Japanese market outlook – aftermath

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Having already been hit by the global economic turmoil, activities in the Japanese investment markets, whether stock markets, the bonds market, or commercial mortgage-backed securities (CMBS) and other real estate related securitisation markets or asset-backed securities (ABS), residential mortgage-backed securities (RMBS) and other more conventional securitisation markets, were undoubtedly affected and slowed down by the devastating earthquake and tsunami that hit the North East coastal part of Japan on March 11, 2011, as well as the ensuing nuclear power plant's fall-out crisis. While more than a year has passed since the catastrophe and although we have been seeing signs of the securitisation market coming back to the pre-global financial crisis level, we have yet to see a full recovery as there are still less than desirable investment activities in Japan in general and especially in terms of securitisation and other structured finance transactions.

Overview of Japanese financial markets

The general sense is that the debt market has especially been affected by the catastrophe and that, as the securitisation market's viability naturally is affected by the general debt market, the securitisation market has been relatively quiet as a result. The difficulty being experienced by the debt market in general is said to be due to, at least partially, the fact that there have been extreme difficulties in the new issue of electric company bonds (or electric power bonds) in the publicly offered bonds market. Prior to the nuclear crisis, electric company bonds in Japan amounted to approximately 20% of the overall Japanese bonds market in terms of outstanding amount size and with electric companies highly rated (for example, Tokyo Electric Power Company (TEPCO) was rated in the range of AA+ and Aa- by various rating agencies prior to the nuclear power plant's fall-out crisis), electric company bonds historically functioned as one of the benchmark issues.

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Following the nuclear power plant crisis, understandably, investors, other than distressed investment investors, had virtually no appetite for electric company bonds and the credit ratings assigned to electric companies continued to take a steep slide.

With the debt market in general experiencing a never-before seen heightened sense of uncertainty in terms of its outlook and perhaps with more than necessary caution paid by investors to the risks in relying on credit ratings assigned by the rating agencies, it is believed that debt investors are being more cautious than ever towards securitisation products; so cautious that, although with the confusion of the debt market resulting in a few issues of bonds with attractive yields, investors are investing largely in the safest investments such as Japanese government bonds, unable to find investments with a more appropriate risk profile yielding higher profits.

However, the main reason for the securitisation markets staying relatively quiet is more likely due to the fact that the Japanese economy has been in an environment where the going interest rate has been close to zero for a very long time and also the fact that the nation has yet to bail itself out of its long lasting deflationary trend. That is, amid the trend where bank loans are financed at a much lower rate than securitisation financing, companies are intent on pursuing securitisation financing and, therefore, fewer originators will look to issue securitisation products.

Governmental efforts to invigorate investment markets

The government is well aware of the less than optimal activity in the investment markets and has been promoting further regulatory developments as a part of its efforts to kick-start the markets. Specifically, the government adopted action plans to relax regulations and enhance market activities, which are being followed in accordance with its action plans such as the implantation of various measures to relax regulations and enhance market activities. Steps aimed at revitalising securitisation markets, including real estate related securitisation markets so as to revitalise the overall Japanese real estate markets, constitute one of the focal points of those actions. Examples of these efforts include the amendment to the Asset Securitisation Law (ASL). In addition, there are continuing discussions regarding the implementation of a relatively comprehensive amendment to the Investment Trusts and Investment Companies Law (the 'Investment Funds Law').

Amendment to the ASL

A Tokutei Mokuteki Kaisha (TMK) is a special-purpose company incorporated under the ASL. Its increasing use for real estate investments started well before the recent global economic turmoil had its effect on the Japanese market. However, deal structures adopting TMKs were generally considered less flexible, particularly in light of the regulations related to asset liquidation plans (ALP) mandated by the ASL. Naturally, recent efforts by the Japanese government included certain amendments to the ASL aimed at making the TMK structure more flexible, which was brought into effect in 2011 and which in turn is expected to attract more investment deals to be implemented using TMK structures. Specifically, the ASL amendments in 2011 include, *inter alia*, (i) relaxation of the regulations on effecting amendments to ALPs, (ii) relaxation of the regulation on use of proceeds of a loan extended to TMKs and (iii) relaxation of the regulations on asset acquisitions by TMKs.

Relaxing regulations on effecting amendments to ALPs

Generally speaking, prior to the 2011 amendment, a TMK needed to obtain the consent of all the interested parties, including both its equity investors as well as debt-investors (i.e., lenders and bondholders), in order to amend its ALP. And, as to the practical burden on TMKs, a TMK was also required under the ASL to file every amendment of its ALP with the relevant government authority, namely a local financial bureau having jurisdiction over the TMK.

