Basel II proposals:

Impact on ship lending

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Shipping is a capital intensive industry, enjoying at best modest average returns on capital invested excluding the short-term opportunistic profits for some, associated with market cyclicality at the expense of others.

Consequently, the borrowing cost by shipping entities is of major importance. Anything that increases such a cost and / or reduces the percentage of shipfinance enjoyed by borrowers and / or alters the security and other terms offered by banks, is, without doubt, fundamental to the industry.

In this paper, we shall analyse the Basel II proposals and their implications, the different opinions expressed as to their impact, both on the shipping industry, as well as on shipfinance banks and the particular vulnerability of Greek shipping.

The Basel II proposals were put forward by the Bank of International Settlements in January 2001 followed up by a working paper in October 2001. Once implemented, they are expected to have a significant effect both on shipfinance as well as loan margins paid by all shipowners, especially the small ones, which represent 2/3 of Greek shipping in number terms.

The existing Basel I regulations began in 1988 via a paper published by the Basel Committee and called International Convergence of Capital Measurement and Capital Standards. It established risk weighting for loan transactions, which would, in turn, determine how much bank capital would be allocated to each such transaction.

The rules were clear, defined but quite crude when it came to risk categorisation and loan collateral implications. Corporate shipping credits, for example, were treated the same irrespective of the size and quality of the corporate borrower. This acted against such corporate credits and in favour of smaller credits, which form the vast majority of shipping credits. It also resulted in some banks making riskier loans seeking higher income without any allowance for actual risk weighting differences. A number of more sophisticated shipping banks did develop their own internal rules which meant, however, that for a number of shipping loan transactions they placed themselves out of the market by being less competitive, when compared to other less sophisticated banks. Indeed, the above factor may well be one of the reasons for the withdrawal of a number of well-known shipping banks from the shipfinance scene. These banks using their own risk weighting systems simply discovered that shiplending was not as profitable as other industries.

The Basel II proposals have come, therefore, to address some of the risk weighting problems faced by all types of bank lending including that of shipping. They introduce the notion of risk weighting based on credit rating. These credit ratings can broadly be divided into two categories. Category A being a standardised approach and based on credit ratings as assessed out by international credit rating agencies such as Standard & Poors, Moodys,etc. Category B, being an internal bank generated credit rating approach or internal approach, which permits banks to develop and use their own credit rating system. Under the internal approach banks may either follow standardised supervisory risk factor weightings or an advanced credit rating system, which provides them with more freedom in assessing credit risk.

Under all systems, however, there would be strict criteria, disclosure requirements and consistent methodology.

The use of a credit rating system is a strict requirement and is expected to revolutionise the supervision of banks. It is also expected that there will be significantly higher capital allocations under Basel II. In a few words, banks are likely to be obliged to retain more capital to support shipping loans, which are perceived as being higher risk loans.

Under Basel II, loans with a corporate rating of BB- to BB+ shall require 100% capital allocation, i.e. the usual 8%.

Companies with a rating below BB-, which represents the vast majority of shipping companies if they were thus rated, should require 150% capital allocation i.e. 12% capital allocation. It is, therefore, obvious that, in order to earn the same returns on capital employed, banks will need to charge under the above scenario 50% more for such loans

Interestingly enough, ships did not count as collateral in the Basel II proposals as far as the standardized approach is concerned and as such it is expected that most shipping banks will opt for the advanced system, seeking to put up a better case for the merits of shipping loans.

In the subsequent October 2001 working paper, ships used as specific collateral for loans are classified under the 'object finance' category. However, shipping loans may also be categorized as 'corporate' credits rather than object or specialised credits.

Indeed, the paper being relatively new has yet to receive its full share of commentary and criticism. The working paper actually invites industry comments leading onto a consultation paper before it shall be finalised by the end of 2002 (probably later) and shall be implemented in 2005.

One significant comment already generated is that if the accord fails to fully incorporate the benefits to a shipping credit of shipping mortgages and other relevant collateral, then it will cause an undue distortion of perception as to the inherent risk of shipping loans.

Such distortion is expected to lead to a dramatic increase in the cost of lending, which may not be sustainable to the shipping industry. Alternatively, a lot of banks may well leave an industry that is particularly capital demanding at a time when they are all seeking to minimise direct use of their capital for the generation of profits.

Already the committee has reacted positively to the recognition of physical collateral and other collateral in the form of secured income streams, guarantees etc that apply to the shipping industry. This will be a relief to many shipping banks and will direct them to adopt and use the advanced credit rating system.

Already there have been voices that more time shall be needed for the consultation period and as such it may well turn out that the implementation may be delayed beyond 2005. However, it is abundantly clear that all banks have taken the proposals seriously and have already adapted to a varying degree their internal credit system and their pricing.

Despite the 3 years or more until its implementation, Basel II will exert enormous pressure on shipping banks to develop their own internal credit rating systems. Already this is being implemented by almost all European Union Banks, especially the German state owned ones that have been continuously criticised by commercial banks that they have been underpricing their loans based on a lower cost of funding being state owned / guaranteed institutions, something that represents unfair competition in favour of state banks.

Interestingly enough, although there remains considerable time until its mandatory implementation and bearing in mind the uncertainty that still surround the proposals, as well as various anomalies, a number of banks have already begun to at least part rely on their own credit rating system, when new credits are being assessed and priced.

