Determining the effects of the global credit crunch on shipping

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The lax US economic policies of low interest rates and huge budget deficits adopted by Mr. Greenspan in previous years had the desirable effect of achieving and maintaining artificially high US growth rates. The abundance of cheap money on a global basis led both banks and investors to relax their risk / reward criteria and accept low quality investments at record low returns. In addition, banks became increasingly involved in the structuring, investing and placing of synthetic investment products, CDIs and SIVs at levels that often exceeded their capital base and relying on borrowing at the inter-bank market. Such products assumed the continuation of the abundance of cheap money, buoyant stock markets, rising real estate prices, high global economic growth and inter-bank confidence.

The rapid development and growth prospects of the BRIC countries may well have served to obscure the risks associated with the above lax credit and investment practices. The high growth rates achieved, especially in China, with its significant effects on international trade, the demand for commodities, the concentration of global investment activity and the huge rise of its stock market shone like a beacon of light, propelling a global investment frenzy that seriously underestimated risk.

The change over between Messrs Greenspan and Bernanke signaled no change of US policy despite the record high budget and trade deficits. The possible effects of globalization in terms of lower product prices and the high productivity growth rates helped cushion the inflationary effects of rising commodity prices in general and of oil in particular.

So what went wrong?

It all began initially with the slowdown of the US housing market and subsequently its fall which led to a mounting US real estate crisis over the past 6 months. Home owners who obtained over 100% loans to finance their purchases relied on rising property prices to service their investments and higher levels of consumer spending. They often lacked the financial means in terms of income and wealth to keep up with the payments in the event of a property slump. This led to the US sub-prime crisis, where the lax credit standards of US banks became readily apparent. However, via the use of structured

products, the US sub-prime crisis soon developed into a global banking crisis, where major quality banks such as Citibank, Merrill Lynch, Bank of America, Barclays, UBS, began to report record loan provisions that not only decimated their profitability but also the adequacy of their capital structures. It seemed that almost every bank had its own 'Pandora's box' of sub-prime related risk which they could no longer hide. The effects of this sub-prime crisis in terms of potential bank losses is now estimated at over $400 billion. Moreover, it is difficult for the banking authorities and even the banks themselves to be accurate about the required loan provisions as these synthetic structured products carry significant potential downside risks.

A domino effect was created, whereby banks started cutting down inter-bank lines offered to other banks. This led to a bank line war and to a severe liquidity crisis as banks found themselves increasingly unable to fund themselves via market credit. The first victim was Northern rock in the UK, which highlighted the shocking effects of the credit crisis with long queues of customers trying to withdraw their deposits and with Bank of England stepping in to guarantee depositors' safety.

The banking market became paranoid with which would be the next bank to experience problems. The switch from easy credit to tight credit conditions was lightning fast and this created a potentially destructive spiraling liquidity crisis that threatened international investor / depositor confidence in the banking system. There was, in short, a liquidity crisis and a flight to quality.

Central banks across the world had to step in to pump liquidity into the markets, act as a lender of last resort and artificially keep their banks and economies going by lowering interest rates. The latter was most prominent in the US, which lowered its interest rates already by 0.75% and where further cuts are expected over the next months. This further huge relaxation of monetary policy came at a time of rising inflationary pressures, requiring a rise and not a fall in interest rates. However, monetary survival is a more significant factor than cautionary economic policy and the central banks had virtually no other choice in order to prevent a huge economic slump.

The effects of the global credit crunch can also be seen in the record fall of the US Dollar against other currencies, as well as in the fragility of world stock markets.

Central banks have recently demanded that all banks report their 'tier 3' exposure (i.e. sub-prime and structured products) as well as the need for banks to maintain their tier 1 and tier 2 capital adequacy. This is likely to lead to banks raising fresh capital via share sales, e.g. Citibank, or by selling off parts of their businesses or consider mergin with other stronger banks.

During the above process from sub-prime crisis to a global credit crisis, investors suddenly became cautious and began to shun risk. There has been a pronounced flight to quality and a radical shift towards higher risk investment premia. In many cases, investors would seek to keep or increase their liquidity and shun all types of risk as confidence waned.

Banks too have had to take drastic steps to contain risk. As the inter-bank market and syndications markets were in shock, solutions for banks had to be found elsewhere and this invariably meant a distinct slowdown in new lending across all industries. It was not a question of switching lending from one risk to another but a question of reducing all new credit and investing activity.