The 2011 amendment, on the other hand, introduced an exception to the foregoing general rule that now allows a

TMK: (i) to amend certain items in its ALP if the ALP itself indicates that such items may be amended merely by a decision of the TMK (i.e., its director or directors, as the case may be) and (ii) to not file certain minor amendments to its ALP with the government authority. However, it is also important to note that the new exception only extends to certain items described in the ALPs. Basically, matters that are deemed to be integral or fundamental to investors' investment decisions described in the ALPs may not be amended using the exception as investors will be deprived of their 'say' in amending the ALP if the TMK is allowed to amend on its own. Although, this has already been criticised as simply being paternalistic as investors can easily protect themselves against such issue by incorporating a contractual arrangement that prohibits the TMK from amending its ALP without the prior consent of the investors.

Relaxing regulations on the use of loan proceeds

Debt financing achieved by TMKs are classified into two categories: (i) bonds, which are called 'specified bonds' that are automatically secured by a general lien unless the relevant ALP provides otherwise and (ii) loans, which were called 'specified purpose loans' prior to the 2011 amendment and are now called 'specified loans', which are unsecured debts. Prior to the 2011 amendment, one of the relatively significant issues surrounding 'specified purpose loans' was that there was a regulation on the use of loan proceeds that mandated the proceeds to be used solely for 'acquisition of the asset described in the relevant ALP' resulting in ambiguity or uncertainty in whether refinancing by a subsequent loan of the initial loan is permissible. Thus the 2011 amendment has abolished the regulation and now allows 'specified loans' to be used for refinancing purposes.

Relaxing regulations on the subsequent acquisition of additional assets

Another criticism of the inflexibilities of TMK structures centred around the regulations on acquisitions of assets by a TMK including without limitation, (i) a general prohibition against the acquisition of partnership interests, (ii) practical burdens placed on acquisitions of movables that are appurtenances to real estate, (iii) legal uncertainty surrounding a subsequent acquisition by a TMK of additional assets and (iv) the requirement that two separate appraisals be obtained when a TMK is to acquire real estate.

Acquisition of partnership interests

The ASL, even following the 2011 amendment, generally prohibits TMKs from acquiring partnership interests, including *tokumei kumiai* interests (or TK interests). However, the 2011 amendment has expanded the exception to this general prohibition and now allows a TMK to acquire a partnership interest (or TK interest) as a part of its investment for securitisation purposes if the relevant partnership's business concentrates on acquisition and investment in real estate or trust beneficial interest in real estate, on the condition that the partnership prohibits itself from subsequently acquiring additional real estate.

Appurtenances

Prior to the 2011 amendment, acquisition by a TMK of moveables such as furniture, fixtures and equipment of a hotel or serviced apartment, even when acquired together with the relevant real property in which such moveables are located, were treated the same as acquisition of moveables independent from any real property and, therefore, were subject to the requirement under the ASL that the moveables be described in the ALP, item by item, as well as the requirements that the moveables be placed in trust with a trustee and that the TMK acquire a trust beneficial interest in such moveables.

While the practical solution was to work around the requirements by, for example, incorporating a master lessee of the acquired property into the deal structure and letting the master lessee acquire the moveables as opposed to the TMK acquiring the moveables, this was of course less than optimal as investors, equity investors or debt investors, would rather have the TMK directly own the moveables, especially if the investments are premised upon the value of the cash flow generated from the business run by the relevant real property. Thus, the 2011

amendment, now allows a TMK to acquire 'appurtenances' to real estate without any need to adopt a trust arrangement and the acquired appurtenances are not required to be described in the ALP item by item.

Acquisition of additional assets

Historically, there were certain ambiguities or legal uncertainties in a TMK's subsequent acquisition of additional assets. That is, although there is no clear prohibition within the statute, rather, there are provisions in the statute that seem to suggest otherwise, it has been generally perceived that a TMK was prohibited from subsequently acquiring additional assets after the initial acquisition, unless the additional assets were sufficiently identified within the initial ALP, except where the additional assets were closely related such as being geographically adjacent to the assets initially acquired by the TMK.

The 2011 amendment to the ASL is believed to have addressed, albeit indirectly, such ambiguities and now the ASL clearly allows a TMK to amend its ALP purporting to provide for subsequent acquisition of additional assets that were initially not described in the ALP. To elaborate, while the 2011 amendment still does not state clearly whether or not the subsequent acquisition of additional assets by a TMK is prohibited, the 2011 amendment has added a provision to the statute that stipulates that a TMK is required to file with a competent government authority having jurisdiction copies of certain contracts regarding the acquisition (purchase) and management of additional assets, together with the amendment to the ALP, when the TMK is to subsequently acquire assets.

