are calls for such action as the nurturing of growth industries that will produce new demand and employment.

With the society and economy at a major turning point as described, the implementation of sustainable and smooth private investment into urban development, without being severely affected by financial market conditions, is essential to promoting new urban renaissance.

<Direction of Concrete Initiatives>

- In light of the process of revision of the Japanese government's Basic Policies for Urban Renaissance and other initiatives, measures concerning supply of funds to private urban developments, measures for regulatory/institutional reforms, taxation system, etc. concerning urban planning, and measures to revitalize the real estate investment market shall be advanced in an integrated manner.

Attachment

<Image of Measures ①>

Development of Long-Term Capital Supply Measures

○ Present State

Sound growth of the real estate securitization market and real estate investment market are essential from the standpoint of the national economy, and qualitative and quantitative expansion of the debt market that underlies such is required.

○ Issues

A disproportionately large percentage of lenders of finance (debt) to Japan's real estate investment market are major banks. In addition, it is far from sufficient in that the bank financing period is short, etc. whereas real estate projects extend for long periods.

On the other hand, with debt for real estate that are to be the subject of securitization projects, the risk control treatment is incorporated into classification as credit for the real estate business. Behind this is that, with progress in the monetization of real estate after the collapse of the bubble, there were increasing cases of real estate, which had been treated as collateral for lending to types of business other than the real estate business, being transferred to SPCs and such resulting in the classification of the type of business when SPCs that own real estate seek bank financing to be newly classified as the real estate business. Furthermore, that amount balance is increasing with expansion of the investment market.

○ Countermeasures

There is a need to press for flexible response, etc. to banks' classification of types of business, etc., as well as to study a structure for matching the long-term funds held by pension, overseas institutional investors, individuals, etc. and debt, while taking into consideration the conditions of the CMBS market in which issuances are decreasing sharply.

<Examples of Concrete Initiatives>

- Review of financial institutions' classification of business types and risk control for SPCs that own real estate that were removed from balance sheets (setting of "investment real estate financing" or other new classification, reviewing of maximum limit on credit for types of business, streamlining of risk control against falls in the price of revenue-generating real estate, etc.)
- Study introduction of standardized long-term CMBS benchmark product (Flat 10) by public bodies that will become a potential investment target of pension and other long-term funds
- Study introduction of mortgage REITs (REITs that can incorporate CMBS and real estate debt as assets in its portfolio)

- Support measures for raising the capacity of regional financial institutions to provide non-recourse loans
- Expansion of the scope of institutional investors in taxation that are allowed to provide debt funds to TMKs and enabling handling of notification procedures all year round
- Stable supply of middle-risk funds (mezzanine)
- Utilization of the Organization for Promoting Urban Development, etc.

<Image of Measures ②>

Creation of New Securitization Techniques for Revival of Real Estate

○ Present State

To achieve further economic growth in a depopulating society hereafter, there is a need for increasing utilization of the wisdom and funds of the private sector in the real estate investment market in order to promote revival (reconstruction, renovation, conversion, redevelopment) of idle/aging real estate and real estate that require additional investment for environmental measures, etc.

○ Issues

Existing real estate securitization techniques do not sufficiently address revival of real estate. In addition, transactions of physical real estate are avoided by pension, life/non-life insurance and other institutional investors due in part to difficulty for SPCs to engage in the real estate specified joint enterprise business and this is why results fail to grow.

Performance of Real Estate Securitization

Securitization technique	Performance for 2009			Cumulative total 1997 to 2009
	Physical real estate	Trust beneficiary rights	Total	
J-REIT	260.3 billion yen	178.9 billion yen	439.2 billion yen	9.0 trillion yen
TMK	92.7 billion yen	385.1 billion yen	477.8 billion yen	11.4 trillion yen
GK-TK structure, etc.	–	737.7 billion yen	737.7 billion yen	24.3 trillion yen
Real estate specified joint enterprise business	81.2 billion yen	–	81.2 billion yen	1.9 trillion yen
Total	434.2 billion yen	1,301.7 billion yen	1,735.9 billion yen	46.7 trillion yen

***Source: MLIT's "Fiscal 2009 Fact-Finding Study on Real Estate Securitization"**

○ Countermeasures

As revival of real estate should be promoted through the real estate investment market, there is a need to diversify securitization techniques by introducing a structure that enables bankruptcy remote SPCs to engage in the real estate specified joint enterprise business under the Real Estate Specified Joint Enterprise Act.

<Image of Measures ③>

Creation of System for Reporting Transactions

○ Present State

Japan's real estate market ranks 26th in the world for transparency. In Asia, Japan also follows behind Singapore, Shanghai and Malaysia to rank 4th. For investors (especially, investors abroad), low transparency of Japan's real estate market not only reduces motivation to invest, but are also causes of increase in the risk premium for Japan's real estate.

○ Issues

Vast information on the real estate market are disclosed in the public and private sectors already in the present state. Nevertheless, the international assessment of the transparency of the real estate market is low. The main cause of this is because such information are not useful enough as information that contribute to investment decisions. The MLIT already provides real estate transaction information, but the provision goes no further than information that pays heed to not identifying properties. This is not viewed as sufficient provision from the perspective of making investment decisions.

○ Countermeasures

In the current provision of information, the method was adopted because it is easy for the general public to understand. Since there are also many management companies that engage in proactive disclosure for transactions of income-generating real estate that are becoming investment targets, such information should be provided with the properties identified.

The current method of gathering transaction information is based on change of registration provided by the Ministry of Justice and is conducted via a questionnaire of the parties involved in transactions. Reporting of transactions of all assets under management that are disclosed ought to be made mandatory and the gathered information should be disclosed as investment real estate information at the level of information that would serve useful in making investment decisions.

<Image of Measures ④>

Development of Ideal Form of Long-Term Fixed Leasehold Contracts that Feature Incentives for Tenants

○ Present State

The regular leasehold contract, which is focused on protecting tenants due to the historical background, is the common lease contract practice in Japan. Furthermore, the lease term is a short two to three years, and mid-term contract terminations and exercise of the right to claim reductions in amount cause cash flows to be unstable.

The fixed-term leasehold system is a structure that can stabilize cash flows. A decade has already passed since the system was introduced and is used for office buildings and rental housing that are supplied by major real estate companies. In the real estate investment market, however, a high percentage of the contracts are still regular leasehold contracts.

○ Issues

The present state of the regular leasehold system that is for a short two to three years and also accepts mid-term contract terminations and exercise of the right to claim reductions in amount being common in Japan's real estate market is causing real estate cash flows to be unstable and increasing the volatility of the real estate market. It is consequently hindering the inflow of long-term stable debt and equity funds.

