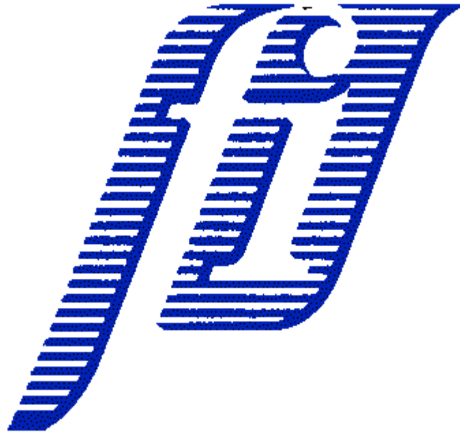

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"The Impact of New Financial Regulations in Europe & the USA"

Paul Slater

Chairman & CEO, First International Corp
www.firstintl.com

“The Impact of New Financial Regulations in Europe and the USA”

Following on from the near collapse of the International Banking System in 2008 it is hardly surprising that Governments in the USA and throughout Europe have been under pressure to institute new regulations and reforms designed to prevent a repeat of the 2008 crisis.

Led by the Basel Committee on Banking Supervision which voted on a host of new measures in early September of this year, various Central Banks in Europe and the Federal Reserve in the US have all indicated a strong desire to tighten the regulations covering banking and also to make some fundamental changes to the way banks will operate in the future.

While the cause of the near collapse of the Banking System has never been singly identified there were many contributing factors.
The popular myth that it was started by US Banks making vast loans to people buying houses that they could not afford, is only a small part of the problem.

Far bigger a problem was the Investment Banks that re-packaged these bad loans and sold them to investors around the world as mortgage backed securities CDOs. Not content with this description they created various forms of trading paper that gambled on these risks and sold a variety or derivatives (a fancy name for bets) including Credit Default Swaps CDS to investors including pension funds and municipality investment funds along with the usual suspects of hedge funds and private equity funds.

The Investment Banks had sought to outdo each other by creating more and more suspect paper across the debt spectrum that was then traded “Over the Counter” thereby avoiding being exposed to public markets or the regulatory authorities.

So popular and profitable has paper trading become, that with the repeal of the Glass-Stiegel Act in the late Eighties, Commercial Banks set up huge trading operations or acquired them by taking over Investment Banks and Brokerage Houses.

The turnover of these trading operations was a multiple of most banks capital but the profits were huge and seductive, and with some clever accounting trickery the magnitude of the risks was hidden from the regulators and the banks' Shareholders.

Meanwhile the economies of the developed world were slowing dramatically as the mountain of debt, corporate, personal and governmental which had fueled economic growth through the first 6 years of the new millennium, began to rear its ugly head.

By mid 2007 Europe and the US were in recession and with it came the collapse of the property markets both residential and commercial. This caused the so-called sub-prime mortgages to default and began the process of bringing down the whole pack of debt and derivative cards that had been so widely sold by the banks.

Government bail-outs of Banks proliferated and the law suits and finger pointing began. This brings us to the new regulations and their effect on the shipping industry.

Basel III and other new Banking Regulations

I do not intend to spend time listing all the new regulations under consideration but will attempt to simply summarize them.

- Banks will be required to separate their various lending portfolios and grade them according to risk. This will be done by Industry in Commercial loans and by other definitions in other sectors such as Governmental.

- Banks will be required to provide extra capital for loans to industries that are graded in the high-risk categories.

- Banks leverage will be restricted to 22 times their capital. A long way down from many European Banks who have 50:1 leverage or Lehman Brothers which was 600:1 when it collapsed.

- Trading portfolios will be subject to regular "stress tests" although some major banks have found ways around this through temporarily shuffling assets (loans) off their books and taking them back again. (Auditors need to be more alert).

- Banks will face serious limitations on proprietary trading or using their own funds to place bets in the commodity and securities markets, particularly where they are managing clients' funds in the same markets.

- Some governments are looking at separating Banking from Trading and Brokering, licensing both of the latter and requiring significant disclosure of their activities.

- The present rules governing investment in Private Equity Firms and Hedge Funds are likely to be changed to restrict Pension Funds from investing in them and requiring them to report in much the same way as public companies have to report.. High net worth individuals with assets of less than $5m, excluding residential real estate will also be prevented from investing in these funds.