The effects of the global credit crisis are unfolding and the IMF as well as other reputable bodies, are forecasting a slowdown in global growth to about 4% for 2008. However, the estimates keep on being lowered and this is worrisome. Indeed, there are many that believe that the US has already entered into a recession, despite the recently published strong economic data.

How deep will be the global credit crisis? How long will be before a recovery?

It is very difficult to forecast its depth. The reason is that there are conflicting forces at work, both economic, as well as psychological.

Without the massive liquidity injection by central banks and the lowering of interest rates, we would be talking of a major crisis that would stop economic growth on its tracks and lead to a world recession. The sheer size of the banking and investment crisis would require a prolonged recession to work the previous years' excesses out of the system. However, both the credit banks and commercial banks are taking steps to assess, contain and address the problem. They are required to do so by the central banks, as well as their own shareholders, aiming to maintain their independence.

Some of the solutions may be painful. They may involve changes in the management and structure of banks, as well as the need to raise capital at not very attractive terms, i.e. Citibank's convertible share loan from Abu Dhabi at an 11% cost. Some may involve the need to merge or be taken over by other more financially robust banks. Often the erosion of control will involve banks accepting the capital infusion of cash rich foreign investors from China, the Middle East or Russia. Let us not forget that China's liquidity reserves are over $1.4 trillion, which are over 20 times larger than those of the US and that Russia and the Middle East countries also have considerable reserves, which can be invested via local investment funds in building up strategic stakes in key sectors.

As with any crisis there will be both winners and losers.

Central banks appear to be increasingly turning from being passive to more active investors and less keen to buy US bonds and be totally invested in the US Dollar. The correction phase will, I believe, last most of 2008. However, it is seen as a healthy correction, which is required by the global banking industry not only in the western economies, but also in the Far East, where, too, over-expansion has led to lax lending criteria for local investments.

It is vitally important that central banks and commercial banks use the credit crisis to begin to put their houses in order and restore the resilience and stability of the global banking and investment system.

In the event that the slowdown in growth shall be marked by a fall in energy prices in general and of oil to a $65 to $75 per barrel, it is possible that the crisis shall be overcome sooner and global economic growth and confidence shall start rising once again. Despite the negative compound bad news, it is remarkable hoe well the world economy has coped thus far and that we still have a respectable rate of global growth.

A key role in this recovery shall be the role of the US economy and if it shall be able to reduce its trade and monetary imbalances via export growth, reductions in military spending and the budget deficit and through sound economic policies. Moreover, the US consumer, who is currently reeling from multiple slaps, will need to regain his confidence. A key factor in doing so, will be the state of the US real estate market in 2008 and whether it will have started to recover. The Fed may well need to kick start the economy and the real estate market by a considerable easing of monetary policy.

What has been the effects of the credit crisis in shipping

Shipping across all sectors and in dry bulk in particular, has experienced buoyant market conditions for over 4 years. As global economic growth has risen to levels in excess of 5% per annum, this has led to an even higher increase in world seaborne trade and increased ton-mile transportation requirements.

The demand for shipping could not be satisfied by the rising supply of vessels via newbuildings, as shipyards were already producing at or near capacity levels. Despite the decline in scrapping to negligible levels, the excess demand conditions have resulted in a huge rise in freight rates and even more so in vessel values. Port congestion too has played a role in keeping up the excess demand conditions for shipping. The above holds true for all sectors but dry bulk is the leading sector, as newbuilding capacity in the period 2004-2007 had been dedicated primarily to tanker and container vessels.

Hence, the multiple rise in vessel values and freight rates. Moreover, the excess demand conditions are expected to last for another approx. 1-2 years before the dry bulk newbuilding orders begin to take effect.

It is true to say that even before the credit crisis, shipping banks and some owners were concerned with the mounting newbuilding order book, the enormous expansion in shipbuilding activity in China and elsewhere, as well as record high vessel prices. These concerns were, however, largely addressed by banks via strict client quality criteria, front-loaded loan repayment schedules and secured employment requirements. As such, shiplending activity continued at ever rising volumes with an implicit growth of 15-20% per annum.

However, as in other industries, shipping, too, experienced its own distortion of risk premia which become lower. Admittedly, the liquidity and quality characteristics of most owners merited some risk premium reduction. Nevertheless, loan yields had fallen to all time low levels, which many banks felt well not commensurate with the risk involved despite improvements in client quality, liquidity and fleet profiles, as well as the positive prospects for shipping.

From a shiplending point of view, the credit crisis can be seen as an opportunity to restore the bank-client equilibrium. As bank lending capability and appetite reduced across all industries, it had an effect also in shipping. Despite shipping being a robust and attractive sector

with solid prospects, it too was caught by the effects of the credit crisis in an indirect rather than direct way.