○ Countermeasures

In order to stabilize cash flows over the long term, there are calls for the signing of fixed-term leasehold contracts that are for the long term and do not accept mid-term contract terminations nor contain the claim for increases/reductions in the amount of rent. However, under the present state where the system allows two choices of leasehold – regular leasehold or fixed-term leasehold, there is no incentive for tenants to select fixed-term leasehold. There is a need to develop the ideal form of fixed-term leasehold contracts that provide incentives to also tenants, such as establishing a special provision that allows transfers or sales of leasehold rights during the fixed-term leasehold period.

<Image of Measures ⑤>

Creation of Japanese Version of UP-REIT Structure (Structure Corresponding to U.S.'s UP-REIT, Down-REIT Structure, Etc.)

○ Present State

The U.S. umbrella partnership REIT (UP-REIT) is a tax structure in which a REIT invests development funds, etc. into an NK (*nin'i kumiai*; voluntary partnership) (operating partnership (OP)) and becomes a partner of the OP and, when the real estate owner invests real estate in kind into the NK (OP), a put option contract stating that NK (OP) units and REIT investment units are exchangeable at any time (can invest OP interest in kind as needed) is signed with the REIT at the same time (issuance of investment unit options with OP interest as the exercise price). When the real estate owner wants to convert OP interest into cash, while legally transactions of OP interest (real estate co-ownership interest) → REIT investment units → cash are conducted, the REIT investment unit book value equals fair value and only the first OP interest → REIT investment units portion is taxed (as income from transfer of real estate) since the transactions are conducted simultaneously. This makes it easier for holders of real estate properties to place the properties onto the REIT market. However, if the OP itself transfers the entire real estate property before the former owner exercises the above option, it is taxed as income from transfer of real estate after all.

○ Issues

Contrary to the U.S., in principle, taxation on capital gains are incurred in Japan at the time of investment in kind into an NK and the system does not allow investment in kind into a REIT itself. This is one of the reasons why there is no vast supply of large blue-chip properties to the REIT market in Japan. Even in the U.S., the former owner is taxed when the OP itself transfers the entire real estate property after development before the former owner exercises the above option, but this is criticized as being a possible conflict of interest between the REIT side that wants to transfer at that timing and the former owner who would not want to be taxed just yet. DownREIT and other methods were developed to avoid that problem, but other specific problems arise depending on the circumstances.

○ Countermeasures

The benefit of UP-REITs is that real estate property equity investors can convert their interest into cash anytime and can defer taxation until that time (from the REITs' point of view, the ease of property acquisitions). On the other hand, in the U.S., challenges have also been pointed out, such as the use of a complicated structure for enjoying that benefit and conflict of interest issues pertaining to the timing of taxation on the equity investor and REIT sides. In

Japan, so that such challenges are not faced, direct taxation deferment (reduction entry of investment units, as well as investment unit options and investment in kind) shall be introduced as a system and linked to blue-chip real estate development and other urban policies in an aim to create a J-REIT market that can support urban development by utilizing private funds.

<Image of Measures ⑥>

Promotion of Investment of Public Pension, Etc.

○ Present State

While expectations are placed on pension, life/non-life insurance and other funds under management as lenders of long-term funds to the real estate investment market, such investment assets still account for a low percentage of real estate investment compared to overseas.

○ Issues

With the real estate investment market size being insufficient yet, losses being incurred from real estate investment in the past, etc., the circumstances make it difficult to proactively consider real estate investment. In particular, little real estate investment is made in the case of many public pensions.

○ Countermeasures

Along with expanding the market size of J-REITs, etc. while taking into consideration investment needs for long-term and stable management, there is a need to encourage public pension and other funds.

<Examples of Initiatives>

- Enhancement of management governance and clarification of diversified investment policy to ensure rational investment under appropriate risk controls
- Marketing to relevant organizations by leaders and other strategic encouragement
- Promotion of establishment of unlisted REITs

<Image of Measures ⑦>

Holding of Joint Study Sessions by the Ministry of Land, Infrastructure, Transport and Tourism and Financial Services Agency

○ Present State

Sound growth of the real estate investment market is important not only for revitalization of Japan's financial market and financial industry, but also for urban renaissance and regional revitalization through ongoing stable fund supply.

○ Issues

The "fusion of real estate and finance" is only in name due to vertical divisions of policy, vertical divisions of industry, vertical divisions of the market, etc., and the real estate market and financial market are not appropriately linked.

○ Countermeasures

There must be stronger policy coordination between the MLIT (real estate administration) and Financial Services Agency (finance administration) by establishing a forum for study between the two and while appropriately discerning market conditions. The forum for study needs to conduct regular discussions on the ideal form of J-REIT and other real estate securitization techniques, an appropriate vehicle taxation system and other challenges facing the real estate investment market and reflect budget, tax and institutional reforms, etc. into concrete initiatives. In addition, upon discussions, wide expert opinions should be sought through such means as posting a summary of the studies (suggestions), etc. on the website, etc.

Reference Material 1

[Related Data]

