# IDENTIFYING TRENDS AND LENDING PARAMETERS IN SHIPPING FINANCE

## 1997 SHIPPING FINANCE IIR CONFERENCE

**Ted Petropoulos, Managing Director**
**PETROFIN S.A., Greece**

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The subject to be covered today is truly wide and I shall tackle it in 4 broad sections, namely **(slide 1):**

A. Analysis and trends in the Shipping Banking Sector.
B. Analysis of Shipping customers' banking requirements.
C. Shiplending parameters and trends.
D. Survivability during market troughs. Is 1996/97 a repeat of the 1980's?

I will continue with an analysis of and trends in the Shipping Banking Sector in 6 sub-sections as follows **(slide 2):**

### 1. 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 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. I will return to this theme later in this presentation.

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: **(slide 3)**

1. Rapid banking industry expansion and globalisation.
2. The increasing development of «specialist» lending
3. Banks blowing up their balance sheets through over-leverage
4. Banks awash with resources to lend and looking for opportunities
5. 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 period and at keener rates.
6. The «discovery» of shiplending by banks throughout the world and especially the major U.S. based wholesale financial institutions that saw an opportunity to lend huge amounts at attractive rates.
7. The mistaken approach by shiplenders and their lack of experience in believing that asset based finance was relatively secure and lending percentages could be increased to relatively high levels of 80%-90% with apparently little risk.
8. 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.
9. The rapid development of the shipbuilding industry especially in Japan and
10. 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, led 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.

## 2. THE GROWTH OF SHIPPING BANKS OVER THE LAST 5 YEARS BOTH IN TERMS OF NUMBERS AND THEIR INVOLVEMENT IN SHIPPING.

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 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 in mind, the importance of worldwide transportation in general and shipping in particular, as well as 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 No. 4**. Information published last November shows that the number of shiplending banks has increased during the period from 67 to 201. You will observe that 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 **(slide 5):**

1. A sustained shipping market recovery over the period.

2. Improving world economic conditions and performance.

3. Lower interest rates

4. Healthier balance sheets by banks and enhanced ability to lend.

5. Attractive returns by banks from shiplending when comparing these with those offered in other industries or activities and

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 full 1996 analysis is presented in the attached **slide No. 6**. 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:

a) «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

b) 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.

c) 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.

d) 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, the attached **slide No. 7**, 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 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.

## 3. WILL THE GROWTH CONTINUE? KEY DETERMINANTS.

The dry bulk market is currently experiencing turbulence in all sectors and especially in the Panamax and Cape sizes. Although rates have recovered recently, 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.

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. 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 publicized 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 $275 bn forecasted by Drewry's 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.

## 4. SHIPPING FINANCE RISKS/REWARDS FOR BANKS

«Shiplending is an exercise in risk limitation».
Successful shiplending requires the avoidance or minimisation of shipping risk. Since shiplending 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 defenses to minimise these. Often defenses are in the form of primary defenses, secondary defense and so on.

Seeking to identify shiplending risks, we can analyse these as related to the following **(slide 8):**

1. Change in overall market conditions.
2. Sector risks.
3. Specific collateral risks.

4. Technical risks.
5. Interest rate risk.
6. Operating cost risk/overturns.
7. Management/organisational risks.
8. Entrepreneurial/strategic risks
9. Liquidity/leverage risks.
10. Insurance/Class/Flag/Port control risks.
11. Credit management skills (or lack).
12. Environmental/Regulation risks.
13. ITF
14. Know how/expertise
15. Fraud
16. Ability to control operations
17. Character/track record
18. Communications/disclosure
19. Location
20. Legal/dispute

The above list is not exhaustive but contains main areas of risk as seen from a banker's eyes. However, shiplending risks are often affected by the following bank related factors and risks **(slide 9):**

BANK RELATED FACTORS AND RISKS

1. Experience of shiplending personnel.
2. Experience of credit approval and controlling departments.
3. Pressure on shiplenders to meet budgets and portfolio yields.
4. Shiplending department's organisation, credit monitoring systems.
5. Access to quality advice e.g. legal, technical, insurance, valuation etc.
6. Personalities' factor.
7. Workout/client support ethos.
8. Panic factors.
9. External influences outside those of the shipping department.
10. Change of policy/management.

