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STOs' market potential in Japan

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Executive Summary

An increasingly wide variety of financial products are being issued on blockchains through security token offerings (STOs). The corporate bond market is expected to see widespread issuance of bonds for retail investors and bonds with bondholder perks through STOs. In the real estate securitization space, recent legislation has opened a path to eliminate legal impediments to STOs. The stage is set for real estate security tokens' rollout through GK-TK and specified joint real estate venture schemes in parallel with business process DX.

Increasingly broad range of products being issued via STOs in Japan

An increasingly broad range of securities products are being issued as tokens through blockchain-enabled security token offerings (STOs). In Japan, STOs are starting to be used in corporate finance (straight bonds, private company shares), real estate securitizations (TMKs¹⁾, specified joint real estate ventures) and the trust space (beneficial certificate issuance trust with regard to, e.g., credit card receivables and residential properties)²⁾.

As STOs steadily increase in prevalence, the lineup of products issued through them is expected to become more diverse. Here we focus on the STO market outlook with respect to two asset classes seen as an especially good fit for STOs: corporate bonds and real estate.

Corporate bonds: focus on retail bonds and bondholder perks

Japanese companies are increasingly raising capital by issuing straight bonds. In FY20, issuance hit an all-time record in excess of ¥15 trillion (see table). While tokenization is expected to potentially spread throughout the entire corporate bond market, bond issuance to retail investors, which accounted for roughly 5% of total corporate bond issuance in FY20, seems particularly likely to migrate to security tokens³⁾. By using a blockchain as the bondholder register for non-book-entry retail bonds, issuers can identify current bondholders and utilize their attribute information for marketing.

NOTE

1) TMK (an abbreviation of the Japanese term for "special purpose company") is a special purpose company established pursuant to Japan's Act on Securitization of Assets. One key distinguishing feature of TMKs is that they operate in accord with a predetermined asset liquidation plan.

2) A number of products that meet the Financial Instruments and Exchange Act and related Cabinet Office ordinances' definition of STO (namely, "electronically recorded transferable rights to be indicated on securities, etc.") have emerged since the definition was first established in May 2020.

3) Retail corporate bonds have accounted for up to roughly 20% of annual total corporate bond issuance over the past 10 years.

Examples of Japanese funding markets likely be tokenized

		(FY20)
Product (scheme)		Issuance/assets acquired
Corporate straight bonds		¥15,048.7bn
	Of which, retail bonds	¥684.0bn
Real estate securitizations	REITs (J-REITs, private REITs)	¥1,699.0bn
	Private funds (TMKs, GK-TKs)	¥1,947.0bn
	Specified joint real estate ventures	¥291.0bn

Source: NRI, based on data from Ministry of Land, Infrastructure, Transport and Tourism and I-N Information Systems

4) Per <https://yu-katsu.jp/q-a/> (in Japanese).

5) Per Japan Securities Dealers Association.

Shareholder perks programs for retail investors are popular in the Japanese stock market, with an estimated ¥100 billion⁴⁾ worth of benefits or gifts distributed to shareholders annually. Security tokens that confer digitally managed perks related to the issuer's business are expected to gain similarly widespread prevalence in the corporate bond market as well. The amount of Japanese corporate bonds outstanding at March 31, 2021, totaled ¥76 trillion⁵⁾, roughly five times FY20 corporate bond issuance. Use of blockchain technology to fulfill registrar and paying agent functions throughout the bond life cycle should promote new long-term ties between issuers and investors.

Real estate securitization: focus on elimination of legal impediments to tokenization

Another asset class in which tokenization holds promise to facilitate investment by individuals and enhance liquidity is real estate. J-REITs are an existing securitized real estate product in which retail investors can invest even small amounts of capital. Because J-REITs are a publicly traded product, however, their price performance tends to be correlated with financial markets. Additionally, J-REITs' diversified investment in portfolios of relatively large-scale properties is not conducive to a feeling of hands-on real estate ownership among J-REIT investors.

6) GK-TK is a securitization scheme that combines the Japanese equivalents of a limited liability company (GK) and limited partnership (TK) agreement. It is regarded as a dynamic and flexible deal structure.

Securitization schemes likely to be used in Japan to structure security tokens that take advantage of real estate's asset characteristics include GK-TK⁶⁾ in addition to the aforementioned TMK, both of which are private fund structures. GK-TKs and TMKs collectively acquired nearly ¥2 trillion of real estate in FY20. However, there are still legal impediments to converting GK-TK and TMK interests into security

tokens. Namely, GK-TKs are required to provide a dated certification in paper form to perfect the transfer of TK (i.e., LP) interests against third-party claims while TMKs are required to issue preferred equity securities in paper form to legally effectuate the securities' transfer to preferred equity members. Both requirements preclude full digitalization of the GK-TK and TMK securities transaction process.

A recent development that could potentially eliminate this impediment with respect to GK-TKs is a June 2021 amendment of the Act on Strengthening Industrial Competitiveness that includes special measures to the existing perfection requirements for the assignment of claims against third parties⁷⁾. Once the amendment takes partial effect on August 2, 2021, GK-TKs' GPs will be permitted to furnish electronic notification of transfer in lieu of paper notification only if using electronic information systems provided by approved implementers. This exception is expected to open the way for GPs to electronically perfect the transfer of LP equity interests to LPs against third parties.

7) A ministerial ordinance on the exception was publicly issued on July 30, 2021.

Another popular securitization scheme is specified joint real estate ventures, which collectively acquired nearly ¥300 billion of real estate in FY20. Equity interests in specified joint real estate enterprises item (i) that carry actual real estate on its own balance sheet are excluded from the Financial Instruments and Exchange Act's definition of a security. They consequently could be issued in tokenized form. Additionally, depending on how the aforementioned special measures with respect to perfection against third parties evolves in practice, the regulatory environment surrounding specified joint real estate ventures could likewise be developed to improve certainty of electronic transaction of equity interests in them.

8) Per Japan Investment Trusts Association.

9) Per Ministry of Land, Infrastructure, Transport and Tourism.

While J-REITs own a hefty ¥26 trillion⁸⁾ of assets in aggregate, their asset holdings account for a mere 1% of the estimated ¥2,600 trillion⁹⁾ value of Japan's total real estate assets. From such a perspective, the Japanese real estate securitization market appears to still have plenty of room to grow. Enhancement of liquidity through new security token products that utilize schemes such as GK-TK and specified joint real estate ventures should further invigorate the real estate securitization market.

Ubiquitous tokenization and business process DX

Security tokens' potential applications are not limited to corporate bonds or real estate. If combined with asset finance or structuring techniques, tokenization may

enable securitization of diverse assets and rights.

Its applicability to the ESG/SDGs is especially promising. In leading-edge overseas markets, security tokens and blockchain technology are already starting to be applied to green bonds and carbon trading. Another domain similarly well-suited to tokenization is IP/content. High-profile IP and content tokenization initiatives are increasing globally.

Whatever the application, digital transformation of business processes, including legal compliance and documentation, is a key first step to adopting blockchain technology to realize business objectives. We hope blockchain technology and security tokens are rolled out soundly across a wide range of sectors.

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