One important caveat is that the Financial Services Agency, which has authority over the construction of and practical implementation of the ASL, publicly indicated during the legislative process of the 2011 amendment that it still takes the view that TMKs are generally prohibited, with the exception as described earlier, from subsequently acquiring additional real estate (only real estate and not a trust beneficial interest in real estate nor other asset classes), despite the amendment to the ASL, due not to the regulations under the ASL but due to the regulations on realtors and real estate investors.

Requirement to obtain two separate appraisals or opinions

The 2011 amendment has also addressed a long-awaited reconsideration of a costly regulation that had been in place since the introduction of the ASL. Specifically, the amendment has abolished a long standing regulation that required a TMK, when acquiring real estate or a real estate related asset, to obtain both an *ex ante* appraisal of the real estate (or the underlying real estate) by a licensed real estate appraiser or appraisal firm that it planned to acquire (and such appraisal was required to be referred to in its ALP and an additional report regarding the contracted purchase price of the real estate), which was also required to be referred to in its ALP. To no one's surprise, this had long been keenly criticised as not efficient cost-wise, resulting only in a paternalistic regulation without regard for the protection that investors truly sought as necessary.

Anticipated amendment to the Investment Funds Law

It is generally believed that the Japanese government is taking steps to implement a relatively comprehensive set of amendments to the Investment Funds Law in 2013 as part of the government's 'Action Plan for the New Growth Strategy' (December 24, 2010). While the majority of the amendments will most likely concentrate on regulations on investment trusts (which could be viewed as being similar to mutual funds), because the Investment Funds Law also governs Japanese real estate investment trusts (J-REITs), it is expected that various regulations and rules concerning J-REITs will also be amended.

While there are still no published proposals on the amendment, considering the contents of the discussions taking place at the Financial System Council, as publicised, the focal points are generally viewed as: (i) lifting prohibitions against the issuance of stock options, which also could be used in rights offerings (or rights issues),

convertible securities and class shares, (ii) permitting acquisition and holding of treasury stock, (iii) permitting the write-off of J-REIT shares without liquidation, (iv) the introduction of a mandatory 'independant' director, and (v) subjecting J-REIT shares to insider trading regulations.

Whether the anticipated amendment to the Investment Funds Law will aid the revitalisation of the J-REIT market may depend largely on whether or not the amendment described in item (i) earlier will materialise, as such lifting of prohibitions may significantly enhance the introduction of new types of J-REIT securities allowing investors to invest according to their risk profile and risk appetite.

Recent developments/works in the pipeline

Securitisation in solar power projects and wind power projects

Another offspring of the nuclear power plant fall-out crisis has been the Japanese government's renewed efforts in aiding and promoting the use of and electricity generation by renewable power sources such as solar power and wind power. With the government introducing a subsidy for renewable power projects through ensuring a certain fixed purchase price, many solar power projects and wind power projects are contemplated by various groups throughout Japan. Faced with the need to come up with the initial working capital, many of the project companies are looking to finance their projects using securitisation techniques. We may see quite a number of such transactions later in 2012.

Covered bonds and secured bonds

Unfortunately, the nation has yet to witness the materialisation of any covered bonds issue or any legislation or rule, despite the efforts, for example, by the Development Bank of Japan to lobby for the introduction of a covered bonds statute. However, with more investors turning their attention to and starting to discuss the need for securitisation products as well as straight corporate bonds secured by mortgages and pledges over specific assets, covered bonds may also become the focus of such discussions.

By way of background, bonds issued as securitisation products and straight corporate bonds are rarely issued as secured bonds. This is primarily because a mortgage or pledge securing bonds will trigger a need to comply with the Secured Bonds Trust Law, which would require the bonds to be held by a trustee in accordance with the statute, and additional costs to establish such a trust arrangement have long been considered economically unjustified. However, now that there are more defaulting bonds, especially TMK bonds issued in real estate non-recourse financing transactions, than there were a couple of years ago, more attention is being paid to the need for bonds to be secured by a mortgage/pledge. For the avoidance of doubt, in the case of TMK bonds, statutory general liens are available by virtue of law, however, with the general lien covering all assets of the TMK, there are certain difficulties in foreclosing on general liens; therefore, we may see more investors and issuers viewing the additional costs as economically justifiable. And, if secured bonds under the Secured Bonds Trust Law become a viable option for market participants, then structured covered bonds using a secured bonds structure may become more feasible.

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