Historically, the shiplending sector has shown 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 shiplending 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 risks by carefully analysing risk, as well as, concentrating a) on the larger, quality names, b) on relatively safe market sectors, c) syndications/club deals, d) larger «corporate» credits, e) getting to know clients well, f) selling non risk products and g) becoming the client's bank across a variety of products and services thereby cementing better the relationship.

## 5. 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 5 years from an average of 175-200 overall basis points per annum to approximately 150 basis points today. The exact portfolio yield would depend on the relative weighting of AAA credits yielding approx. 100 bank's points as opposed to slightly lower quality credits yielding approx. 150 basis points and lower but still acceptable 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 in 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 **(slide 10):**

1. Sale of derivatives such as swaps, interest rate caps etc.
2. Multicurrency lines
3. Sale of FFA and other hedging products
4. Advisory/structuring services to clients
5. Assistance to clients in public floatations
6. Arrangement of syndicates and/or clubs.

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

1. Securatisation
2. Shipping commercial paper
3. Equity related «lending»
4. Cross product selling e.g. real estate, portfolio management etc.
5. Mergers and acquisitions

6. Sale and purchase of assets.
7. Provision of «corporate» advice and services.

I will now turn to the second section of this presentation, namely:

## B. ANALYSIS OF SHIPPING CUSTOMERS' BANKING REQUIREMENTS

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

These requirements and points of emphasis are presented in **slide No. 11** and I will deal with each one in turn stressing their relative importance.

1. Loan to asset percentages.
2. Overall cost.
3. Duration of loan (low daily breakeven 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 shiplending officers and senior management. Low staff turnover.
8. Personalities of officers.
9. Reaction to problems.
10. Reaction to a «market change» (pro-active/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 client 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 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 alike have begun to expect a more pro-active marketing approach from their banks. Often their criticism is «they offer me nothing new». At times of market difficulty, good clients expect «their» bank to offer them vessels for management or purchase.

Despite 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 turn-over at banks and the build up of personal rather than corporate relationships.

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

**C. TRENDS IN SHIPLENDING PARAMETERS AND TRENDS**

In this section I will not deal with how banks evaluate a credit, a subject which shall be covered by another fellow speaker. I will instead concentrate on analysing the changes and trends in shiplending parameters and requirements, as well as, pointing to some newer areas of bankers' concern.

I have tried to summarise these changes and trends in the attached **Slide No. 12**:

**CHANGES / TRENDS IN SHIPLENDING PARAMETERS**

1. Higher percentage of finance provided.
Average percentage for medium risk clients has grown from approx. 60% to 65% over the last 5 years as a result of greater competition.

2. Longer loan periods.
Often accommodated via balloons or rear-loaded repayment structures.

3. Older collateral.
Acceptance of older vessels into bank's collateral position from generally 15-18 years at maturity 5 years ago to approx. 20-22 years at maturity today for Tankers, Combos and Capes and 22-25 years for Multi-purpose, Container and Bulkers upto handy size.

4. Reduction in spreads/fees i.e. lower overall yields. Increased use of prepayment fees or adhoc fees.

5. Reduction of financial covenants. Increased emphasis on «sole discretion of bank» covenants.

6. Increase in non-recourse lending.

7. Insistence on multi-vessel package financings

8. Closer loan monitoring and increased information required.

9. Greater emphasis on technical condition of collateral.

10. Greater emphasis on quality insurances, as well as acceptable class, flag and ITF cover.

11. Greater emphasis in shipping clients' organisational and management abilities and ISM certification.

12. Increased avoidance of specialised tonnage.

13. Greater emphasis on cash flow and payments being made via financing bank. This is often documented.

14. Banks are more informed and aware of market trends, subscribe to more publications and forecasting services and thus are more influenced than before.

