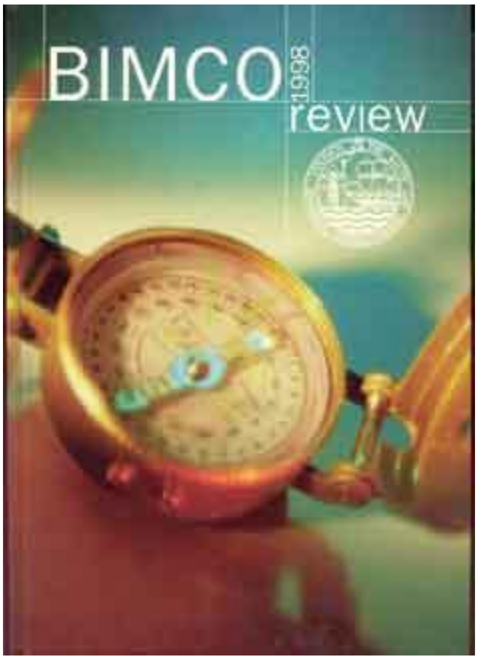
Identifying Trends and Parameters in Shipping Finance

By Ted Petropoulos, Managing Director, Petrofin SA, Greece.

<u>**January 1998**</u>



The subject to be covered in this article is truly wide and I shall tackle it in four broad sections, namely:

- *Analysis and trends in the shipping banking sector;*
- *Analysis of shipping customers' banking requirements;*
- *Ship lending parameters and trends;*
- *Survivability during market troughs - is 1996/97 a repeat of the 1980s?*

I shall continue with an analysis of trends in the shipping banking Sector in 5 subsections.

Analysis and Trends in the Shipping Banking Sector

Brief historical review

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 comprehended, bank departments set up, budgets 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 overreact to changes and realise losses. This pattern has unfortunately been a prominent feature of ship lending over the decades and has added to the widespread belief that ship lending is a high-risk activity for banks. I shall return to this theme later in the article.

Bank activity is also determined by general economic cycles and the outlook for the worldwide economy as well as by conditions within the international banking industry. Ship lending 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 resource or indeed lack alternative lending opportunities, then these factors will also play a role in ship lending activity.

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

- *Rapid banking-industry expansion and globalisation.*
- *The increasing development of 'specialist' lending.*
- *Banks blowing up their balance sheets through over- leverage.*
- *Banks awash with resources to lend and looking for Opportunities.*
- *Keen competition to banks in their traditional lending role from the development of new 'paper' lending instruments that took advantage of the development of the Eurodollar market and allowed major clients to borrow larger sums for longer periods and at keener rates.*
- *The 'discovery' of ship lending by banks throughout the world and especially the major US-based wholesale financial institutions that saw an opportunity to lend huge amounts at attractive rates.*
- *The mistaken approach by ship tenders and their lack of experience in believing that asset-based finance was relatively secure and that lending percentages could be increased to relatively high levels of 80-90 per cent with apparently little risk.*
- *A generally widely-held belief that in the inflationary and loose monetary growth conditions of the 1970s, shipping assets were a stable or even appreciating asset.*
- *The rapid development of the shipbuilding industry, especially in Japan.*
- *The plethora of international shipping companies 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, ship lending 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 ship lending syndicates reveals names that are scarcely unknown and have long departed from the ship tending 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 banks' appetite and ability by. Pressures from within the industry in terns of poor conditions and over-lending as well as pressures from outside, together with the higher capital-adequacy ratios decreed by the central banks, led to the virtual abandonment of the ship- ping 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 ship lending 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 on non-risk products and services.

The growth of shipping banks

Seeking to establish the number, commitment to shipping and nationality of shipping banks, PETROFIN researched and published for the first time a detailed analysis of international ship lending in 1992 and has continued with this research and publication every year since.

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 the Hong Kong & Shanghai Bank, Royal Bank of Scotland, City University Business School and others.

The 1992 results show ship lending by only 67 banks, 39 of them with a major role and 28 with a minor or local role. Of these 77 per cent were European-based and only 18 percent North American-based. Bearing in mind the importance of worldwide transportation in general and shipping in particular, as well as the capital-intensive nature of the industry, the number of banks involved was truly startling.

