



Bank activity in the shipfinance market in the 1990s

By Ted Petropoulos, MD, Petrofin S.A.

December 1996 – Economic Outlook

The subject of this article is Bank Activity in ShipFinance in the 1990s.

The topic will be covered in three sections. Firstly, a brief review of the Ship Finance Market in the 1970s and 1980s. Secondly, a detailed review of bank activity over the last five years and where we are today, and thirdly, some predictions about the rest of the decade and beyond.

As a general observation, bank activity follows shipping cycles and the performance of the Shipping Industry. As the shipping industry improves and its outlook appears secure, the interest of banks in shipping rises and vice versa. This is natural and to be expected.

However, it takes time for banks to realise and respond to shipping industry cycles and prospects. Invariably by the time the message is received and realised, departments are set up, budgets are determined and lending commences, the industry's course may well have changed.

This phenomenon hits mainly the non-traditional shipping lenders, who lack the long-term experience and commitment to the industry and are most likely to over-react to changes and realise losses. This pattern has unfortunately been a prominent feature of shiplending over the decades and has added to the widespread belief that shiplending is a high-risk activity for banks.

Bank activity is also determined by general economic cycles and the outlook for the worldwide economy as well as conditions within the international banking industry. Shiplending competes in risk / reward terms with all other bank lending.

If the terms are attractive relative to other lending or if the banks have a surplus of resources or indeed lack alternative lending opportunities, then these factors will also play a role in shiplending activity.

Looking over prevailing conditions in the 1970s, we can determine the following factors that influenced shiplending activity, namely:

Rapid banking industry expansion and intangible or even appreciating asset.

The rapid development of the shipbuilding industry especially in Japan and

The plethora of international shipping entrepreneurs in general and in Scandinavia, Greece and the Far East in particular who were keen to share in this shipping and banking frenzy and sought to make their fortunes overnight.

As a result of the above prevailing conditions, shiplending grew in leaps and bounds in the 1970s and although there is no research material of the number of banks involved, at that time, the writer would estimate their number at over 500. A quick review of the participants in major shiplending syndicates reveals names that are scarcely unknown and have long departed from the shiplending scene.

The protracted shipping crisis of the 1980s, the disintegration of asset values and cash flows and problems by banks in other lending areas such as energy, aviation, property, third world lending etc. have all shaken the appetite and ability by banks.

Pressures from within the industry in terms of poor conditions and overlending as well as pressures from outside, together with the higher capital adequacy ratios decreed by the central banks, lead to the virtual abandonment of the shipping industry by banks in the 1980s.

Huge losses were made as banks sought to eliminate their exposure under adverse market conditions and the «stigma» to the shipping industry as a high risk industry became firmly entrenched.

As the 1980s progressed, the number of active shiplending banks tumbled to not more than 25 in which we can find the traditional names associated with the industry over time and until today. Banks avoided the shipping industry due to the perceived high risk, their constraints on capital and emphasis in non-risk products and services.

During this period, shipping became a «Lenders market» and banks were able to reduce the percentage of offered finance and loan repayment periods, tighten on covenants and conditions whilst enjoying much higher fees and spreads.

The improving ship market conditions especially in the dry bulk and container appears in the late 1980s and early 1990s together with the attractive shiplending terms and conditions began to attract more banks.

Seeking to establish the number, commitment to shipping and nationality of shipping Banks,

PETROFIN S.A. researched and published for the first time a detailed analysis of international shiplending in 1992 and has continued with this research and publication every year hence.

These reports have become the main source of information and reference to the industry over the years and have been widely quoted in the press and the annual reports of Hong Kong and Shanghai Bank, Royal Bank of Scotland, City University Business School and others.

The 1992 results show shiplending by only 67 banks of which 39 with a major role and 28 with a minor or local role. Of these 77% were European based and only 18% North American based. Bearing mind, the importance of world transportation in general and shipping in particular, as well the capital intensive nature of the industry, and given the great number of international and national banks worldwide, the small number of banks involved was truly startling.

The subsequent 5-year period 1992-1996 witnessed an explosion of shiplending interest by banks and this can be shown in the attached slide. Current information shows that the number of shiplending banks has increased during the period from 67 to 201. The major lenders have grown but less rapidly from 39 to 62 where as the minor lenders have grown from 28 to 139, a truly impressive growth.