Changes in CMBS Issuance Amount

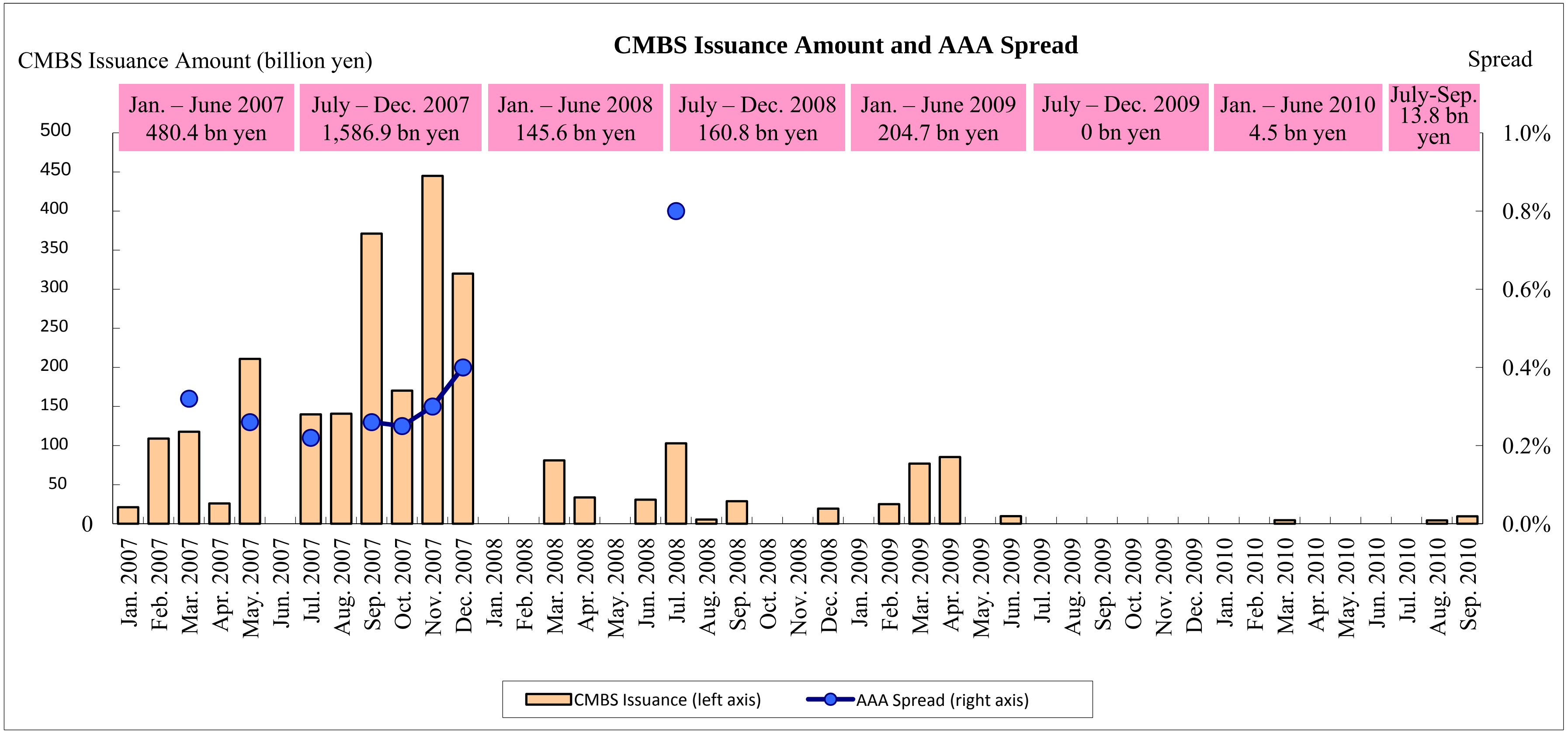
*Commercial Mortgage Backed Securities (CMBS): Securities backed by mortgages on loans for commercial real estate. Rental income from the commercial real estate, etc. serves as the source of principal and interest payments.

2007: 2.07 trillion yen

2008: 0.31 trillion yen (− 85.2%)

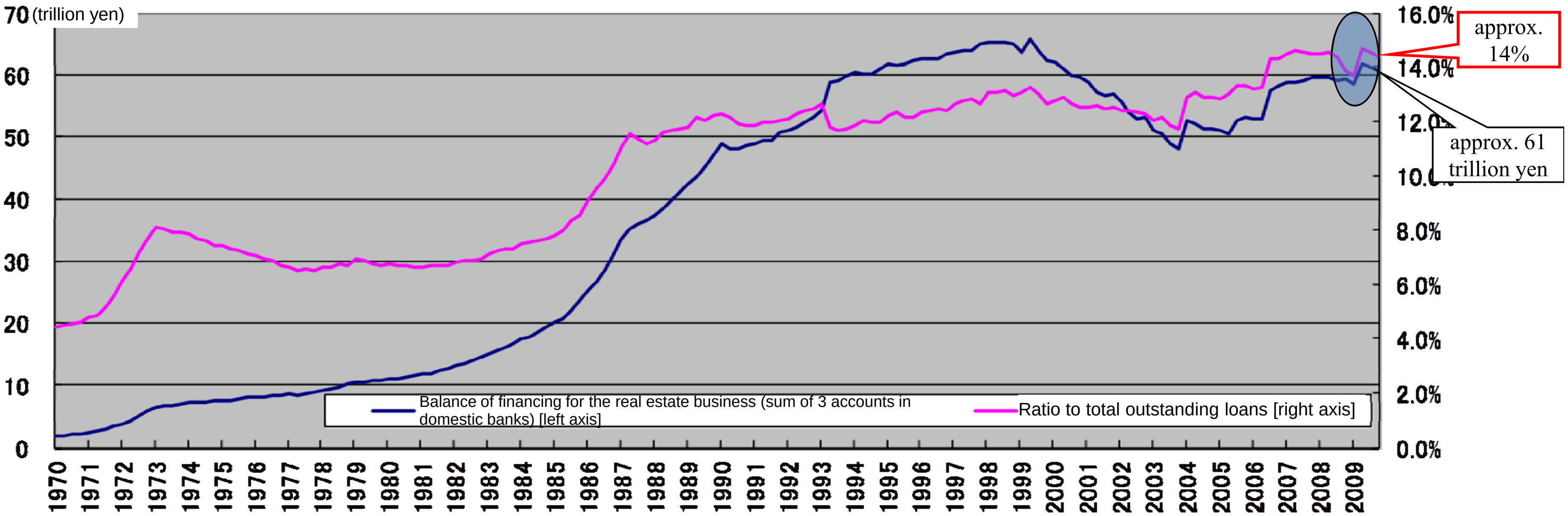
2009: 0.20 trillion yen (− 33.2 %)

【Source: STB Research Institute】



Status of Financing to Real Estate Businesses

In comparison to the late 1990s, the balance of financing related to real estate businesses by domestic banks is lower, but its ratio to total outstanding loans is higher.

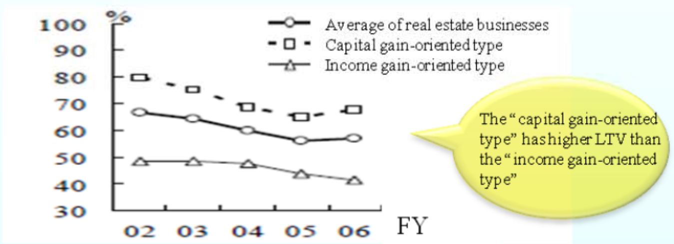


Environment surrounding real estate loans

It should be noted that the robustness of real estate businesses' balance sheets against an unexpected fall in real estate prices depends greatly on the type of real estate business. That is, real estate businesses are divided into two types: "income gain-oriented real estate businesses," earning profits mainly from income gains such as lease and management of real estate properties; and "capital gain-oriented real estate businesses," earning profits mainly from capital gains such as sales of developed real estate properties and dealings in properties

Excerpt from Bank of Japan "Financial System Report (September 2008)"