The subsequent five-year period 1992-1996 witnessed an explosion of ship lending banks and figures increased during the period from 67 to 201. The major lenders have increased, but less rapidly, from

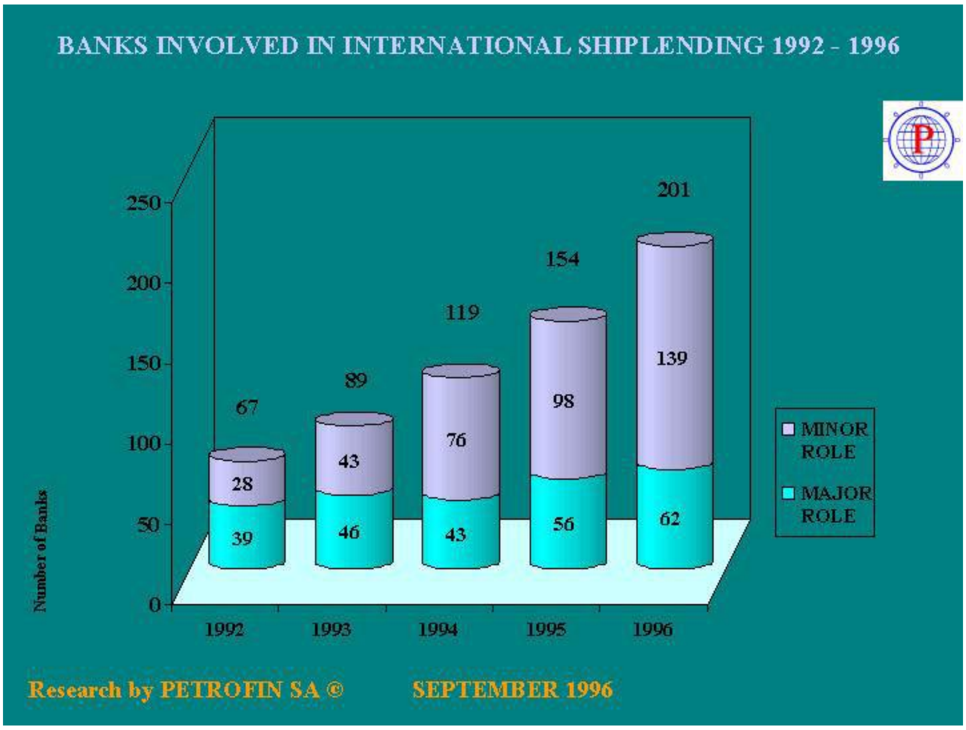
39 to 62, whereas the minor lenders have increased from 28 to 139, a truly impressive growth.

The main reasons for this growth are the following:

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

The total number of banks has grown from 154 to 201 over the one-year period of 1996.

TABLE A: Banks involved in international shiplending between 1992 & 1996 - Major and Minor



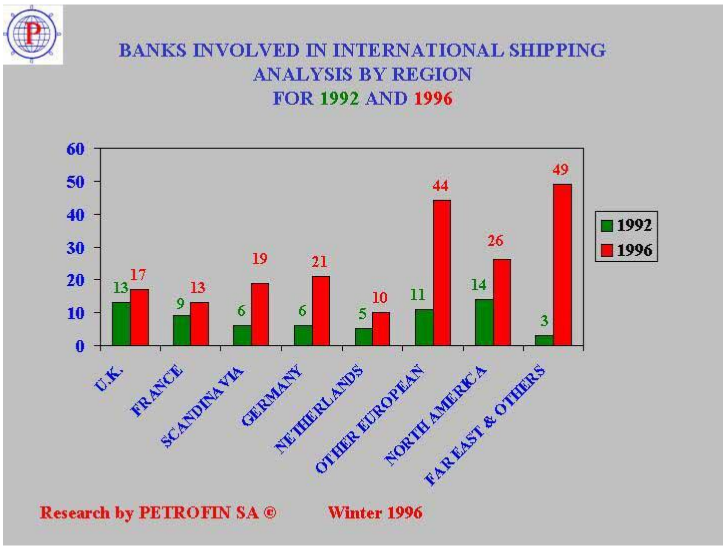
Specifically, you can observe that:

- *'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 sup- ports our belief that growth potential in the number of major banks is limited over the next five-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 UK 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 per cent in 1992 to 64 per cent in 1995 and 58 per cent in 1996, whilst the Far East sector has grown from only five per cent in 1992 to 26 per cent in 1996.*

Analysing the five-year period 1992-1996 demonstrates 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 ship lending 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 ship lending field.

TABLE B: Banks involved in international shiplending 1992/1996



Will the growth continue?

The dry bulk market is currently experiencing turbulence in all sectors and especially in the Panamax and Capesize areas. Although rates have recovered recently, banks have been busy re-evaluating their loan portfolios, reviewing clients' cash flows and 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.