The main reasons for this growth are the following:

- *A sustained shipping market recovery over the period.*
- *Improving world economic conditions and performance.*
- *Lower interest rates*
- *Healthier balance sheets by banks and enhanced ability to lend.*
- *Attractive returns by banks from shiplending when comparing these with those offered in other industries or activities and*
- *A fading image of shipping as a high risk lending area.*
- *Smaller banks wishing to keep their clients and income from client services*

The full 1996 analysis is presented in the figure 1. You will observe that the total number of banks has grown from 154 to 201 over the one year period.

Specifically, you can observe that:

- *«Major role» banks in Europe and North America have stayed the same and the only growth has been recorded in the Far East and other nationalities sector. This supports our belief that growth potential in the number of major banks is limited over the next 5-year period*
- *The number of minor/local European based banks has grown from 65 to 90 in only one year with this growth coming from all nationalities except the U.K. where numbers have stabilised for the time being.*
- *The number of minor/local «Far East and other nationalities» based banks has also grown impressively over just one year from 20 to 33 underlining the growth of the Far East as a major commercial and transportation, growth centre.*
- *The European subtotal for major banks has continued to fall from 77% in 1992 to 64% in 1995 and 58% in 1996 whilst the Far East sector has grown from only 5% in 1992 to 26% in 1996.*

Analysing the 5-year period, 1992- 1996, Figures 2 and 3 demonstrate the points quite vividly. You can observe firstly the strong overall growth of

Scandinavian and German based banks representing a re-entry of these banks to shiplending rather than fresh banks in the industry and secondly the explosive growth in other European and Far Eastern banks which represents mainly new entrances into the shiplending field.