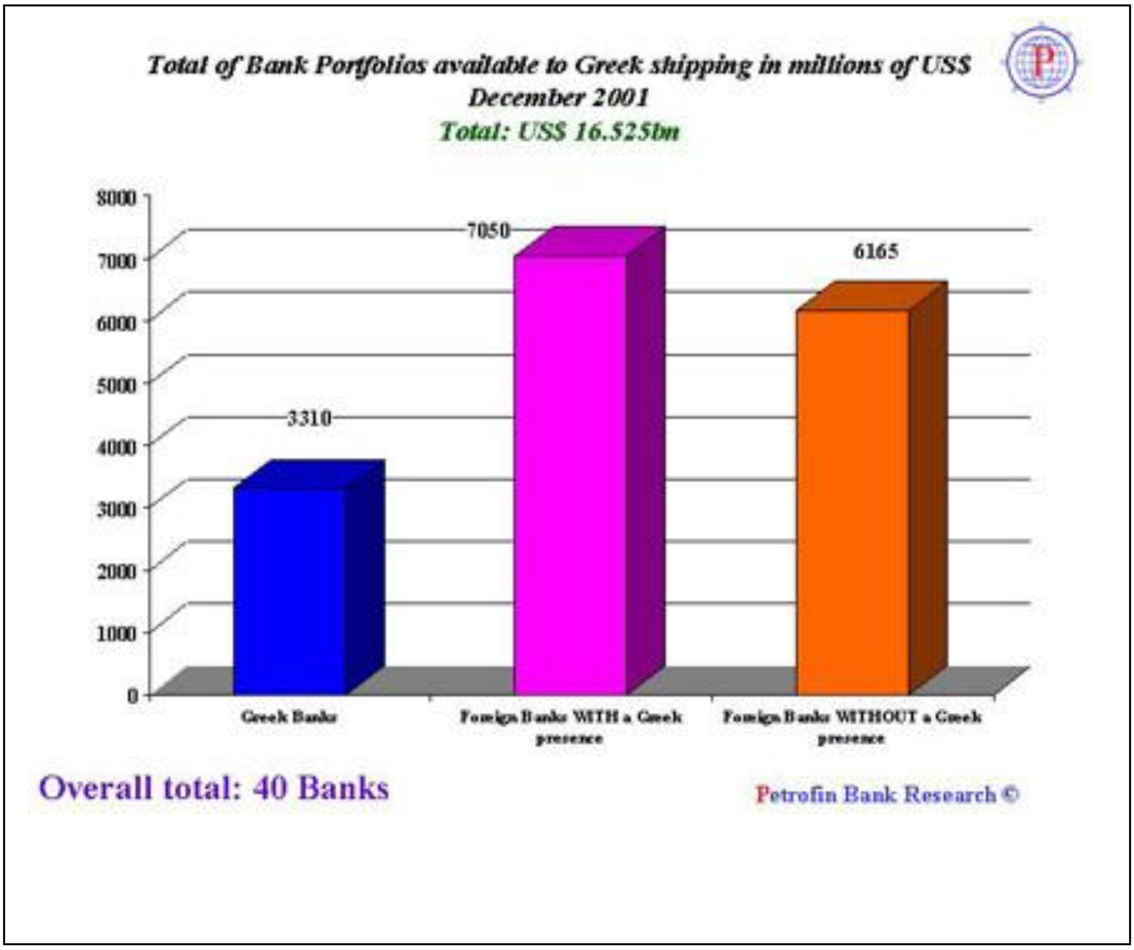
A number of banks have begun to use Basel II as an excuse for increasing their loan margins even though its effects are years away.

In shipping, which is regarded as a particularly risk-heavy industry, the implementation of the Basel II in whatever final form will undoubtedly lead to higher margins for all shipping credits, something that has already begun. Although only EU banks are directly affected by the proposals, it is expected that the pressure for higher margins will be eagerly followed by non-EU banks. Alternatively, non-EU banks may well maintain a competitive edge over their EU rivals.

A debate has begun over how Basel II will affect the number of shipping banks, as well as their combined shiplending appetite. On the one hand, the optimists who believe that nothing will change in the longer run as the banks will maintain their level of interest in shipping as a major industry and one where they possess expertise and that Basel II will not have a permanent long lasting effect.

In our opinion, Basel II will be significant over the period up to its implementation and immediately thereafter as it poses new challenges to the shipfinance industry. However, to the extent that the shipping industry will pay the higher margins and provided these shall be based on the advanced credit rating system, the effect on the shipfinance industry will be more subdued than anticipated. Indeed, there is room to believe that as shipping credits begin to pay their way (something they have not done for decades) it is quite possible that shipfinance may receive the interest of new entrants seeking lending opportunities.

Turning to the Greek shipfinance market, it is expected that large corporate-style Greek shipping entities shall fare better than small owners. The main reason is that larger entities (public or otherwise) even those not of an investment grade, will still be able to receive a higher credit rating based on their corporate size and other characteristics, as opposed to small owners. The loan margins, therefore, for these companies are expected to be reduced.



According to the latest Petrofin Research ©, out of the 749 Greek shipping companies in 2002, 488 or 65.15% represent companies with fleets of 1 - 4 vessels. It is for this reason obvious that the margins to be paid by such owners which are already higher than those of larger owners, will increase even further. Also, with increased loan margins a reduction in the finance percentages of these companies is expected, something that small owners should brace themselves for.

As the proposals are still in the process of being reviewed and amended, it is premature to quantify the full effects on margins and terms for Greek shipowners. Nevertheless, it is correct to say that most Greek companies are not investment grade or 'corporate' credits and are indeed smaller on average than their European counterparts. As such, the impact of Basel II is expected to fall heavier on Greek shipping and even more so on the smaller owners, who may find the terms they shall be receiving as prohibitive for their further investment in shipping.

Once again the impact of revised regulations this time in the banking industry will add to the regulatory weight already felt by Greek shipowners from so many sources.

For the majority of Greek owners, therefore, survival is the name of the game. One thing is for sure; few Greeks will light a candle for the Basel II proposals.

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