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 levels and in terms of losses).

For the immediate future, we believe that 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 slow- down 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 average tonnage. Someone has to assist in the funding of the $275 billion forecasted by Drewry's, and experience has shown that although equity resourcing will grow, the main growth will be in the lending area.

Shipping finance risks / rewards for banks

'Ship lending is an exercise in risk limitation.' Successful ship lending requires the avoidance or minimisation of shipping risk. Since ship lending income lies mostly within a band of 100-200 yield basis points and is determined by competition, success will depend on avoiding losses. Here, a bank has to identify and assess all risks and build defences to minimise these. Often defences are in the form of primary defence, secondary, defence and so on.

Seeking to identify ship lending risks, we can analyse these as related to the following:

- *Change in the overall market conditions;*
- *Sector risks;*
- *Specific collateral risks;*

- *Technical risks;*
- *Interest rate risk;*
- *Operating cost risk/overturns;*
- *Management/organisational risks;*
- *Entrepreneurial/strategic risks;*
- *Liquidity/leverage risks;*
- *Insurance/class/flag/port control risks;*
- *Credit management skills (or lack);*
- *Environmental/regulation risks;*
- *ITF.*
- *Know-how/expcrtise;*
- *Fraud;*
- *Ability to control operations;*
- *Character/track record;*
- *Communications/disclosure;*
- *Location;*
- *Legal/dispute.*

The above list is not exhaustive but contains main areas of risk as seen by a banker's eyes. However, ship lending risks are often affected be, the following bank-related factors and risks:

- *Experience of ship lending personnel;*
- *Experience of credit approval and controlling departments;*
- *Pressure on ship lenders to meet budgets and portfolio yields;*
- *Ship lending department's organisation, credit monitoring systems;*
- *Access to quality, advice, e.g. legal, technical, insurance, valuation etc;*
- *Personalities factor;*
- *Workout/client-support ethos; 8. Panic factors;*
- *Influences beyond those of the shipping department;*
- *Change of policy/management.*

Historically, the ship lending sector has shows a poor record whereby all banks have sustained losses from time to time as a result of the above factors. In some instances, these losses were sufficient to convince banks to depart the ship lending sector, e.g. Bank of America, whereas others have remained with stricter lending and smaller budgets.

With some notable exceptions, e.g. RBS, ABN, FNBM and some others, most banks have become very wary of shipping and have sought to minimise risk by carefully analysing it as well as concentrating on:

- *the larger, quality names,*

- *relatively safe market sectors,*
- *syndications/club deals,*
- *larger 'corporate' credits,*
- *getting to know clients well,*
- *selling non-risk products and*
- *becoming the client's bank across a variety of products and services thereby cementing better the relationship.*

Credit versus non -credit services and trends

Credit-related rewards are as follows:

- Spread margin;
- Arrangement fee;
- Prepayment fee (if applicable);
- Annual management fee (if any);
- Drop-dead fees (if any);
- Profit participation fees (if any).

The pressure on overall credit yields has been enormous, primarily, due to competition between banks, the scarcity of good credits, the lack of alternative lending opportunities, the plethora of lendable resources and the shift towards specialised lending.

Credit yields have largely fallen over the last five years from an average of 175-200 overall basis points per annum to approximately 150 basis points today. The exact portfolio yielding would depend on the relative weighting of AAA credits yielding approximately 100 bank's points as opposed to slightly lower-quality credits yielding 175-200 basis points.

In order to enhance their portfolio yields, banks have been emphasising for a long time non-credit-risk services such as remittances, deposits, foreign exchange and operating account business. Indeed, some of them have prided themselves on having more client deposits than loan exposure. As competition has also intensified, though in the provision of operating services, banks have sought to develop additional services such as the following:

- Sale of derivatives such as swaps, interest-rate caps etc E Multi-currency fines;
- Sale of FFA and other hedging products;
- Advisory/structuring services to clients;
- Assistance to clients in public floatations;
- Arrangement of syndicates and/or clubs.

The trend, though, is for the large shipping banks to develop new services in the following areas:

- Securitisation;
- Shipping commercial paper;
- Equity-related 'lending';
- Cross-product selling, e.g. real estate, portfolio management etc;
- Mergers and acquisitions.

Analysis of Shipping Customers' Banking Requirements

Although banking credit criteria and risk analysis have received a lot attention over the years, there has been comparatively little emphasis on analysing a client's point of view, as to what he is looking for in a bank.