LTV Ratios of Real Estate Businesses

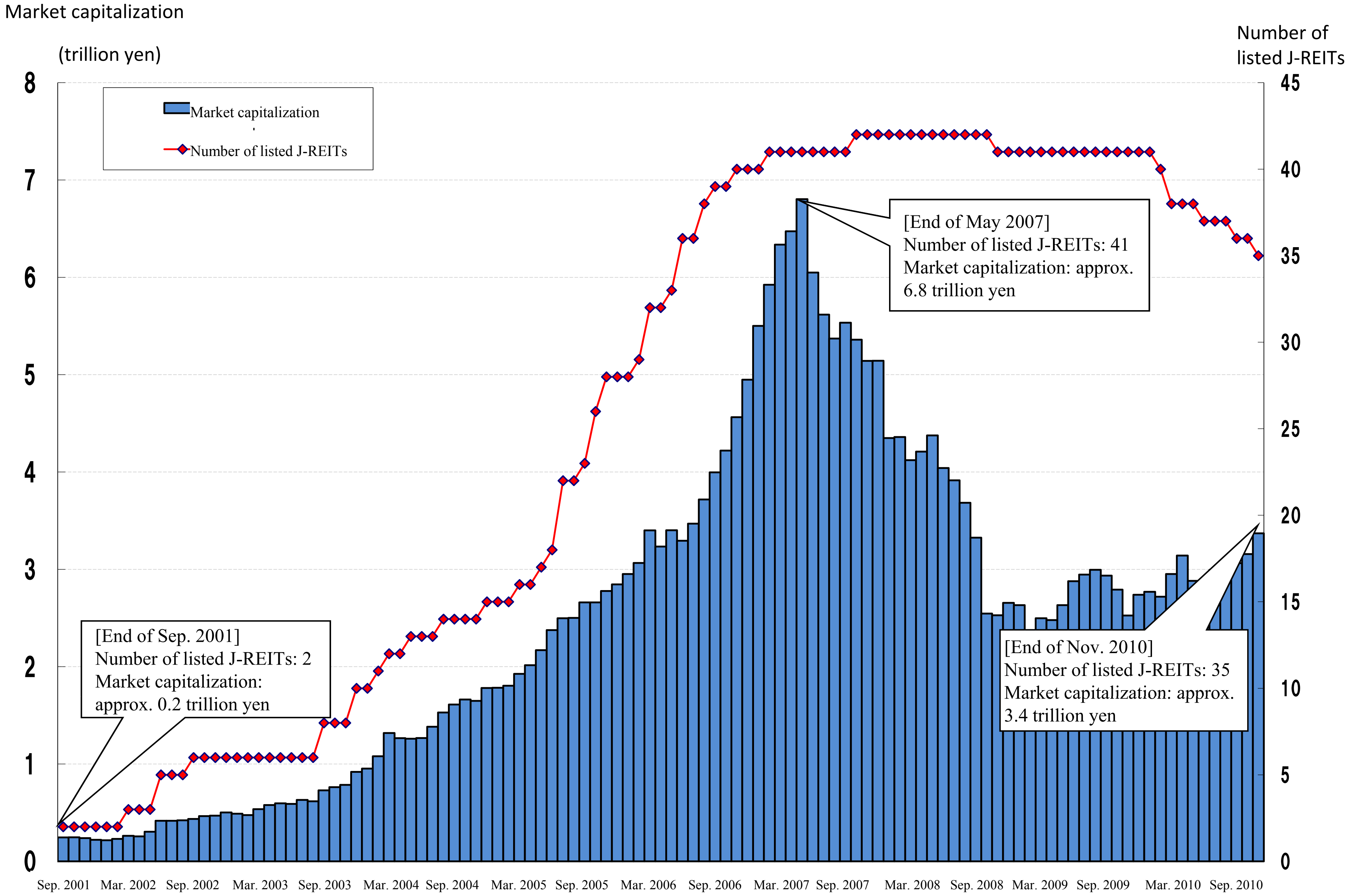


(Note 1) Bank of Japan estimation. LTV = (Interest bearing liabilities – Cash and deposits) / (Inventory assets + Income properties).

(Note 2) Figures are based on 68 consolidated companies listed from fiscal 2002 to 2006. "Capital gain-oriented type" businesses mainly earn profit from capital gain, for example, by selling real estate. "Income gain-oriented type" businesses mainly earn profit from income gain, for example, by leasing real estate properties or property administration.

Excerpt from Bank of Japan "Financial System Report (March 2008)"

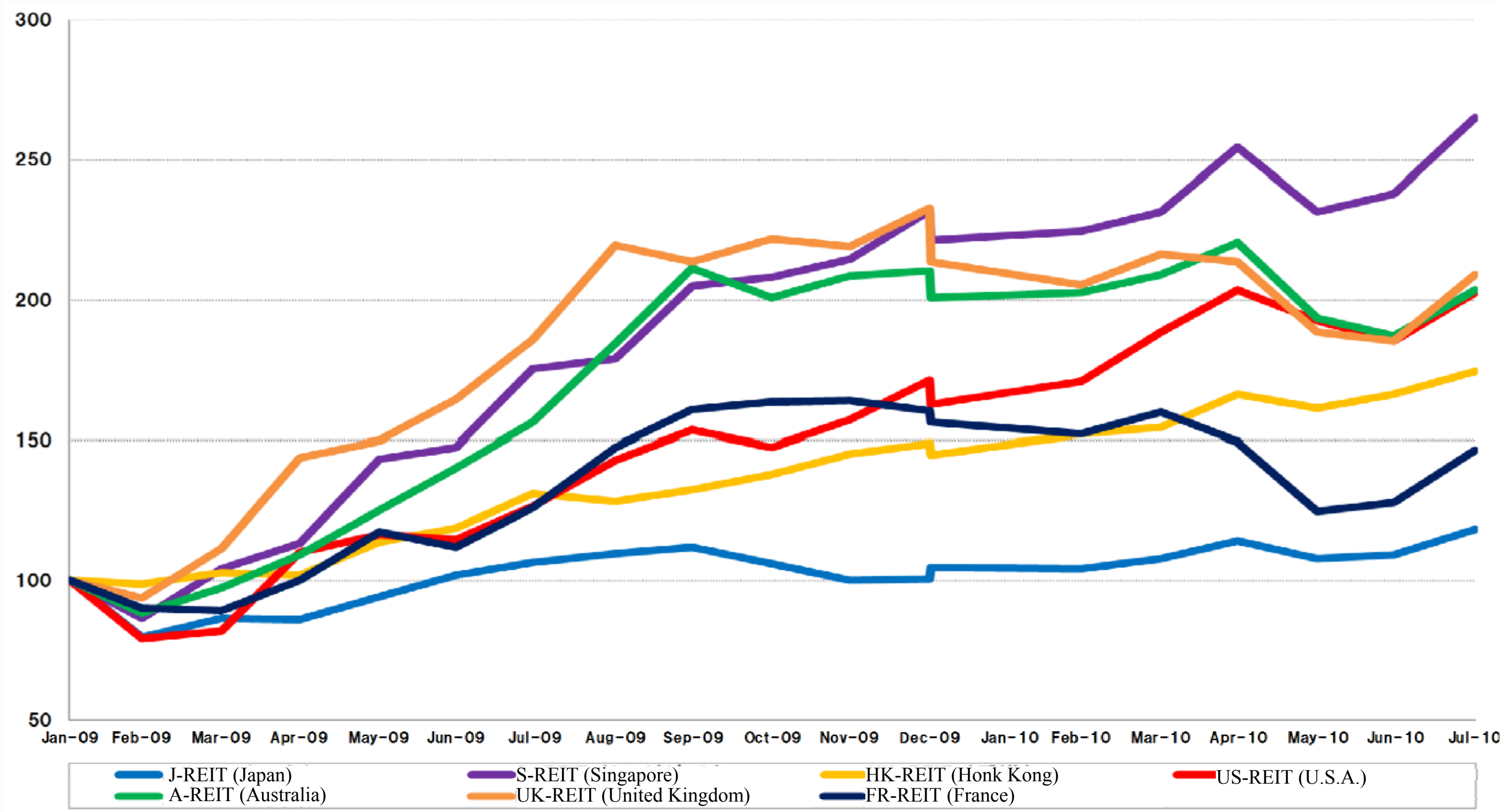
Market Capitalization and Number of Listed J-REITs



