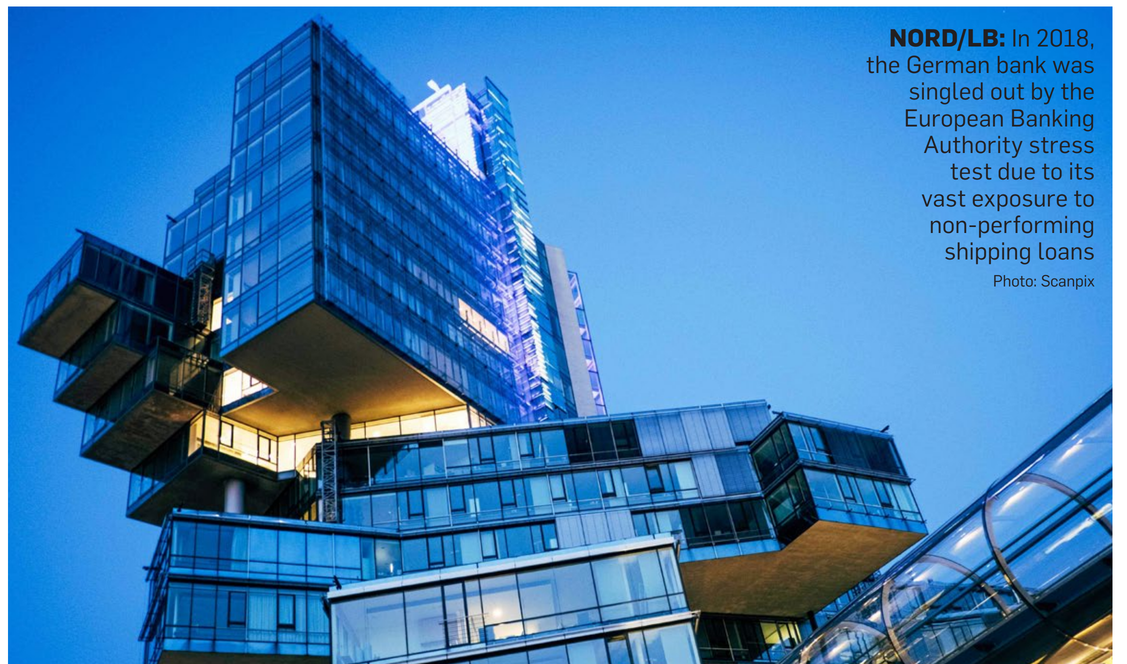
{VIEWPOINT}

Zam Khan

It's time we faced the fact that banks and shipping don't mix

Sovereign wealth funds, financial conglomerates and pension funds are better placed to provide future financing for shipping than banks due to the risks and cyclicality of the business



NORD/LB: In 2018, the German bank was singled out by the European Banking Authority stress test due to its vast exposure to non-performing shipping loans
Photo: Scanpix

Global trade is used as a barometer of the health of the world economy. That is not surprising, since 90% of traded goods are transported across the sea during some part of the journey to your shopping trolley. While fleet capacity has roughly doubled since 2008, aggregate bank lending has declined by around 20%.

Global in nature, shipping is an attractive investment because it is not generally exposed to a specific country or regional risk. Banking, surely, needs to provide more much-needed capital to the industry, you might think. Wrong.

Banks are ill equipped to hold a large exposure to shipping portfolios on their balance sheets. In particular, banks have a poor record of generating profits through the cycle and have suffered titanic losses.

They are also facing a high capital burden on their shipping portfolios. Coupled with the cost of regulation and lower margins, this doesn't present a compelling business opportunity.

A "wait and see" approach has been prevalent in shipping lending for most of the past decade, with holders of debt often acting only when forced by a change in the capital situation or regulatory pressure.

This accumulation saw banks move away from their traditional banking activities and take on the role of special servicers and restructuring agents. This has resulted in apparently low IFRS loan losses without changing the underlying credit quality. Shipping loans are operationally intensive, legally complicated and above all risky, given the volatility of the shipping markets.

