Why has ship finance dried up and how long will this last?

By Ted Petropoulos

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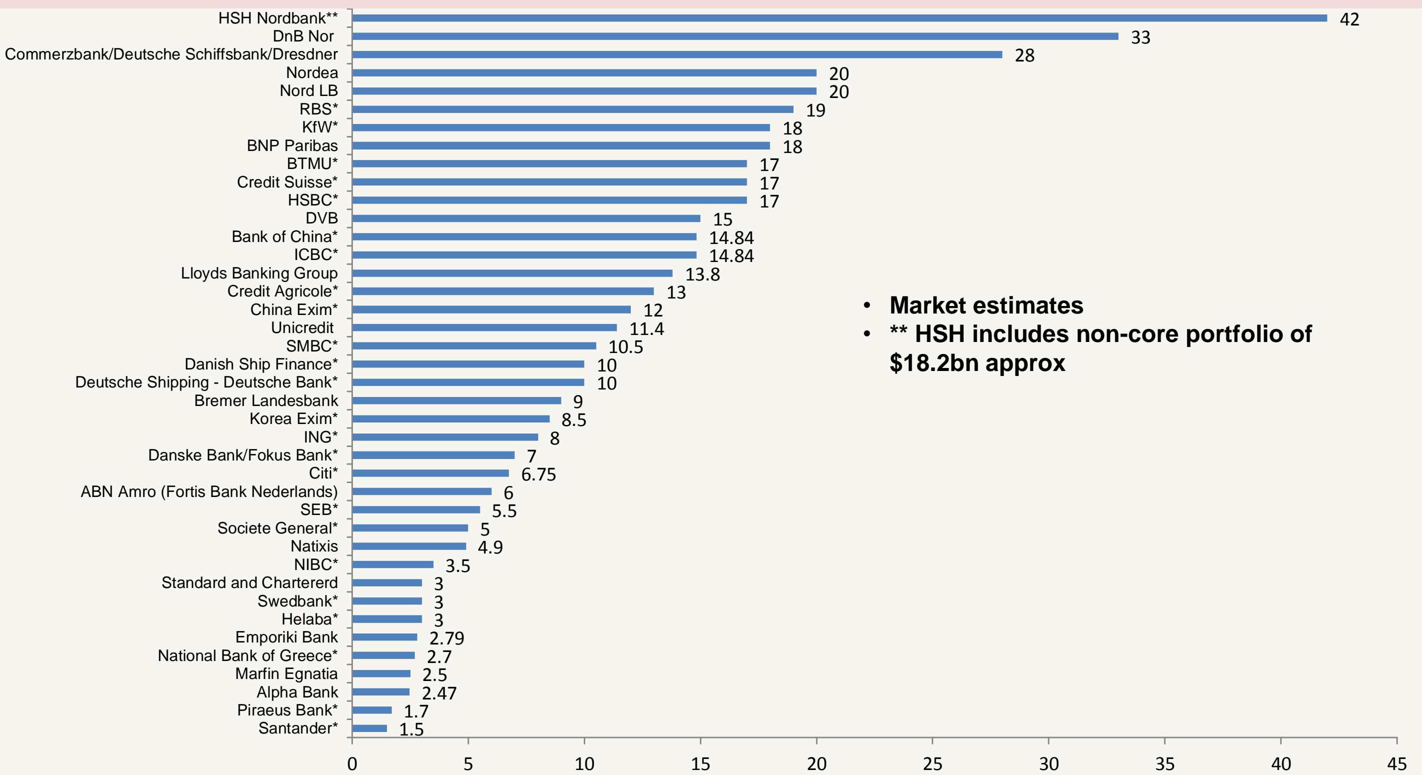
For Nafs

Ship finance availability deteriorated as the year progressed. This is due, in part, by the slow down by 32% in the number of sale and purchase vessel transactions and the decline year on year by an average of -55.6% (Source *Clarkson Research Services Limited)* since 2009, in new building orders. Also, switching banks has become a costly exercise, as the cost and terms of new borrowings have also increased. In addition, the average price of each vessel has declined and this too has had an impact in the overall levels of new finance required.