These requirements and points of emphasis are:

1. Loan to asset percentages.
2. Overall cost;
3. Duration of loan (low daily break-even rate);
4. Quickness of initial response and provision of commitment;
5. Consistency in responses and handling of issues;
6. Flexibility and ability to accommodate clients' requirements;
7. Expertise and track record of bank, its ship lending;
8. Personalities of officers;
9. Reaction to problems;
10. Reaction to a 'market change' (proactive/post-active);
11. Indirect cost of a loan (e.g. legal, inspection, valuation, insurance, class/flag);
12. Level of information requirements for approval and throughout the life of the loan;
13. Capacity to underwrite;
14. Reputation/standing in the industry and/or financial standing of the bank. Other clientele;
15. Bank-client loyalty;
16. Quality and cost of non-credit services;
17. Ability to present investment opportunities;
18. Ability to assist clients in realising their strategy and goals and/or corporate banking services.

In recent years, banks have begun to stress non-credit-related services in an effort to improve their risk-reward position and in an effort to differentiate between their client services. Where bank-client relationships are close, banks have sought to offer corporate banking and other advisory services normally reserved for 'merchant-banking relationships'.

Clients have also begun to expect a more proactive marketing approach from their banks. Often their criticism is that 'they offer me nothing new'. At times of market difficulty, good clients expect 'their' bank to offer them vessels for management or purchase.

Despite the efforts of banks to get closer to their clients and thus build up 'protective walls' around them, competition has driven loyalty to a very low level. This process has not been helped by the high shipping personnel turnover at banks and the build-up of personal rather than corporate relationships.

As the number of banks and their interest in shipping grow, so will competition, and clients, will benefit from the bank's greater efforts to differentiate their products and ser vices. It is expected that in the future, the provision of credit will be of less importance to shipping clients thin the combined weight of all the other services of a bank. In addition, in the future, the role of commercial banks anti of merchant (- type) banks will become more distinct, with the former offering credit-related services and the latter providing coordinating, advisory and specialised services.

Ship Lending Parameters and Trends

In this section I will concentrate on analysing the changes and trends in ship lending parameters and requirements, as well as pointing to some newer areas of bankers' concern.

Changes/trends in ship lending parameters

- *Higher percentage of finance provided. Average percentage for medium-risk clients has grown from approx. 60 to 65 per cent over the last five years as a result of greater competition.*
- *Longer periods. Often accommodated via balloons of rear-loaded repayment structures.*
- *Older collateral. Acceptance of older vessels into bank's collateral position from generally 15-18 years at maturing five years ago to approximately 20-22 years at maturity, today for tankers, combos and Capes, and 22-25 years for multipurpose, container and bulkers up to Handysize.*
- *Reduction in spreads/fees, i.e. lower overall yields. Increased use of prepayment fees and of ad hoc fees.*
- *Reduction of financial covenants. Increased emphasis on 'sole discretion of bank' covenants.*
- *Increase in non-recourse lending.*
- *Insistence on multi-vessel package financings.*
- *Closer loan monitoring and increased information required.*
- *Greater emphasis on technical condition of collateral.*
- *Greater emphasis on quality insurances, as well as acceptable class, flag and ITF cover.*

- *Greater emphasis in shipping clients' organisational and management abilities and ISM certification.*
- *Increased avoidance of specialised tonnage.*
- *Greater emphasis on cash flow and payments being made via financing bank. This is often documented.*
- *Banks are more informed and aware of market trends, subscribe to more publications and forecasting services and thus are more influenced than before.*
- *Banks require more frequent financial reports from clients in the form of management accounts, including information on liquidity and prior-debt and trade-debt levels, and detailed cash flow forecasts.*

In addition to the above, I wish to discuss in greater detail some areas of increasing concern to banks:

1. Increasing efforts of regulation.

In addition to more stringent class, flag and port control regulations, owners have had to deal with ISM/ISO certification. Here banks are concerned that breaches in ISM procedures would endanger both their clients and themselves.

Soon banks will have to make specific provisions about ISM certification in their loan documentation and would presumably declare an event of default if the certification is not obtained or lost. Even if bankers were to be more accommodating, would port authorities allow vessels to enter or depart without such certification?

2. Hostile conditions for shipping

In addition to the above, shipping has become in some parts of the world almost a dirty word. Ship trading is often halted for obscure reasons from a great variety of bodies each having the right to stop a vessel from trading. In addition, increasing use of ship arrests is being made for legitimate or spurious reasons by creditors who favour some jurisdictions such as South Africa to the point where owners and banks clarify these ports as 'dangerous'.