Comparison of Market Capitalization in REIT Markets of Various Countries

- The recovery after the Lehman Shock in the J-REIT market is delayed in comparison to other countries
- The REIT markets in Singapore and Honk Kong are growing rapidly

Changes in index value, with market capitalization of Jan. 2009 as 100



Changes in market capitalization

	US-REIT (1960~)	J-REIT (2000~)	S-REIT (1999~)	HK-REIT (2003~)
As of Apr. 2006	37,301.7 billion yen	3,471.1 billion yen	980.2 billion yen	635.4 billion yen
As of Apr. 2008	31,723.9 billion yen	4,208.9 billion yen	1,984.0 billion yen	899.3 billion yen
As of Apr. 2010	27,640.3 billion yen	3,141.8 billion yen	2,122.8 billion yen	998.6 billion yen

Reference Material 2

[Expert Opinions from Interviews of the Committee on Real Estate Investment Market Strategy (Summary)]

Reference Material 2

Expert Opinions from Interviews of the Committee on Real Estate Investment Market Strategy (Summary)

<1st Meeting>

[Commercial Real Estate Finance Council (CREFC)]

- Same as the documents published on the website

<2nd Meeting>

[Dalton Advisory K.K.]

- It can be said that the development of J-REITs up till now has helped increase the transparency of real estate transactions and lowered the risk premiums, and, as a result, it has assisted in raising the presence of the Japanese real estate market in the international arena.
- However, from the investment management perspective, and with regulatory issues on the financing side, weakness from the governance aspect, as well as the market environment where the credit capability of sponsors have been emphasized rather than relationships with sponsors, it must be noted that this growth has been accompanied by distortion.
- In order to achieve further development of the J-REIT market in the future, the evaluation axis of market participants needs to shift over more to the value of assets and management capability. In order to do so, deliberations must be conducted on strengthening governance as an important step. Sponsor companies no doubt hold interdependent relationships with the development of J-REITs, and I would like to note the fact that the view is finally spreading that a high evaluation of REITs from the market is a necessary condition within a comprehensive strategy.
- Recently, the real estate market has entered into the recovery phase. The market is watching carefully to see how J-REITs will grow, such as what types of assets they will acquire with what level of prices. Rather than acquiring real estate at a lower price than the appraisal value at the peak of the cycle, fundamentally, I think that acquiring such assets at a slightly higher price than the appraisal value at the bottom of the cycle should be more highly evaluated.
- There is plenty of room for REITs to further develop by flexibly evolving the ideas of participants. Some examples are, allowing greater flexibility in financing, improving internal management methods, deliberating the introduction of the UP-REIT scheme of the U.S., and establishing self-regulatory organizations, among other things. Furthermore, there is no room for doubt that the development itself of J-REITs will encourage the inflow of investment funds into the entire real estate market, and contribute to the prosperity of the Japanese nation.

[Office for Promotion of Regional Revival]

- Same as the documents published on the website

<3rd Meeting>

[The Association for Real Estate Securitization (ARES)]

- Due to the introduction of real estate securitization, a new industry of real estate investment management business was formed, and it has played a prominent role in urban regeneration. However, it has slowed down after the global financial crisis.
- By providing domestic savings with real estate or infrastructure that have stable cash flow through the real estate investment market, a situation will be created where funds are provided with higher risk development projects. By the creation of this type of benevolent cycle of funds, urban regeneration will make progress, and the international competitiveness of large cities, which are the drivers of Japanese economic growth, will be enhanced.
- A national consensus regarding the view that "in order to achieve growth of the Japanese economy, revitalization of the real estate investment market is absolutely necessary," is lacking. As a result, the long-term growth strategy of Tokyo, or the growth plan for the Japanese financial industry has not been made clear, and things have been left neglected without having established a consistent philosophy concerning the design of the investment-related system.
- A change in awareness is necessary, which involves the creation of a national credo on urban regeneration, re-evaluation of the role of the real estate investment management business, and a change in mindset pertaining to the fund provision for real estate and infrastructure. The government should create a package of highly workable and detailed reforms, and promptly implement them one by one.
- As concrete measures, we would need the following to be implemented: Promotion of the growth of the J-REIT market, securing diversified investment within the pension system, development of a highly stable investment vehicle system, development of a system for attracting private funds into PPP/PFI, and establishment of an investment entity based on a government policy which would promote concentration on the investment service business and enhancement the business' functions.

<4th Meeting>

[Japan Securities Dealers Association (JSDA)]

- We at the JSDA formulated the "Regulations Concerning Distributions, etc. of Securitized Products" and the "Standardized Information Reporting Package" (hereinafter, "SIRP") in March 2009, and enforced them in June of the same year. The idea of this action was that, although there have been no cases in the Japanese securitization market where the complexity of the formulation of securitized products has resulted in a problem in localizing risk as has occurred in the U.S. market, it was important to take precautious measures to ensure that the problem did not occur in future.

- Under the “Regulations Concerning Distributions, etc. of Securitized Products”, members of the JSDA are required to establish procedures to properly communicate information to their customers who are investors, concerning the details and risks of the underlying assets, etc. of the securitized products that they distribute.
- Furthermore, SIRP was prepared concerning the following 4 types of products, for the purpose of aligning the viewpoint of information. It states that a member may use SIRP as a reference if it judges that its use as a reference is appropriate in communicating information to its clients.
    - RMBS (securitized products backed by Japanese housing loans)
    - Narrowly defined ABS (securitized products backed by Japanese lease and credit receivables, etc.)
    - CLO (securitized products backed by pools of corporate loans, etc)
    - CMBS (securitized products backed by Japanese commercial real estate loans)
- By enhancing and standardizing the information communicated to clients who are investors, the traceability of securitized products would be ensured, and it is expected that this would contribute to the development of the sounder securitization market.