15. Banks require more frequent financial reports from clients in the form of management accounts, including information on liquidity, 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 by 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 shall have to make specific provisions about ISM certification in the loan documentation and would presumably declare an event of default if the certification shall not be obtained or shall be lost. Even if bankers were to be more accommodating, would port authorities allow vessels to enter/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 are 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.

Partner's quarreling 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 successfully prepare and collect claims 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 bakers 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 ton water contaminated grain cargo was allowed to escalate into an actual loss of over $1.0m 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.

**D. SURVIVABILITY DURING MARKET TROUGHS**

The main key points of advice in dealing with banks, the market and internal issues are as follows **(slide No. 13)**:

**To the Banks**

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

**To the market and internal**

- Handling creditors
- Handling aggression
- Keeping morale high
- Handling issues pro-actively
- Hints at economising
- Maintaining a clear strategy
- Develop an investment plan and to merely a survival plan
- Maintaining control and decision making

**Before drawing this presentation to a close, I have been asked by the organisers to deal with the question is 1996/7 a repeat of the 1980's?**

My clear response is that it is not, for the following main reasons that appear in **slide No. 14**, namely:

**Key Differences**

1. Growth in world trade is continuing at consistent rates of between 3%-4% 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,

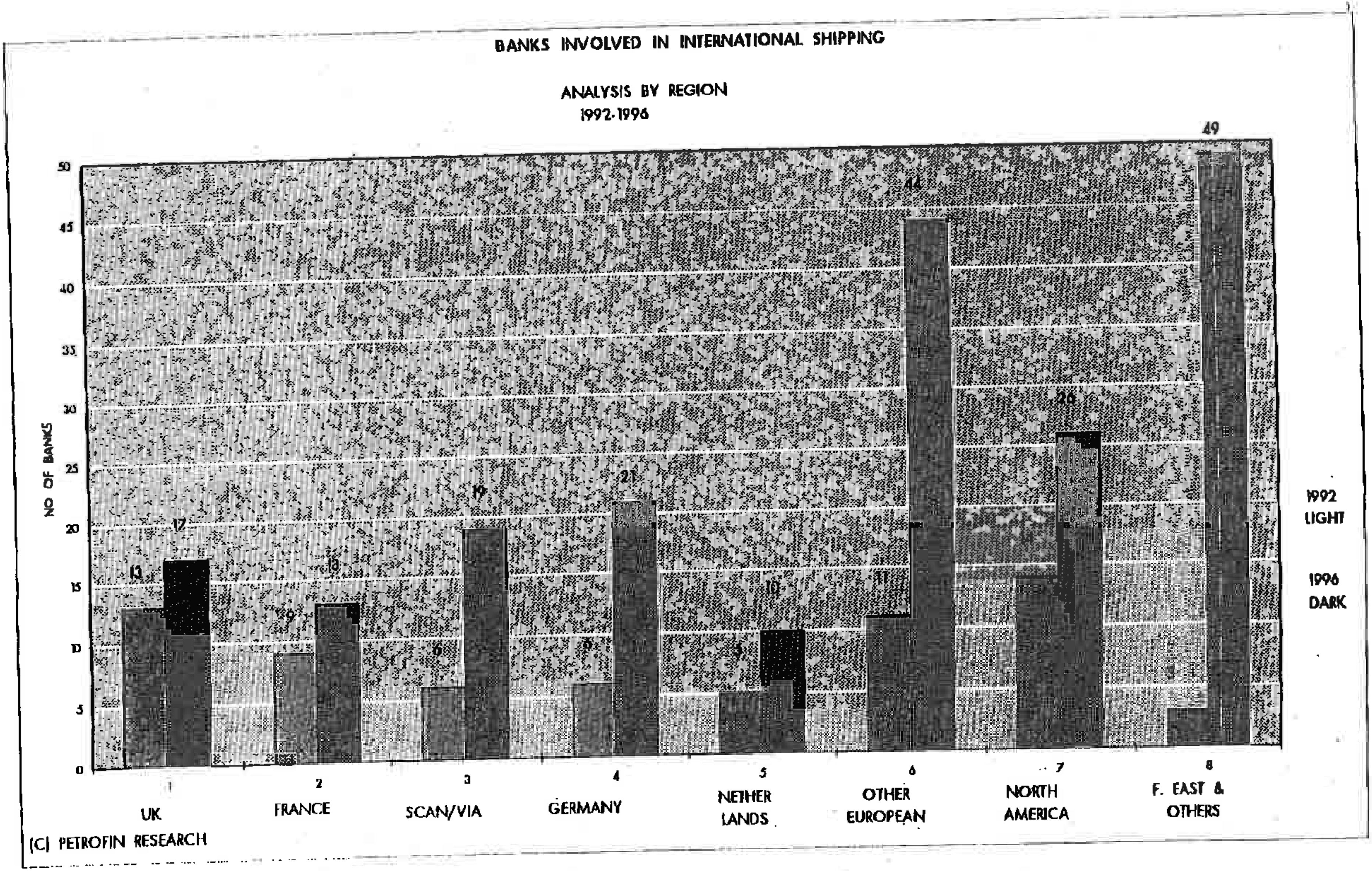
4. Over ordering is limited to only some segments of the dry bulk and container business,
5. The world fleet is aging and needs replacing,
6. Operating conditions for old, sub-standard vessels are becoming particularly hostile and as such more vessels will be laid up or scraped.
7. The operating efficiency 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 are expected to remain) low which adds to the stability and financial solvency of shipping being a capital intensive industry
9. The U.S. Dollar being the only international currency is relatively strong and stable and
10. The shipping industry and banks display more confidence, commitment and liquidity than in the past.