- State and Public Employee Pension Funds will face limitations on their investing in Equities and Commodities, and prevented from buying, directly or indirectly through funds, over-the-counter securities or any other derivatives.

The Dodd-Frank Act which was signed into law in the US in July of this year was far reaching but incomplete, as most of the actual regulations have still to be worked out.

With the results of the US mid-term elections changing the balance of power in Congress this bill will be hotly debated and the banks are lobbying fiercely to try and roll-back some of the proposed regulations and water-down others.

All of this will take some time to enact and further time to achieve some international unity, but in the wake of the vast losses that have appeared since 2008 and the continued unwillingness of banks to lend, pressure from companies and the public will force many of these measures through before the next US election in 2012.

As with most regulations it is the effect of their enactment that is in many ways more important than their enforcement.

Thus although it may be many years before the new regulations go on the statute books, banks will begin to change their structures and work practices sooner rather than later.

In the murky world of Derivatives considerable attention is being paid to the opaqueness of the “Over the Counter” markets and their lack of transparency.

The main proposal under consideration is that all such trades must be cleared through a recognized Clearing House and therefore recorded. Business could only be conducted between principals registered with the Clearing House and the trading information would be made available to the registered traders and the regulatory authorities on a daily basis.

Registered traders would have to show evidence of their financial strength and ability to settle all trades. Further consideration is being given to limiting the amount of debt or leverage traders could take on, all of which would be part of new reporting requirements.

The Effects of the Changes

For shipping all of this is particularly troublesome as it is in the middle of its own deep recession and is considered a “high risk” industry.

Bank financing will be increasingly difficult to find as even those banks with large shipping portfolios are unlikely to be allowed to expand them or even
maintain them by re-lending their repayments.

With the exception of China, no new shipping banks are expected to emerge over the next few years, and even in China the lending is carefully directed to support Chinese shipyards and Chinese charterers.

In the Shipping Finance World there is a significant move towards more conservative landing, particularly with regard to newbuildings.

Pre-delivery or construction finance is going to require equity investment by owners of a larger percentage, 40% of the contract price, and evidence of full post delivery finance being in place before any bank debt is advanced.
Post delivery finance will require evidence of longer term contract of charter support along with the higher percentage of equity required.

Cash distributions or dividends will be restricted and requirements for increased cash reserves will form part of new loan conditions.

Ship valuations will be mandatory on an annual basis with covenants and ratios linked to these valuations, and the likelihood of writing down values will have a big effect on Net Asset Values, which I have repeatedly argued are misleading in shipping companies.

Of more immediate concern is the reemergence of loan covenant defaults for which temporary waivers were granted last year but probably not renewed. This together with the huge amount of debt that shipping companies are due to repay over the next three years will severely strain most companies' resources.

The absurdity of companies raising more equity or high yield debt in order to pay dividends is a prelude to forced asset sales, cancelled newbuilding contracts and in some cases complete insolvency.

The outlook for Shipping

Shipping is a service industry which derives its income from the seaborne carriage of raw materials, manufactured goods and energy cargoes.
These trades depend on the simple demand for these cargoes and that depends on the economic health and growth of the consuming economy.

The US demand for goods manufactured in Asia and particularly in China has been the engine that has driven the recent shipping bubble. This engine has stalled and is unlikely to restart again in this decade, particularly if currency balancing takes effect.

Moreover there is no chance that the European economies will replace the US decline.

China has already recognized that it needs to grow its domestic and regional markets to support the huge expansion that has already taken place in its various industrial sectors. It is also looking to reduce its consumption of oil and oil products over the next 10 years and reduce its reliance on coal as its principal energy source.

All of these factors will have a serious effect on the global demand for shipping services, with reduced ton/miles and changing patterns of trade. The existing oversupply of shipping capacity is well evidenced in all market sectors and the continued construction of new ships that vastly exceeds the retiring of older ones will only deepen the problems.

The most pressing problem that shipping faces however is not the lack of bank financing but how to afford what has already been borrowed. There are very significant loan amortizations coming due from the public shipping companies over the next couple of years which will be extremely difficult to refinance.

The shipping industry needs to worry less about new banking regulations and concentrate more on reducing fleet sizes, consolidating their businesses into financially stronger entities and stop speculating on newbuildings which have no identified employment.