[Tokio Marine Asset Management Co., Ltd.]

In order to improve the business environment for J-REITs, and expand its market, we think that the following responses from the system aspect are possible:

- One possibility is to permit J-REITs to receive profit from real estate development. However, by permitting this, it is possible that the risk-return characteristics of J-REITs will significantly change.
- It is possible that granting tax incentives on the side of contributors of property, as in the UP-REIT scheme for U.S. REITs, will make the transaction of property more active.
- In order to allow origination of new types of real estate-owning REITs, the set-up environment should be improved from the system aspect by broadening the scope of targeted real estate and relaxing regulations.
- More leeway should be granted for retained earnings, especially retained earnings from capital gains on selling property, up to a certain limit in order to stabilize the management of J-REITs.
- A diverse means of financing should be made possible, including the acquisition of treasury investment units, capital increase via allotment, and issuance of CBs or preferred stocks.
- The difference between taxable profit and accounting profit needs to be eliminated, and the possibility of a corporation tax burden occurring needs to be eliminated.

- Rules on decreasing capital should be established, so that a decrease of capital can be conducted to compensate for losses at the time a large amount of losses is posted, other than refunds and dividends in excess of profit.
- Like overseas REITs, a situation needs to be created where J-REITs can become an investment target for many more types of investors (e.g. pension funds), and not just for individual investors, through their incorporation into stock price indices, so that the J-REIT trading market might be expanded.
- The prohibition of conflicts of interest transactions with sponsors, application of insider trading rules, and strengthening of governance (appointment of outside directors for asset management companies, etc.) are needed.

<5th Meeting>

[CB Richard Ellis Research Institute K.K.]

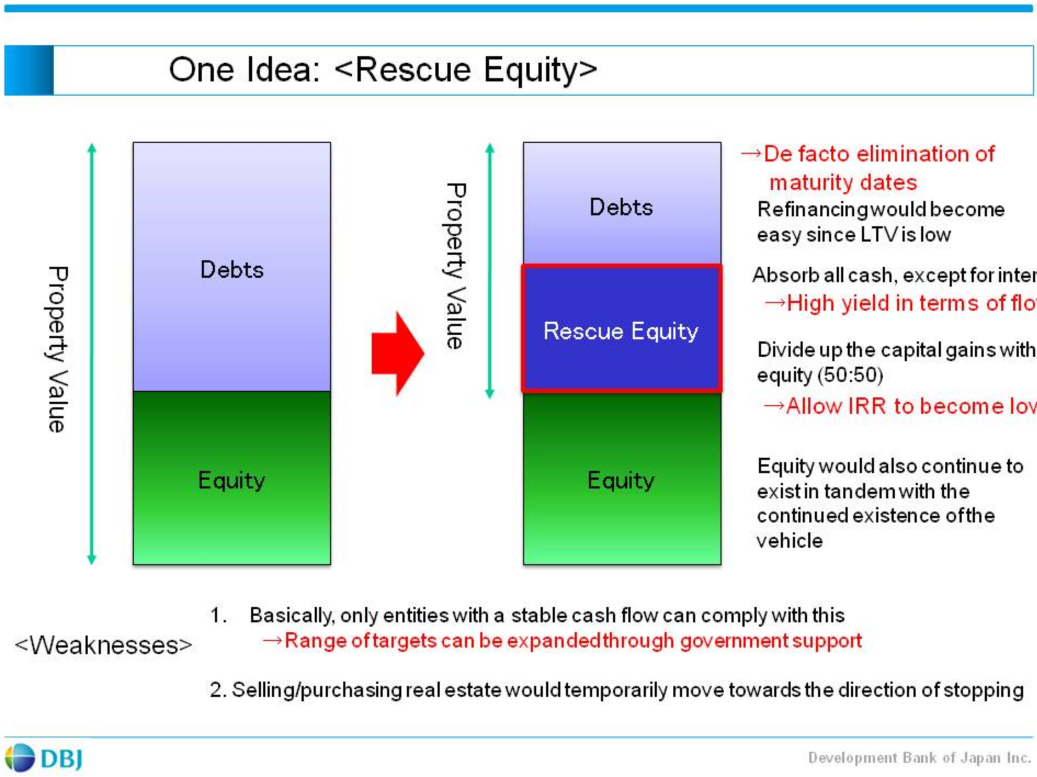
- The real estate investment market in Japan is not inferior to those in Europe or the U.S. in terms of size, stability or risk level. On the other hand, it is greatly inferior in terms of growth, yield levels, sufficiency of information and transparency.
- The same trend can be seen when compared to Asian countries. The Japanese real estate investment market is also inferior in terms of provision of incentives.
- In individual areas, a very negative evaluation is given for the areas of growth, cap rate levels and provision of incentives.
- With regards to sufficiency of information, a positive evaluation is no different than Hong Kong and Singapore, but with the case of Japan, the degree of negativity is high.
- In terms of the availability of information, Japan is underestimated following China.
- The disparity between sectors in terms of information disclosure level is large.
- The lack of transparency of the ordinary leasehold system is also an issue.
- The contradiction of the financing environment is perhaps incomprehensible to foreign investors.

<6th Meeting>

[Mori Building Co., Ltd.]

- Same as the documents published on the website

[Development Bank of Japan Inc.]



[GIC Real Estate International Japan KK]

- Non-disclosure of summary

<7th Meeting>

[Osaka Gas Co., Ltd.]

- Non-disclosure of summary

[Moody's Japan K.K.]

- Same as the documents published on the website

[Tokyo Stock Exchange, Inc.]

- TSE's J-REIT market is based on the clear concept of providing investment opportunity to investors with the intention of making "virtual" investments in real estate. In our listing regulations, we have set forth provisions on listing criteria, delisting criteria and timely disclosure requirements.
- For listing criteria, there are various criteria, such as soundness of governance structure of the asset management company, and the ratio of real estate and related assets to total assets under management. Delisting criteria include among others, liquidity and financial status.
- In order to secure market transparency and to protect investors, we require timely disclosure in the same manner as for the issuers of stock, concerning information on the investment

corporation and assets under management.

