SHIPPING FINANCE IN THE WAKE OF BASEL III

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The shipping industry is undergoing a secular shift in the balance between commercial bank loans and the capital markets as a source of financing for its capital expenditures. Many shipping banks – the traditional source of funding for the shipping industry - have either reduced their exposure to the industry or exited the sector entirely. Those that remain have tightened credit standards while increasing the pricing spreads and shortening the tenors of their shipping loans. This retrenchment has been caused not so much by any single perfect financial storm as by a series of market disturbances that has given the shipping banks scant opportunity to adapt to the new environment. Following the collapse of Lehman Brothers, loans to shipowners that had totaled $94 billion in 2007 fell to $38 billion in 2010; while they since have rebounded, they were still substantially below pre-collapse levels at $56 billion in 2013.[1] The stresses shipping banks underwent following the Lehman collapse were exacerbated by the exposure several of them had to the sovereign debt crisis in the Eurozone. German shipping banks found themselves especially vulnerable as a result of the almost total collapse of the Kommanditgesellschaft (KG) limited partnership model of shipping finance that they had helped fund and in some cases helped promote. That model relied on an indigenous network of small retail equity investors that was itself very vulnerable to the ensuing credit crisis. This traumatized investor base abandoned shipping KGs, leaving behind undercapitalized shipping limited partnerships and their overcommitted shipping banks.

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In response to these crises, regulatory bodies have stepped up their oversight of the commercial banking industry, and shipping loan portfolios have been a particular area of focus for asset quality review and stress testing. A regulatory initiative that will have a significant impact on shipping banks is the Basel III framework promulgated by the Basel Committee on Banking Supervision. While not specifically directed towards shipping loan portfolios, the liquidity requirements of the Basel III framework are likely to have longer lasting effects on the availability and terms of shipping loans than the financial crises that lead to their formulation.

The Basel Committee on Bank Supervision is a non-governmental organization that was originally established in 1974 by the central governors of the then G10 countries in the aftermath of the breakdown of the Bretton Woods system. Its decisions have no legal force. Instead, the Committee formulates supervisory standards and guidelines and recommends best practices in the expectations that individual national authorities will implement them.[2] Even before the Lehman Brothers collapse, the Committee recognized the need for strengthening the previous Basel II framework to address shortcomings in bank governance and risk management. Beginning in 2008, the Committee published a series of consultative papers and proposals designed to strengthen the capital adequacy and liquidity of banks. Of particular relevance to the shipping banking industry are the liquidity standards that were finalized in 2010 and the implementing rules that were published this year.

The Basel Committee on Bank Supervision developed two minimum standards for funding and liquidity, which were designed to achieve separate but complementary objectives. The first objective was to promote banks' short-term resilience by requiring them to maintain sufficient high-quality liquid assets that can be converted into cash to meet their liquidity needs in a severe stress scenario lasting for 30 days. To this end, the Committee developed the Liquidity Coverage Ratio (LCR) standard. The second objective was to reduce banks' funding risk over a longer time horizon by requiring them to fund assets with a minimum amount of stable sources of funding in relation to the assets' remaining maturities and other liquidity risk profiles. To meet this second objective, the Committee has proposed the Net Stable Funding Ratio (NSFR) standard.[3] In addition to reducing mismatches in the maturities between a bank's funding sources and its loans and other activities, the NSFR offsets the incentive for banks to fund liquid assets with short-term funds that mature just beyond the LCR's 30 day test horizon in order to comply with the LCR. Unlike the LCR, the NSFR standard is still in proposed form. The NSFR as proposed by the Committee in January 2014 underwent technical changes from the concept originally advanced by the Committee in 2010[4], and may be further modified in response to comments received by the Committee. The NSFR is scheduled to go into effect on January 1, 2018.

The NSFR is defined as the ratio of the available amount of stable funding to the required amount of stable funding. This ratio should be at least 1 to 1 on an ongoing basis:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

Available stable funding is defined as the amount of the bank's capital and liabilities expected to be reliable over the one-year time horizon considered by the NSFR. The most stable sources of funding generally consist of regulatory capital and capital instruments, borrowings and term deposits with a remaining maturity of at least one year. These sources are assigned a 100% ASF factor, and are fully credited towards the available amount of stable funding. Funding sources that are regarded as less reliable are assigned lower ASF factors, reducing their contribution to the available amount of stable funding proportionately; these generally consist of various funding sources with maturities of less than a year.