Investment conditions over the next 5 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.

## BANKS INVOLVED IN INTERNATIONAL SHIPLENDING 1996 (1995)

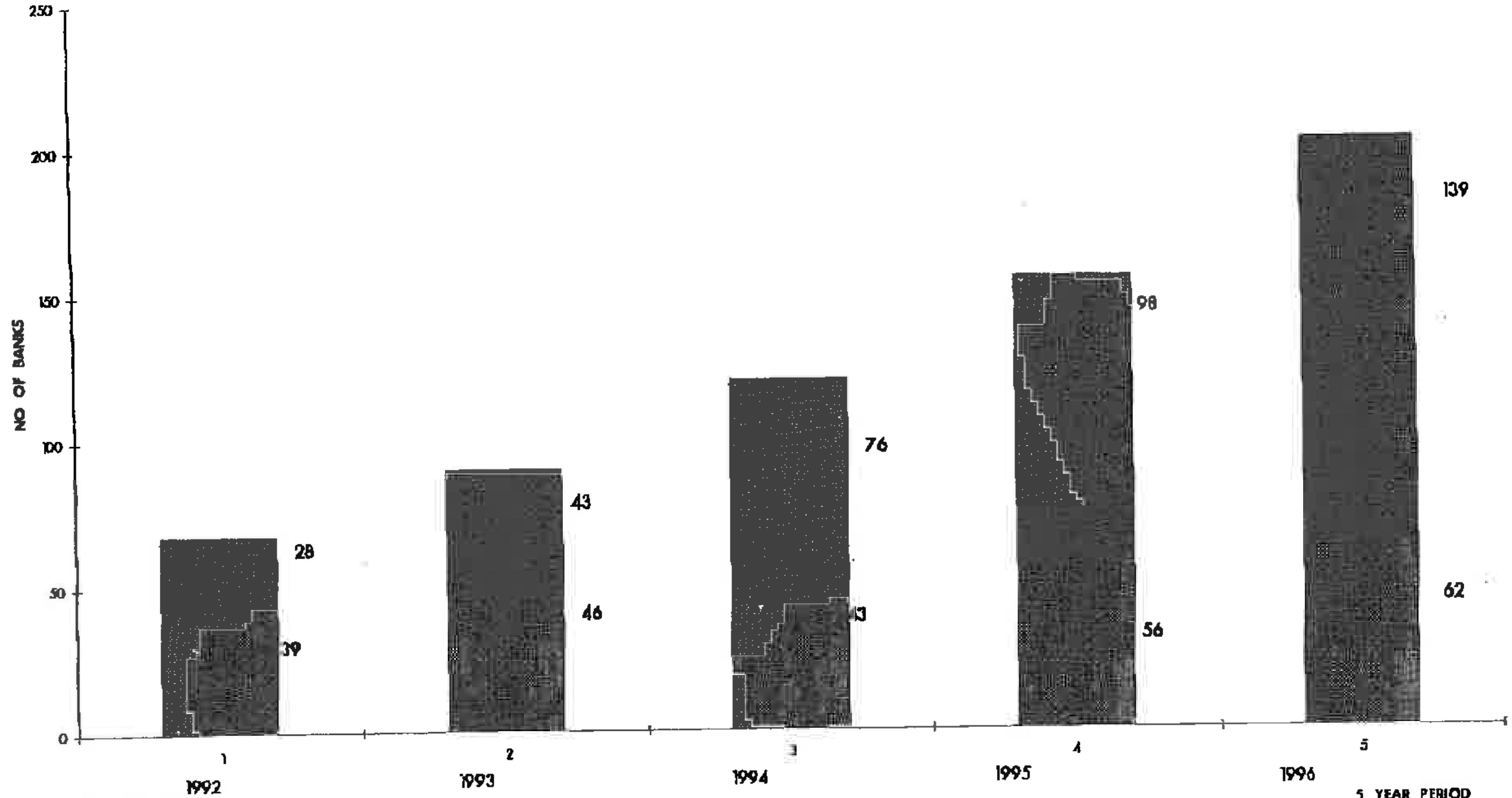
| COUNTRY / REGION | MAJOR ROLE | | | | MINOR / LOCAL ROLE | | | | TOTAL | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | No. | | % | | No. | | % | | No. | | % | |
| UNITED KINGDOM | 7 | (7) | 11.3 | (12.5) | 10 | (10) | 7 | (10) | 17 | (17) | 8.5 | (11) |
| FRANCE | 5 | (6) | 8 | (10.5) | 8 | (3) | 5.8 | (3) | 13 | (9) | 6.5 | (6) |
| SCANDINAVIA | 6 | (7) | 9.7 | (12.5) | 13 | (10) | 9.4 | (10) | 19 | (17) | 9.5 | (11) |
| GERMANY | 8 | (7) | 13 | (12.5) | 13 | (7) | 9.4 | (7) | 21 | (14) | 10.5 | (9) |
| NETHERLANDS | 5 | (5) | 8 | (9) | 5 | (3) | 3.6 | (3) | 10 | (8) | 4.9 | (5) |
| OTHER EUROPEAN | 5 | (4) | 8 | (7) | 41 | (32) | 29.5 | (33) | 46 | (36) | 22.8 | (23.5) |