- Since the launch of the J-REIT market in September 2001, we have revised listing regulations to respond to various market needs while striving to protect investors. Some examples are making listing examination process more transparent and sufficient, enforcing disclosure of asset management structure and functioning, and tightening regulations on timely disclosure. On the other hand, we have deregulated delisting criteria pertaining to assets under management in order to provide a higher degree of freedom in managing assets.
- Issues related to expansion of J-REIT market are how to increase in the number and breadth of investors (e.g., degree of awareness of individual investors and trust from foreign investors), and how to supply products that are even more attractive (e.g., making necessary changes in legal framework to increase financial stability of investment corporation through permitting alternative financing methods and more earnings to be retained, and providing a diverse array of products to the market).
- TSE’s recent activities to expand the market are promotional activities targeting domestic individual investors and foreign institutional investors, creation of new J-REIT-related indices, establishment of TOKYO AIM, a market dedicated to professional investors, and revision on listing rules that goes in tandem with legal deregulation to permit alternative financial methods.

[Japanese Association of Real Estate Appraisal]

- With the environmental changes surrounding the real estate market (globalization, trend of the “stock economy”, metropolitan regeneration, etc.), responses to new market needs are being required. We would like to appropriately address these, and measure up to expectations from society and the public by fulfilling our social responsibility and by carrying out social and economic activities.
- We are deliberating on the ideal way of appraisal that would fulfill these purposes, and are currently in the process of formulating a vision for the real estate appraisal business which will serve as a guideline.
- Due to the trend of the “stock economy” and the demographic movement, the involvement of individuals with real estate has changed dramatically. As a result, the real estate market has become familiar to individuals, and needs for various market information at an individual level have started to appear. Today, real estate appraisers are required to proactively address these needs.
- On the other hand, with regards to organizations, needs have arisen which have a great impact on the interests of multiple users behind a client, and appropriate responses are required, such as appropriate responses to new needs for asset appraisals in corporate accounting or public accounting, and responses to various needs from the perspective of investors based on legal valuations in the real estate investment market.

- The aforementioned new needs are common globally. Therefore, there is a need to establish a system for allowing foreign users to easily comprehend the Japanese appraisal system, or further its consistency with foreign appraisal systems. At the same time, there is a need to make an economic contribution in the broad sense, by encouraging East Asian and ASEAN countries to actively use the land system as infrastructure, including the appraisal system.
- Under the real estate appraisal system, appraisers are required to sufficiently fulfill responsibilities towards the client. The valuation results influence multiple users, let alone the client, and without trust, the system cannot survive. Trust can only be earned by holding an appropriate relationship with the client, and so we would like to pour effort in improving the system in order to ensure this.

<Hearings from Individuals>

[Ernst & Young Shinnihon Tax, Mr. Kyoji Yamamoto]

Review of J-REIT Taxation (Reform Requests)

[1] Suggestion for Avoidance of the Taxation Occurring from Differences between Tax and Accounting treatment

- J-REITs will incur a larger tax burden than regular corporations when there are differences between tax and accounting treatments. This may arise where certain expenses such as impairment loss and amortization of asset retirement obligations are not deductible expenses for tax purposes. In such a case, J-REITs may be taxed at the rate of 86.18% because of tax on tax.
- In major foreign countries, REIT is not actually taxed due to discrepancies between tax and accounting treatments. This means that J-REIT has less competitive in global REIT market.
- A J-REIT with accumulated retained earnings driving from extraordinary in connection with a merger may be able to make dividend distributions in excess of the amount of the discrepancy between tax and accounting treatment. J-REITs without accumulated retained earnings are in jeopardy of taxation due to discrepancy between tax and accounting treatment, such as impairment loss.
- Due to future changes in accounting standards, “profit” under the accounting standards may be lower than before, but the equivalent amount of cash flow will not decrease. I suggest that the profit should not be taxed if J-REITs make a distribution of monies equivalent to profit before impairment loss.
- Since J-REITs are also permitted to deduct deemed dividends (including return of capital deemed to be dividend distributions for tax purposes) as a deductible expense under the tax laws such taxation can be avoided by making a large amount of deemed dividends, in case where a discrepancy between tax and accounting treatment occur.
- If J-REITs make “Distribution in Excess of Earnings,” allowed under the Investment Trust and Investment Corporation Law, a small amount of deemed dividends arises under the

current tax laws . However, as this is too small compared to the total amount of the distribution in excess of earnings, I recommend changing the computation formula so that all distribution amounts in excess of earnings can be treated as dividend distributions for this purpose.

- For that portion, unitholders will be taxed as dividend income. However, by treating all return of capital as dividends, the complicated calculation of capital gain/loss on distribution in excess of retained earnings, or adjusting the book value to the following period after return of capital, will be relieved. Due to this merit, I believe that unitholders themselves will express little dissatisfaction.

[2] Introduction of an Advanced Depreciation System for Investment Units

- In the place of building owners who do not have enough funds, if J-REITs who have enough funds renovate buildings in their stead, those buildings may be possibly revived as assets with high added value.
- However, building owners who possess leasing real estate with unrealized gain seem not to be able to dispose the real estate to avoid taxation on such capital gains.
- As such, I want to request that an “Advanced Depreciation System for Investment Units” be established. In the event that a real estate contribution in kind is made to a J-REIT and the contributory receives investment units issued by the J-REIT in compensation, under this system, capital gain taxation is deferred until the time the contributory sells those investment units.
- However, under the current Investment Trust and Investment Corporation Law, making a contribution in kind to J-REITs is not permitted. As a consequence, it is conceivable that building owners first sell real estate to J-REITs, and then acquire investment units with those proceeds.

[Zeirishi-Hojin PricewaterhouseCoopers, Ms. Akemi Kito]

- Under accounting terms, an absorption-type merger of investment corporations is based on the purchase method. This is where the surviving corporation acquires the assets and liabilities of the dissolving corporation at market value, and there is a possibility of recognizing goodwill at the time of the merger. On the other hand, under the tax system, in the event of a qualified merger, the treatment is that the surviving corporation has succeeded the assets and liabilities of the dissolving corporation at book value, and goodwill is not posted at the time of the merger.
- Due to differences of the treatment between accounting and taxation concerning the acquisition prices of assets and liabilities, or goodwill posted, the surviving corporation may be taxed a levy. For example, in the event that there are assets succeeded at the time of the merger with a market value that is higher than its book value, the acquisition price of the said assets under accounting terms will exceed the acquisition price of the said assets under

the tax system. Thus, depending on the depreciation or amortization posted, or timing of selling them, a situation arises where taxable income exceeds accounting profit. According to the present tax system, since only dividends paid out from the accounting profit is in actuality deductible as an expense, the amount that taxable income exceeds accounting profit is taxable to the investment corporation. ("Deemed dividends" are also allowed to be deducted as an expense, but since the current corporation tax system is also applicable to investment corporations, "deemed dividends" do not actually arise from the amount of distributions which exceed accounting profit.)