It is too early to be able to provide hard figures for the slowdown in ship finance, as our Petrofin Bank Research ©, as of 31.12.2011, shall only be available in about March of next year. Whereas bank finance demand has softened for the above mentioned reasons, the supply of ship finance is now at a standstill. Increasingly, as the year progressed, one after the other, banks declined to offer terms or greatly restricted such loans only to their existing and most financially robust and larger clients.

According to the latest Petrofin Bank Research©, in Graph (1), we present the top 40 global ship finance banks, representing $461.19bn out of a total global ship finance estimate of $500 bn. In order to illustrate the shift in interest by ship finance banks, Petrofin Research conducted research among the top 40 global ship finance banks, over the period 2009 to 2011. We divided all 40 banks into 3 categories, namely, those with a neutral / unclean policy / capacity to lend and those with lending capacity.



The results are shown in Graph 2. As you will see, there has been a marked deterioration in the period from the end of 2010 to November 2011. Noticeably, the portfolio adjusted banks with reduced loan capacity rose to 46.1% of the total from 30.41%, a year earlier, whilst those with lending capacity fell from 53.49%, last year, to 29.58 in November 2011.

Graph 2

Global ship finance portfolios
2009, Top 40 banks: 462.9bn
Mid-2010, Top 40 banks: $436.18bn
November 2010, Top 40 banks: $449.76bn
November 2011, Top 40 banks: $461.19bn

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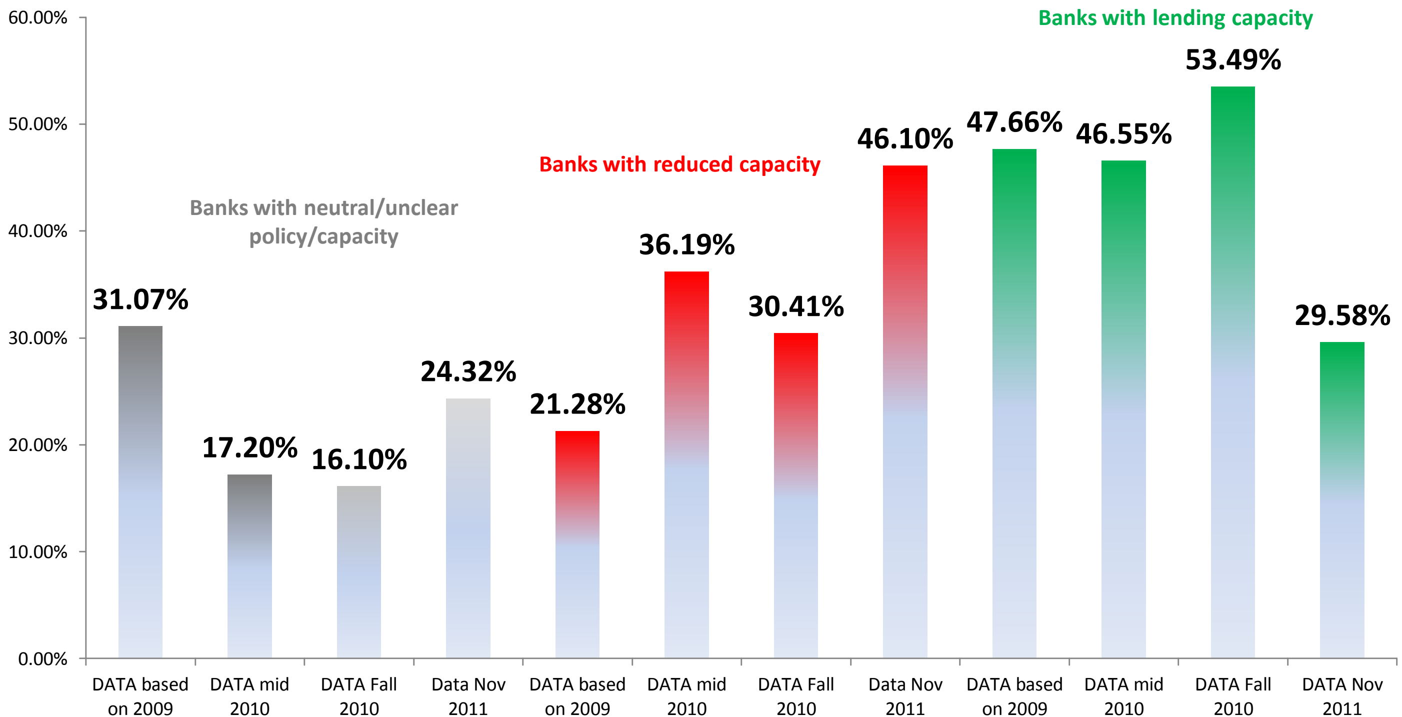
The reason the portfolio looks increased, although the declining banks are up to 55.65% is that some Chinese banks' portfolios were revised upwards according to new data.