The amount of required stable funding is measured based on the amount of stable funding that must be available to support different categories of bank loans and other assets. This amount is calculated by multiplying the carrying value of the bank's assets by the RSF factor applicable to the relevant asset categories. RSF factors are determined on the basis of maturity, as well as credit ratings, borrower class and asset class that are regarded as affecting liquidity risk. Loans with remaining maturities of less than a year are generally assigned RSF factors of 50% or less, and therefore would require support by at most half of their carrying value in available stable funding. Loans with remaining maturities of at least one year are generally assigned RSF factors of more than 50%. For example, unsecured long-term loans to all but the highest rated corporate borrowers have an RSF factor of 85%, while secured long- term loans to corporate borrowers have an RSF factor of 100%. Such loans would require support by as much as 100% of their carrying value by available stable funding.

Back from the banks of the Rhine to the world of shipping finance: The NSFR standard creates challenges for banks to extend substantial long-term loans, both from a regulatory and a financial point of view. Under the standard banks must support long-term corporate loans with corresponding levels of long-term funding. The categories of funding that receive full credit as sources of stable funding, such as long-term debt and term deposits, are the most costly and difficult to raise. A less costly alternative for a bank to reduce the mismatch between the asset and liability sides of its balance sheet is to reduce the tenor of its loans. Although the NSFR does not go into effect until 2018, many loans currently under consideration will be affected by the standard. As a result, banks have already begun to adjust their loan portfolios in anticipation of the NSFR effective date. This trend has been most pronounced in sectors that rely heavily on long-term bank financing, such as project, aircraft and shipping finance. Shipping in particular has relied on the availability of bank facilities with tenors ranging from five to 10 years to finance its capital expenditures. There is anecdotal evidence in the marketplace that the NSFR standard has put pressure on the shipping banks that remain in the sector to exit the sector, and on those that remain to reduce the tenor of their shipping loans and increase their pricing spreads to cover their increased cost of capital. In explaining the reasons for its withdrawal from the shipping sector in its public disclosure, Commerzbank specifically mentioned the rising liquidity requirements under Basel III, especially for long-term financing.[5] There is some concern that other banks may follow suit for similar reasons.[6] The pressures that Basel III has placed on shipping banks, already weakened by the past and continuing debt crisis, may induce other banks to scale back their shipping lending further.

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Where, then, may shipping companies turn to fill the shortfall in long-term bank financing in the wake of Basel III? There is no single answer, but increasingly shipping companies have been turning to the capital markets. The retrenchment of bank lending to the shipping sector has been accompanied by increasing activity in both the debt and equity capital markets. The rebound in the capital markets for shipping issuers has been broad based, ranging up and down the capital structure, from high yield debt to preferred equity, with perpetual and mandatorily redeemable terms, to common equity of corporations and partnerships. Private equity also has played a major role in supplanting bank debt, particularly for shipping issuers that are unable to tap the public markets. The reopening of the capital markets has facilitated this surge in private equity investment in shipping, by providing the funds' investees with access to long-term high yield debt to sustain them through the investment horizon and providing the investors the prospect of an eventual exit through a capital markets offering.

Much of this increased activity has been in the most direct alternative to bank debt, the high yield debt market. Shipping companies have turned to the U.S. and the Norwegian yield debt markets, as well as the hybrid U.S. term loan B market. High yield bonds provide some structural advantages for shipping issuers in search of long-term financing. The high yield debt markets generally offer long-term debt with maturities ranging from five to 10 years, and high yield notes typically are non-amortizing over the life of the issue. As a result, they offer the shipping issuer a potentially stable capital base that matches long-term liabilities with the long-term assets in the issuer's fleet. In addition, the covenant structure of high yield debt is particularly well suited to a cyclical industry such as shipping. Unlike bank debt covenants, which require maintenance of specified financial ratios, high yield debt covenants are incurrence based. In the recent downturn of vessel values, bank loan maintenance covenants oriented towards liquidation values, such as the standard loan-to-value maintenance covenant, arguably created self-fulfilling prophecies and precipitated cascading default crises among many borrowers that were servicing their debt adequately. Such maintenance covenants proved particularly problematic for issuers to manage, as compliance with them is largely affected by the state of vessel market and outside of the borrower's control. An incurrence covenant structure gives the issuer greater ability to affirmatively manage its debt compliance during a downturn by restraining its borrowing, investment and dividend activity. These advantages of high yield debt for the shipping industry have been long appreciated by chief financial officers of shipping companies. However, in the past their choice between high yield and bank debt has largely been determined by the significantly higher interest rate spreads commanded by high yield debt as compared to bank loans. The impact of higher interest rate expense is magnified by the call protection provisions in high yield notes and the significant prepayment premiums required after expiration of the no-call period, all which make it expensive to refinance a high yield debt instrument when interest rates fall. However, the departure of key banks from the shipping sector and the increased costs of capital which banks must incur to comply with the Basel III liquidity requirements have tended to narrow the differential between bank loan and high yield debt spreads. As a result, high yield debt is likely to become a more competitive alternative to long-term bank financing for shipping companies.