- In the future, in order to energize and facilitate the reorganization of the J-REIT market, the government needs to establish a measure to avoid taxation which accompanies the discrepancies between the account processing and tax processing for mergers. In view of the introduction of IFRS etc., the situation is moving toward a greater difference occurring between account processing and tax processing. Therefore, rather than creating individual measures by identifying and responding to each source of difference, the measure needs to be a comprehensive one, covering the entire spectrum, in preparation for differences occurring between accounting and taxation rules.
- There is an urgent need to establish a policy for effectively resolving taxation which accompanies discrepancies between accounting and taxation rules by allowing a certain amount of additional payment. For example, in the event that taxable income exceeds accounting profit, and if distribution in excess of earnings is carried out, an amount no larger than the taxable income can be recognized as deemed dividends on a priority basis.

[Sakura & Co., Mr. Takafumi Inaba]

- Goodwill or negative goodwill arises when REITs merge. Under the current tax system, goodwill is not accounted for in determining satisfaction of conduit requirements. While negative goodwill is accounted for to an extent, the period for recognizing distributions of the amount equal to negative goodwill is fixed (100 year-amortization method, or land-linked method).
- Negative goodwills are arising in REIT mergers that are currently being executed and there are needs for using that negative goodwill for maintaining stable distributions and other purposes (covering losses incurred from capital losses on property, etc.). Furthermore, while goodwill is not arising in REIT mergers that are currently being executed. In the future, there remains the possibility that goodwill will arise for mergers during phases when investment units are rising.
- In the event negative goodwill is used to maintain stable distributions and other purposes, under the current tax system, there is the likelihood that a lack of dividend resources will arise at the time when distributions equal to the necessary amount of negative goodwill must be recognized. Furthermore, with regards to goodwill, only goodwill under accounting terms

is posted, and a difference arises between accounting and taxation treatment concerning the amount equivalent to amortization expenses. Therefore, taxation on taxable income which exceeds the accounting profit may occur.

- Mergers between REITs would not only contributed to the soundness of REITs' finances, or enhance the REIT market, but they are also thought to energize real estate trading through the restructuring of portfolios, etc. after the mergers have taken place. Therefore, it is far from agreeable that goodwill and negative goodwill arising from a merger should become a threat to the satisfaction of conduit requirements.
- In conclusion, it is desirable that a measure to eliminate the factor of instability in the tax system in connection to mergers (Examples of individual responses to the abovementioned issue are: recognition of a treatment similar to impairment loss be permitted for goodwill, allowing flexibility in terms of the period for recognizing distributions with regards to negative goodwill, and recognizing distributions which exceed profit as deemed dividends under the tax system as a response towards the general issue of the causes behind differences between accounting and tax practices, etc.) be implemented.

<8th Meeting>

[Pension Fund Association]

- Non-disclosure of summary

[Mitsubishi Estate Co., Ltd.]

1. Concerning the Real Estate Investment Market

To expand the size of the market, an increase in the supply of high-quality, income generating real estate asset , and participation of long-term perspective investors are necessary.

<Activities to Expand the Market Size>

(1) Improvement of the Legal Infrastructure to Promote Development and Regeneration of Real Estate

Revision of the Real Estate Specified Joint Enterprise Act, granting incentives for the supplies of *kizon futekikaku* real estate (real estate that no longer conform to the law but are not categorized as illegal structures) or buildings built based on former seismic codes, relaxation of fixed property taxes, etc. during the development period, etc., and relaxation of fixed property taxes, etc. for environmentally-friendly buildings.

(2) Improvement of the Securitization Scheme

Mitigation of the impact from the difference between taxable profit and accounting profit, introduction of measures to be able to deduct reserves as expenses to allow the build-up of retained earnings, and continuation of the relief measure for real estate transaction tax

(3) Expansion of Investor Class who Desire Long-term, Stable Yields

Making appeals about the attractiveness of products by continuously spreading information

(4) Introduction of Long-term Funds of Pensions, etc.

Establishment of a system for diversified investment, and real estate investment through public funds

(5) Prompt Response to Globalization

Promotion of real estate investment from overseas, creation of a structure for promoting participation of overseas players, and the development and spreading of real estate indices.

2. Concerning Urban Regeneration

<Measures to Strengthen the International Competitiveness of Tokyo>

(1) Selecting areas that would assist the realization of growth strategy, or that would strengthen the competitiveness of Tokyo, and positioning them as a national priority.
“Haneda-Shinagawa-Tokyo City Axis”

(2) Establishment of a structure of supplying on a priority basis long-term, stable funds to responsible entities which would contribute to the speedy and fundamental formation of bases and enhancement of city value (Area Management)

(3) Introduction of a comprehensive measure to create demand (Budget measure for developing large-scale transportation infrastructure, etc., relaxation of the tax system, including reduction of corporation tax, relaxation of various regulations, and others)

[Organization for Promoting Urban Development]

- Same as the documents published on the website

[Trust Companies Association of Japan]

(1) From the Standpoint of an Intermediary

- As long as the current situation of the real estate investment market continues and the overall market pie does not grow, the only choices left are to cut costs or take risks. In that sense, we are concerned that the growth potential of the economy as a whole is very poor.
- Currently, the REIT market is the de facto driving force behind the real estate investment market. From that point of view, we feel that the speed of growth of the REIT market is a little slow. It is conceivable that the underlying problem concerning this is the “liquidity or ease of converting products to cash,” and “trustworthiness” of the real estate investment market. With regards to REITs, it is conceivable that the issue of “liquidity or ease of converting products to cash” is covered for by the system. On the other hand, with regards to how to nurture trust for the real estate investment market from general investors, there remain probably many issues. With regards to this point, it is desirable to carry out the necessary developments of a system.
- Another major issue is that the evaluation of REITs is greatly influenced by the stock market.

REITs tend to be viewed as belonging to the same category as stocks through which investors try to aim for capital gain. It is desirable that the difference between the two be questioned to society, and that evaluations are made which indicate pure real estate value.

(2) From the Standpoint of a Trustee

- Society's evaluation towards the business of being entrusted with property and managing them is slightly low, and when combined with the competition between trust companies, fees are starting to drop to a large degree. In order to maintain the trust of investors towards securitized products, it is desirable that an appropriate trust fee can be secured.
- With regards to building renewal and redevelopment projects, we discuss the entrustment of properties by closely examining the properties. In order to secure profit during development, it would be appreciated if provision of assistance be considered to help fill in the time lag of revenues.

(3) General View

- Earning the trust of investors is integral to expanding the market.
- Another issue is how to promote an inflow of from Japanese individuals to the market.