FIGURE 2

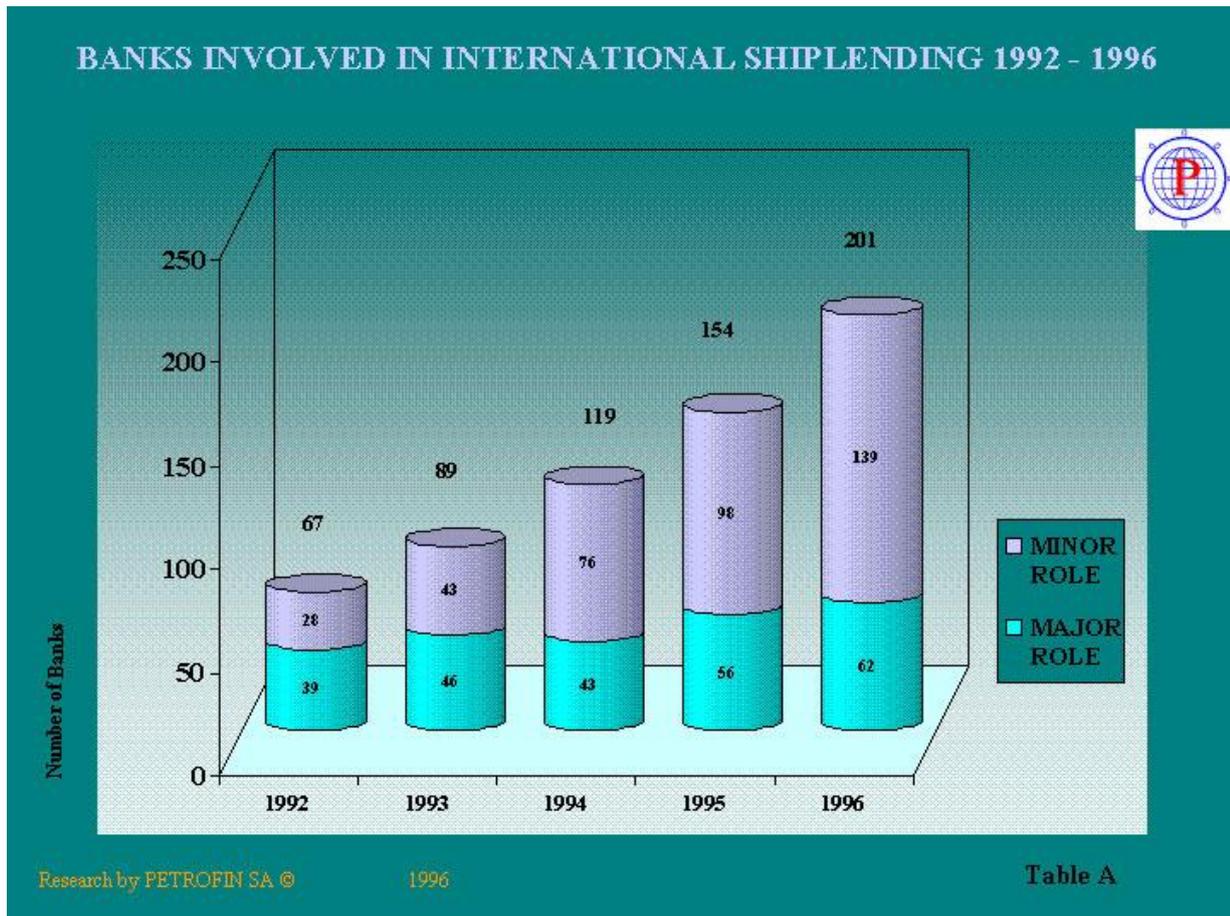
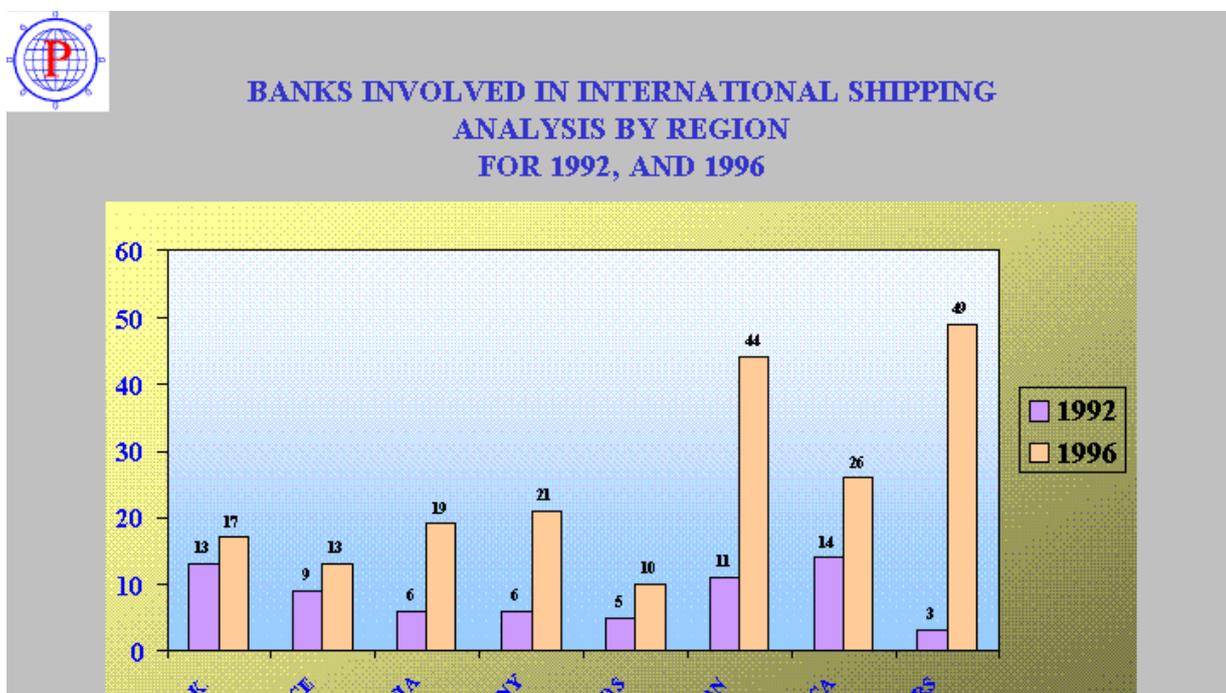


FIGURE 3



I wish to now concentrate on the future and present to you our predictions for the immediate and longer term.