3. Increased strife arising from disputes within shipowning companies.

Partners quarrelling is not new but as the size of shipping firms becomes larger in response to market, financial and regulatory pressures, disputes between port owners have become more prominent. Indeed, de-merger advice has been a particularly active area of our practice.

4. Tightening of market credit

In the aftermath of some notable shipping failures and the fall in the dry bulk market, unsecured creditors have tightened their provision of credit to their shipping clients. This has put further pressure on the already hard pressed liquidity position of owners and has affected their ability to service bank debt properly.

5. Tightening of insurance-claim provisions

It has become harder for owners to prepare and collect claims successfully due to changes in the appropriate provisions, especially the 'onus of proof' and the development of an 'anti-claim' bias. Banks are concerned about delayed or uncollected claims, which affects their collateral position.

6. Lack of 'effective' cover by P&I clubs

Most bankers and owners are disappointed with the cover and service obtained from P&I clubs. The overall system promotes delays, high legal fees and complications, as well as differentiated treatment of members by their club. Recently, a 20-tonne water-contaminated grain cargo was allowed to escalate into an actual loss of over $1 million by 'sticking to the rules'. To counteract this danger, banks have begun to use their weight with clubs to influence them to move faster at resolving disputes.

INTERNATIONAL SHIPPING BANKS 1996-1995

COUNTRY/REGION	MAJOR ROLE		MINOR ROLE		TOTAL		%	
	1996	1995	1996	1995	1996	1995	1996	1995
BRITAIN	7	7	10	10	17	17	8.5	11
FRANCE	5	6	8	3	13	9	6.5	6
SCANDINAVIA	6	7	13	10	19	17	9.5	11
GERMANY	8	7	13	7	21	14	10.5	9
HOLLAND	5	5	5	3	10	8	4.9	5
OTHER EUROPEAN	5	4	41	32	46	36	22.8	23.5
NORTH AMERICA	10	10	16	13	26	23	12.9	15
FAR EAST & OTHER COUNTRIES	16	10	33	20	49	30	24.4	19.5
GRAND TOTAL	62	56	139	98	201	154	100	100

Survivability during Market Troughs

The key points of advice in dealing with banks, the market and internal issues are as follows:

To the banks:

- Adequate and truthful information
- Avoidance of misunderstandings
- Handling inter-bank problems

To the market and the internal issues:

- Handling creditors
- Handling aggression
- Keeping morale high
- Handling issues proactively
- Hints of economising
- Maintaining a clear strategy
- Developing an investment plan
- Maintaining control and decision-making

Is 1996/97 a repeat of the 1980s? My clear response is that it is not, for the following main reasons:

Key differences

1. Growth in world trade is continuing at consistent rates of between three and four per cent per annum.
2. There is potentially more room to grow in the ex-Soviet republics, China and other developing areas.
3. The international financial/banking system is healthy and capable of financing growth.
4. Overordering is limited to only some segments of the dry bulk and container business.
5. The world fleet is ageing and needs replacing.
6. Operating conditions for old, substandard vessels are becoming particularly hostile and as such more vessels will be laid up for scrap.
7. The operating efficiency of the world's fleet is declining due to more regulations, restrictions and scrutiny of vessels' condition, as well as port congestion.
8. Interest rates are (and expected to remain) low, which adds to the stability and financial solvency of shipping being a capital-intensive industry.
9. The US dollar, being the only international currency, is relatively strong and stable.
10. The shipping industry and banks display more confidence, commitment and liquidity than in the past.

Conclusion

Investment conditions over the next five years across all market segments will undoubtedly provide all participants with specific opportunities to be exploited, as well as the opportunity to realise their own business and investment strategies.

Biography

Mr Theodore Petropoulos is Petrofin's founder and has been its joint managing director since 1987. Mr Petropoulos is an international banker with particular emphasis on shipping, commercial and project finance, strategic investment and banking advice, company evaluations and privatisations and mergers and acquisitions, as well as foreign exchange. He started his career in the family shipping *business in the early 1970s, joined the First National Bank of Chicago, London, in 1975 and became an assistant vice- president in 1980. He served as head of FNBC's Piraeus branch in 1979 and stayed in Greece until 1982 when he joined ABN Bank, London, and worked as the head of Transportation, Energy and Project Finance until early 1985. In 1985 he became general manager of the London branch of a Swiss bank.*

From Bimco Review - January 1998 Issue