For many banks, ship lending budgets were temporarily slashed, certainly until 2007 year end. For some, a new stop lending policy was adopted. Banks less affected by the credit crisis adopted a policy of lending only to existing clients and of carefully picking the best risk / reward credits. As a consequence, owners became increasingly uncertain about their banks' response to fresh loans and this has dampened down second-hand purchase activity. The impact, however, was small, as despite the credit crisis, vessel values have continued to rise. This may also be explained by the flight of investors towards real income producing assets. Shipping IPO activity became more uncertain and the risk appetite of investors was reduced but was still evident.

As such, a large number of scheduled IPOs were put on hold, as a result of investors wanting lower share prices and as shipping banks could no longer underwrite the huge bank loans required. Indeed, a number of shipping banks had found themselves over-exposed in having underwritten, but not syndicated, many previous transactions.

Other than making loan and investment transactions more difficult to materialize, the real effect has been on spreads and fees. Banks have taken the opportunity to adjust their margins by approx. 15-25 basis points for target clients. As credit demand outstripped supply, banks have adopted a tougher stance toward even their targeted clients, knowing that they could always place their limited funds to other credits. Consequently, the market shifted away from owners and towards banks, which must be seen as a correction from a previous rather unbalanced position.

In addition to higher yields, banks focused increasingly on credit terms and conditions wishing to make each new loan transaction even safer. This is only to be expected when banks have paid so dearly for credit excesses in other sectors and the loan quality standards by credit evaluation departments have toughened.

Those with existing credit lines, felt fortunate but the application of such lines became increasingly more difficult, as banks became stricter.

The 'existing client' policy resulted in clients needing to shop around more if their own bank(s) could not accommodate them.

As the year end is approaching, nearly every bank has reported their unwillingness to extend new credits prior to the year end. However, most still favour fresh lending for 2008, on a careful, selective basis.

Fortunately for shipping banks, due to the front-loaded loan repayment profile of their loan portfolios, transacting no new business in one year would usually result in a 20-25% reduction in their lending via repayments and pre-payments arising from vessel sales or refinancing. Very few other industries can match such an immediate reaction to a stop lending policy and this allows room for banks to continue lending and earning transaction fees without necessarily increasing their overall shipping loan portfolio.

Banks in general rely on a continuous stream of loans to boost profitability and cannot afford to stay still for long. As long as shipping prospects remain solid, in an otherwise uncertain world, there may even be a shift of loan resources by banks away from other less stable industries towards ship lending which still offers a very attractive mix of credit and non-credit related income.

Shipping banks could even exploit their ability to enter into fresh lending as a result of the newbuilding boom and the rising newbuilding deliveries scheduled for 2008 and beyond. Readers should bear in mind that the vast majority of newbuildings for delivery in 2009 and beyond have yet to be finance. Often a client would secure pre-delivery finance but would not wish to pay commitment fees for post delivery finance. Consequently, there may be a rush of owners to secure newbuilding finance and banks may well have the upper hand for a change.

As the negative effects of the global credit crisis shall dissipate over the next year, ship lending is expected to continue to grow over the next 12 months, even though at a more modest pace.

What banks and owners will increasingly focus upon in the future, however, shall be the impact of the slowdown in global growth on shipping demand. The rapidly rising shipping supply especially in 2009 and beyond will require an equally strong increase in the demand for seaborne trade. Will this happen? How long can China, India and the rest of the fast developing countries continue to grow at such pace in the light of a distinct slowdown in the US, Europe and Japan? Will the current physical under-supply conditions change and how quickly?

Banks and owners will increasingly focus on assessing the prospects of a global growth recovery by 2009 and beyond at a time of rising supply as most owners have charters in place for 2008 and less so for 2009. It is the 2010 and beyond market conditions that banks and owners will wish to continuously assess and look for any positive or negative signs.

To summarise, the effects of the global credit crisis have so far had only a modest impact on ship lending which continues to remain a rewarding activity for banks. Ship lending volume growth is expected to resume after a slowdown in late 2007 as long as the global economy shall continue to grow, even at most moderate levels.

All eyes will be focused on the prospects of the containment of the credit crisis in 2008, which may lead to resumed higher global growth in 2009 and beyond which if it should materialise, may well absorb the impact of the rising shipping supply.

The impact of news and shifts in the prospects for shipping may well result in higher market volatility but shall also provide the opportunity for all market participants to share in the changing dynamics of the shipping market.

It should be an exhilarating ride.