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Shipping companies also have returned in numbers to the equity capital markets, which were robust in 2013, in both IPOs and follow-on offerings. Many of these offerings were deleveraging transactions, in which the issuers applied the proceeds of the offerings to repay bank loans, in some cases curing defaults under their maintenance covenants. Deleveraging has been an important feature of those IPOs that shipping companies undertook as master limited partnerships (MLPs). Shipping MLPs typically have relatively moderate leverage, with debt and equity capitalization roughly balanced. Shipping MLPs maintain this balance because their distribution structure facilitates regular access to the equity capital markets, even in down markets. MLPs make steady distributions to their partners on a quarterly basis, a distribution structure that supports yield based pricing and tends to stabilize the unit price during the ups and downs of the industry cycle. For a shipping MLP to sustain such steady distributions requires the appropriate asset base, featuring long-term time charters and a relatively young fleet with predictable maintenance and replacement capital expenditure requirements. For shipping companies with the right asset profile, the MLP structure has enabled them to reduce their reliance on bank debt to finance their capital expenditures. Some of the more successful shipping MLPs have returned to the equity capital markets multiple times, including in down markets to finance opportunistic acquisitions. These acquisitions typically have been financed through a combination of bank debt and common equity, or through an initial drawdown of revolving bank debt that is paid down out of the proceeds of an equity offering to restore a balanced debt/equity ratio.

While the Basel III framework has been criticized by the banking industry for the restraints it imposes on long-term lending, perhaps it will have the salutary effect of introducing a more balanced approach to shipping finance. As the fates of shipping banks as formidable as HSH Nordbank and Commerzbank demonstrated, the banking industry was overextended in the shipping sector and suffered from a mismatch between its short-term liabilities and long-term shipping loans and other assets. Enhanced access by issuers to the capital markets may take some of the pressure off of the shipping banks, while providing issuers with more stable sources of long-term debt and permanent equity capital. Capital markets financing through the issuance of traded securities may have the benefit of diffusing the risks associated with long-term lending to a cyclical industry, such as shipping, to a broader creditor base. In addition, the capital markets may more efficiently quantify and thereby manage these risks by pricing long-term debt in the market, without the regulatory incentives banks have to avoid marking down the carrying value of their loans – incentives that the NSFR liquidity standard may only amplify in order to maintain the required amount of stable funding. The ongoing shift in shipping finance to the capital markets may lead to a more robust model for long-term financing for the shipping industry.

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[1] See statistics provided by Nigel Anton, Global Head of Shipping Finance of Standard Chartered Bank, cited in *Financing is returning to shipping: Standard Chartered*, Seatrade Global, March 21, 2014, available at http://www.seatrade-global.com/news/americas/financing-is-returning-to-the-shipping-market-standard-chartered.html.

[2] See *History of the Basel Committee*, available at ww.bis.org/publ/bcbs/history.htm.

[3] *Consultative Document – Basel III: The Net Stable Funding Ratio*, January 2014, available at http://www.bis.org/publ/bcbs271.htm.

[4] See Basel III; *International framework for liquidity risk measurement, standards and monitoring*, December 2010, available at http://www.bis.org/publ/bcbs188.pdf. For a list of the key changes from the original proposal in 2010, see *Consultative Document – Basel III: The Net Stable Funding Ratio*, at Annex 1.

[5] Commerzbank Aktiengessellschaft, Supplement dated July 12, 2012, to various bases prospectuses, *Recent Developments – Commercial Real Estate Finance and Shipping Finance to be wound up completely while maximizing value*, available at http://www7.warrants.commerzbank.com/SiteContent/7/7/2/470/22/Supplement_July_12_2012.pdf.

[6] See remarks by Juergen Fitschen, co-chief executive of Deutsche Bank, cited in Reuters, June 12, 2012, *Deutsche Bank CEO: Basel III rules can disrupt economy*, available at http://in.reuters.com/article/2012/06/28/deutschebank-baseliii-idINL6E8HSMK220120628.