Banks do not always have the courage to shrink their business model and restructure their balance sheets to traditional core areas, which is essential to achieve higher profitability. In 2018, Germany's Nord/LB was singled out by the European Banking Authority stress test due to its vast exposure to non-performing shipping loans, where two-thirds of its €11.5bn ($16.6bn) portfolio was underperforming even after significant reductions.

A stockpile of legacy, underperforming assets in the current economic climate is illogical and presents a poor funding case for any bank. Banks are levered multiple times, so even a small loss of capital can translate into big losses for equity holders when most European banks already trade at a significant discount to book value, with constraints on internal generation of capital and external capital raising.

Banks need to reduce their legacy exposure and remove these assets from their balance sheets at a time when freight rates have slumped and the global economy is on a downward spiral.

However, while senior management tends to underestimate the risk of this idiosyncratic and highly volatile asset class, experience has shown that losses can surprise on the downside.

On the other hand, the traditional lenders and banks are not as nimble in this sector. As an asset class, shipping behaves differently from other forms of secured lending; it can depreciate much further than a more traditional asset class, such as real estate. It needs constant new investment, while ultimately a bank is liable for maintenance once a borrower is stressed and as the asset value declines.

So where will the future source of capital be found? The broader trend is for deep-pocketed investors, such as sovereign wealth funds, including China Investment Corp, Singapore's GIC and Abu Dhabi Investment Authority, and conglomerates in Asia, where there is a growing appetite for shipping and similar asset classes. The same trend is emerging with certain endowments and pension funds in North America.

Bank profitability will not soon return to the levels of the heady pre-crisis days. Record low interest rates, the late-stage credit cycle and disruption from non-bank players are the main issues to contend with at the moment. At this stage of the cycle, carrying exposure to shipping could pose a shock to bank balance sheets. The key financial metrics of pre-provision income and return on equity could be eroded at a point in the cycle at which banks would be least able to recover.

There is no clear rationale for banks to play a dominant role in an industry that is likely to be detrimental to their demonstrated success in more traditional areas of lending. ■

RECORD LOW INTEREST RATES, THE LATE-STAGE CREDIT CYCLE AND DISRUPTION FROM NON-BANK PLAYERS ARE THE MAIN ISSUES TO CONTEND WITH AT THE MOMENT

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ON WATCH

UK government slammed for 'tone-deaf' slave ship tweet

TradeWinds' weekly column taking a sideways look at shipping

● The UK has a long and perhaps not so proud history of maritime trade.

So when the UK's Department for Transport decided to use this as background to the launch of its Maritime 2050 plan last week, it drew heavy flak from historians and academics.

The problem was images featuring fluyts, East Indiamen and steamships — all vessels used in the slave trade and colonisation efforts in previous centuries.

"This is what happens when the historical memory is limited to a narrative in which we simply abolished slavery. It is remarkably tone-deaf, never mind historically illiterate," historian and author Kim Wagner told UK newspaper The Guardian.

Priyamvada Gopal, of the faculty of English at Cambridge University, said that Britain's history of commercial shipping was "a deeply violent one, which included shipping millions of black and indentured bodies tightly packed in the holds of ships to be exploited on plantations".

TAINTED IMAGE: A controversial picture from the tweet
Image: Department for Transport

● Prophetic scheduling of the week: the Saudi International Oil Fire Safety Conference started in Riyadh on Monday, two days after drone attacks set two major refinery centres ablaze in the country. So, no doubt, there was plenty to talk about for those in attendance.

● For the last two months, an obscure Twitter account, @abolishjonesact, has tweeted once a day, every day. The message is simple. Every tweet is the day of the week, and "we should abolish the Jones Act".

The Jones Act is the US cabotage law that ensures cargoes shipped between US ports are on American crewed, built and owned ships. Supporters of the century-old law say it protects domestic jobs in shipbuilding and seafaring, while bolstering national security.

Opponents include many Puerto Ricans, who argue the Jones Act unfairly raises the prices of goods on the island, which has a median household income more than $37,000 lower than the national figure of $57,652.

The account includes the Puerto Rican flag as its avatar and "free Puerto Rico" in its bio.