The dry bulk market is currently experiencing turbulence in all sectors and especially in the Panamax and Cape sizes. Although rates have recovered recently and the BIFFEX has recorded an impressive comeback, the previous fall from approx. 2,500 to 1,000 is very large and took the industry largely by surprise.

Banks have been busy re-evaluating their loan portfolios, reviewing clients cash flows, building up detailed information data on vessel movements and their condition, as well as handling the small number of distress situations that have arisen thus far. On the whole, the response by banks to the recent falls in the dry bulk market has been restrained, responsible and accommodating which shows that some lessons from the past have not been forgotten.

Our own opinion is that the recent dry bulk recovery is a mere correction and that rates and indeed values will remain depressed in 1997. Should this take place, then the resolve of banks and the patience of their credit departments will be tested and we anticipate that some of the recent entrants into the field will fare badly in terms of the quality of their loan portfolios (representing largely fresh lending relationships entered at high market levels) and in terms of losses.

For the immediate future, we believe that the rate of growth of shiplending banks will slow down. Specifically, although we do not expect any major changes in the numbers of «major role» banks, we may well see the early departure of some smaller European and Far Eastern banks.

However, this would represent only a temporary slowdown in the otherwise continuous growth of this market and we anticipate that once this interval period is over, numbers will continue to grow. Should the industry experience a period of longer-term recession, involving numerous and well publicised shipping Group failures, then the rate of growth may well cease. We regard this, though, as an extreme scenario with a small probability of being realised.

Our own predictions are that, in 10 years time, the number of major banks will have grown to over 75 and the number of smaller banks to over 250 i.e. a total in excess of 325 banks. This should not unduly worry the major industry lenders since the growth arises mainly in the smaller bank sector, which is adding much needed capacity to the market.

The shipping market will require enormous amounts of fresh lending to meet anticipated demand and the substitution of overage tonnage. Someone has to assist in the funding of the \$275bn forecasted by Drewrys and experience has shown that although equity resourcing will grow, the main growth will be in the lending area. In addition, smaller banks are required to finance the smaller owners or older vessels, which do not interest the major lenders.

As the industry demonstrates a longer-term greater stability and indeed «comes of age», it will be seen as a relatively safe sector. This will be so especially if it occurs during periods of slowdown, thus rewarding prudent and consistent lending policy by banks. Once achieved it will add to the industry's attraction for banks.

We anticipate a temporary halting in the decline of average loan yields and a hardening of terms. However, loan yields will continue to fall over the next 5-10 years as the industry assesses itself as one where long term profits can be achieved by responsible and committed banks and where the inherent risks are similar to the average risks encountered to all sectors of the world economy.

Another area of lending that we expect to come back to fashion is that of «CLUB» or syndicated lending. Here major banks with the necessary and proven record in the industry will take advantage of the appetite by smaller banks and their growing number.

As shipping becomes increasingly a «corporate» lending area rather than one involving mere asset finance, syndicated lending will increase, thereby providing the opportunity to the major banks to maintain their overall yields and margins. It will involve, of course, harder work and high financial engineering and credit monitoring skills but there does lay the challenge of the future.

New financial instruments will be used by major banks in the lending area including the development of «shipping commercial paper» as a mean of obtaining longer term shipping finance by the large well known shipping Groups at more competitive rates. Securatisation too will enter the field of shipping, once again in the top quality segment of the shipping industry and we see enormous room for growth in new financial lending instruments. These will be developed by the U.S. and European investment banks in general, as well as the major German lenders. The later, given their commitment to container shipping could thus find a new niche whereby their lending risks shall be reduced whilst their non-risk income from services will rise.

As the use of derivatives and other non-risk shipping products and services increases, so will the «cross selling» banks for their whole range of products and services to their shipping clients. The increasing regulation of the industry may well be causing 'j' adjustment problems but in the future will enhance shipping's credibility and generate substantially greater interest by the banking industry worldwide.

The challenges and opportunities for banks in the shipping industry have never been wider and do offer room for growth for all banks. Banks that develop the correct strategy in a timely and innovative manner and which strategy takes full advantage of their own strengths, will reap the benefits of the opportunities offered in the market over the next decade.