These are major swings, as traditionally bank lending policies have tended to be rather stable over time, despite some turnover in the composition of the top 40 banks.

WHAT ARE THE REASONS FOR THE LACK OF APPETITE BY THE TOP SHIPPING BANKS?

To some extent, as we approach the end of each year, loan availability by banks is reduced as banks wish to delay drawing new loans prior to 31.12.2011, which is the cutoff date for their 2011 financials.

More importantly, though, the impediments for fresh ship lending relate to the following non-shipping and shipping factors.

The NON-SHIPPING FACTORS are the following:

1) Increased provisions, due to sovereign risk factors e.g. Greece, Italy, Portugal, Spain etc. These provisions hit the banks' capital base.

2) The need to increase capital adequacy, as of 30th June 2012 to 9% (Basel III).

3) Mounting loan provisions, due to the deteriorating European market conditions, as they affect bank clients' ability to service loans. This, too, affects the banks' capital base.

4) Liquidity related issues.

The illiquidity of European banks (which constitute approx. 82% of global shipping loans) has grown as the year has progressed. This is related to the mounting European and euro crisis, as it affects most European companies, whereby interbank lending has ground to a virtual halt. Depositors (corporate and individuals) are distrustful of European banks, preferring instead non-European banks. In consequence, European banks have been forced to borrow Euros from the European Central Bank (ECB) and swap them for US Dollars at a high cost. As a result of this financial strain, a number of banks e.g. French banks, resorted to a process of significant de-leveraging, in order to also meet the capital adequacy criteria.

Admittedly, recently, the Fed together with other non-European central banks eased the US Dollar related availability and cost by offering US Dollars to the ECB at a lower cost. Despite the above, as an indication of the increasing support provided by the ECB, overnight European bank exposure rose to Euro8bn, as of early December 2011.

The funding issue affecting European banks is much larger, however. In accordance with the European Banking Authority, in 2012 alone, European banks shall have over Euro 700 billion in bond maturities. It is estimated that only a portion of these will be replaced by new bonds, thereby leaving a huge balance to be funded by the ECB.

This is a most unhealthy situation and one that undermines European bank confidence and willingness to enter into new commercial risks (loans).

Due to the estimated fresh capital that shall be required by European banks (amounts vary between Euro 100bn – Euro 300bn over the next few years), bank share prices have fallen to such low levels, that any capital increase would severely dilute existing shareholders. Moreover, even at these low share price levels, bank share investor appetite is at present low. Consequently, banks resort to raising capital and liquidity via loan securitized bonds, convertible share issues and other hybrid capital raising techniques.

It follows, therefore, and it is quite understandable, that if banks are fighting a daily battle to maintain their liquidity and meet their capital adequacy requirements, they would be unlikely to enter massively into new loans. Increasingly, therefore, banks have become very defensive and utilize their loan portfolio runoffs to shore up their liquidity instead.

The SHIPPING RELATED FACTORS are also important. With the exception of the offshore sector, all other shipping sectors are facing difficult market conditions. Vessel values and even more importantly, freights, have weakened to the point where most vessel cash flows cannot fully service their debt repayments.

