

Risky business

Shipping is viewed as a risky sector from most lenders' point of view, although a few stalwart institutions have stuck with the industry. But how will the troika of widespread consolidation, securitisation and Basel II affect the relationship between owners and their banks? By Barry Parker

Tanker ownership and bank finance are closely intertwined, and each successive wave of financial innovation seems to bring the shipping boys back into the embrace of conventional funding sources. In a very private business where profitability is the result of good timing on buying and selling the hard assets, the flexibility afforded by commercial lenders cannot be readily matched by other types of debt. A handful, maybe two handfuls of large financial institutions have stuck with shipping, but even the stalwarts are shifting their approaches to deal with both tightening standards and the teachings of modern portfolio theory on how to manage risk.

Vessel owners have expressed a great deal of concern about three issues that can not be separated- consolidation, securitisation and the rules governing capital adequacy; in preparation for this article, we questioned bankers on how they viewed the likely impacts of this troika. Most observers acknowledge that the Basel Convention (with Part I already implemented and Part II now being finalised) catalyses a trend toward tighter control of risks in loan portfolios. One approach to risk reduction is to package shipping debt into 'securities' that can then be offered to other lenders (thereby spreading risk around), while another approach suggests that banks may completely avoid high risk sectors or borrowers.

Securitisation

Bankers are continually inventing new instruments to attract investment, and securitisation refers to the general concept of combining a number of credits into a new instrument that can then be marketed. This has been successful in the consumer sector, where new investment vehicles have been created around credit card receipts, home mortgages and automobile loans, for example. From the City of London, the epicentre of the maritime industry, the Royal Bank of Scotland's (RBS) Ian Fisher offers the view that securitisation of shipping loans is in its early stages, but sees a profound impact on how banks manage and deal with risk as a result of Basel II. Fisher points out that securitisation may not be a source of fresh capital, where investors are other shipping debt players. He says that RBS is unenthusiastic on the subject and points out that the close personal relationships required in ship finance are lost where a debt holder cannot "see the whites of his clients' eyes". Likewise, in Fisher's view, the owner is often uncomfortable if his loan is transferred to other holders.

Slightly to the east, Monish Sahni, Citibank's senior analyst for global shipping and logistics, has a perch high above the Thames in Canary Wharf. He comments that a number of efforts, in which shipping banks have packaged loans and subsequently sold them into capital markets, outside of shipping, have not yet been completed. While Sahni does not see such activity as the beginning of a significant trend, he does see securitisation as a management tool for institutions to "free up capital so that they can make more loans". He does, however, see it as a potentially valuable technique for banks wanting to partially clear the decks - reducing balance sheet liabilities partially or, potentially, to completely exit the shipping sector and deploy bank capital into more profitable or less risky sectors.

According to Dagfinn Lunde, who rejoined the banking world in the summer of 2000 following a five-year stint as the International Association of Independent Tanker Owners' (INTERTANKO) managing director, "There is a cautionary side of

securitisation." Lunde, now head of shipping finance and member of the board of managing directors of Deutsche VerkehrsBank AG (DVB), explained that securities that are created for sale to investors must contain some strong credits. He went on to explain that "the danger is that a bank's portfolio might actually be weakened if the jewels are securitised." Based in the Rotterdam office of Nedship (DVB's Shipping Division), Lunde asks, "What would then be left in the portfolio?"

Capital Adequacy

In the late 1980s, the Bank for International Settlements, through its Basel Committee, began formulating broad guidelines on capital requirements for banks within its purview. Ian Fisher of RBS suggests that the Basel Convention was an evolutionary concept under which Basel I will be followed by "further refinements of what we already have," as banks begin to look more closely at the risk of individual loans in order to get the overall umbrella of bank risk to the appropriate level. He acknowledges that smaller tanker borrowers are riskier and that in the future they might face increased pricing or possibly, an unwillingness on the part of some banks to deal with companies below a certain threshold. As banks devote more attention to bigger borrowers, smaller companies may consider getting together or joining up with a larger player in order to gain critical mass. RBS has not seen such activity yet in the tanker side, but has in other segments. Fisher adds that borrowers may find that diversifying the portfolio mix of vessels could lead to a lower perception of risk. Monish Sahni of Citibank draws an explicit link between securitisation and the Basel II rules, which will become effective in December 2006, commenting that banks' need for risk management tools could occasion further efforts to package and re-market their shipping paper. He points out that the long term nature of shipping deals, typically seven to ten years, means that banks looking at business now must be considering the likely impacts of Basel II, since they will be "living with today's decisions even after Basel II comes into effect". Sahni says that banks are generally doing "a lot of reading and studying up" as they strategise for the capital requirements dictated by Basel II. He agrees that "credit will be pricier for smaller borrowers". Dagfinn Lunde of DVB notes that his institution looks at a borrower's present and anticipated cash flows "microscopically", going well beyond the rigour required by accounting standards.

Consolidation

The practice of combining businesses, whether through acquisition or merger, is a natural response to the notion that financial risk comes along with the operational risk typically seen in small undiversified companies. Yet, other dimensions are revealed from conversations with Sahni. Over the past decade, the number of customers has shrunk as integrated oil companies and players with a big breadth at one vertical stage of the oil chain have all felt the urge to merge. The number of financiers (which Sahni argues should be treated like suppliers of other inputs to tanker companies) has also been reduced as financial institutions have seen economies from combining. If you take it as a given that "large customers like to deal with big suppliers, and vice versa", then the logic for a shrinking number of tanker owners becomes inescapable. When asked about the likely course of consolidation, Sahni said that he could envision a business, 10 years hence, where the top 20 companies comprised between 40 to 50 per cent of the industry in terms of tonnage. But more subtly, the qualitative pressure for owners to provide better and more reliable financial statements may, at the same time, provide some ballast for the existing structure. "In a world of Enrons and Worldcoms, one ship tanker companies do not have a monopoly on bad information," says Sahni. Some banks may see smaller owners as a viable target sector, but must show regulators that they are approaching this business with a robust and reliable methodology for assessing companies. Owners need to be sensitive to the needs of the banks, and those

owners not providing company information in the format required by lenders will be adversely impacted. Asked if the ability to provide detailed and accurate company information could help enable owners to overcome the impediment of small size, Sahni answered, "Yes," and recited a list of big companies in the headlines for providing bad information.

The Nature of Risk

Operational risk cannot be separated from financial risk. Lunde, with a perspective that includes 13 years of maritime lending at what is now Den Norske Bank prior to joining INTERTANKO in 1995, suggests that banks may view larger companies as less risky due to their presence in multiple markets. Having worked early in his career as finance director for the Klaveness Group, one of the largest Norwegian owners, he knows firsthand about the virtues of diversification. "A small tanker owner with one or two ships might have very conservative accounting, excellent disclosure and a first class operating style, but what if that entire sector takes a prolonged downturn?" Such a view represents the pendulum-like movement buffeting ship finance - a few years ago, underwriters sang the praises of specialisation. But now, as the need to dress companies up for industry outsiders has waned, risk mitigation has achieved a new primacy.