| EUROPEAN SUBTOTAL | 36 | (36) | 58 | (64) | 90 | (65) | 64.7 | (66) | 126 | (101) | 62.7 | (65.5) |
| NORTH AMERICA | 10 | (10) | 16 | (18) | 16 | (13) | 11.5 | (13) | 26 | (23) | 12.9 | (15) |
| FAR EAST AND OTHER NATIONALITIES | 16 | (10) | 26 | (18) | 33 | (20) | 23.8 | (21) | 49 | (30) | 24.4 | (19.5) |
| TOTAL | 62 | (56) | 100 | (100) | 139 | (98) | 100 | (100) | 201 | (154) | 100 | (100) |

Source: PETROFIN ©



BANKS INVOLVED IN INTERNATIONAL SHIPPING
ANALYSIS BY REGION
1992-1996
NO OF BANKS
0
5
10
15
20
25
30
35
40
45
50
13
17
9
13
6
19
6
21
5
10
11
44
26
3
49
1
2
3
4
5
6
7
8
UK
FRANCE
SCAN/VIA
GERMANY
NETHER LANDS
OTHER EUROPEAN
NORTH AMERICA
F. EAST & OTHERS
1992 LIGHT
1996 DARK
(C) PETROFIN RESEARCH

BANKS INVOLVED IN INTERNATIONAL SHIPLENDING 1992-1996

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