The above factors have adversely affected the quality of banks' shipping portfolios, resulting in a larger number of loans entering either the "watch" category or requiring restructuring or entering the default category and requiring provisions or foreclosure. I should hasten to add that thus far there have been relatively few defaults and foreclosures. However, there is no doubt that the situation is worsening, as evidenced from a late November 2011 Petrofin top bankers' survey, whereby over 82.7% expected higher loan write-offs, provisions and restructures for 2012.

Due to the significant order book overhang, most analysts anticipate that adverse market conditions and the fleet over supply condition shall last for a considerable

number of years. Clearly, therefore, banks see the poor shipping industry prospects as non-conductive to lending.

Lastly, as an increasing number of borrowers are finding difficult to meet existing loan obligations, the effective loan portfolio run off of banks is reducing (we estimate this at about 7% per annum, currently).

Admittedly, not all banks have developed a negative posture. Some banks, such as ABN, Standard Chartered, HSBC, Credit Suisse have shown signs of wishing to expand their overall shipping exposure, acting in a counter cyclical and client selective manner.

The last question is HOW LONG WILL THE CURRENT SHIP FINANCE SQUEEZE LAST?

To answer this question, we must consider how both the non-shipping and shipping factors that affect ship finance shall develop in the next couple of years.

The issues facing European banks are expected to be addressed decisively in 2012. It has been made abundantly clear that should banks fail to meet their capital adequacy requirements, the central bank of each European bank shall acquire shares in each bank, utilising funding from the ESFS fund of the European Union. These monies would need to be returned within 2 years by the bank either from generated surplus cash flow or by the sale of bank units or the bank itself. Either way, it is expected that both the capital adequacy and liquidity issues (barring the collapse of the euro area) shall improve in 2012 and further in 2013.

I draw confidence from the awareness by the central banks and the EU of the risks associated with the European banking industry and the need to take such action and introduce such measures, as to alleviate both the banking and euro crises.

I, also, foresee that a number of European banks will be acquired by Far Eastern banks or shall need to merge, in order to survive.

A revival of the European economies and a reduction of country budget deficits are joint pre-requisite for the alleviation of fear in European banks. The problem that needs to be politically covered is how to achieve both at the same time.

In shipping, the market adjustment mechanisms have already begun to take effect. Scrapping volume is high (estimated at 35.56mDWT for 2011 – the highest since 1985 – Source *Legacy Shipbroking S.A.*) and the total orderbook is declining (-18.89% - Source *Clarkson Research Services Limited*). The absence of newbuilding ship finance also acts negatively towards further ordering and so does the very poor cash flow. For example, in October 2011, for the first time over the last 5 years, there have been no Greek fresh shipping newbuilding orders.

Our own analysis has suggested that the rate of net fleet capacity increase (additions – deletions) shall continue to decline and may match ship demand in 2013. If so this would be positive news. However, as there has already been a large supply surplus that has developed over the years, the question arises of how long it will take before demand outstrips supply and eliminates this surplus.

Confidence is drawn from the fact that as we speak, rates across all sectors are very poor but they still cover operating expenses and in the case of dry bulk leave a surplus towards interest and loan repayments. This suggests that we are below but not too far from market equilibrium levels. Consequently, as both the order book overhang and the rate of increase in the fleet deadweight capacity shall fall, it is expected that increased demand (primarily from the Far East) shall allow shipping to recover and freight rates to harden over the next couple of years.

It is, therefore, a matter of time, before shipping markets shall return towards equilibrium and shipping loan appetite shall return.

Moreover, current loan margins are at their highest ever, loan conditions are very strict and shipping loans are very attractive, provided the global banking market and the shipping market shall stabilize, providing banks with the confidences and capacity to recommence lending and for new banks to enter the field of ship finance.

Although there are still considerable risk issues at play, it is anticipated that 2012 shall be a year of stabilization, in global banking and liquidity, leading to an improvement in global economic growth and trade, as well as shipping, from 2013 onwards.