

**OUTPACING THE TEMPEST
THE CONSEQUENCES OF BASLE II ON INSTITUTIONAL LENDING
IN SHIPPING FINANCE TRANSACTIONS**

PETER MEASURES* & ANGELO L. ROSA**

INTRODUCTION

Institutional lending in the context of ship finance is a process increasingly fraught with viability issues given shifts in international banking regulation that place risk-assessment mechanisms in a position of unprecedented significance. The Second Capital Accord of the Basle Committee on Banking Supervision (“Basle II”) will, when implemented, impose a formulaic approach to risk assessment that equates the viability of a lending relationship with a demonstrable, sustainable cash-flow and corporate transparency. The “one-size-fits-all” approach of the first Basle Accord was adequate for a time. However, the increasing complexities of the international banking sector, along with a greater than ever emphasis on risk, have proved the first Accord too unsophisticated for twenty-first century corporate finance. Basle II’s requirements will provide a more sophisticated structure within which to evaluate investment risk, injecting a degree of prudence into the financing equation with the objective of promoting greater stability in the international banking community.

The shipping industry possesses an almost Garbo-esque profile in the world of international finance. As such, many sectors of the shipping industry are ill prepared to cope with the demands of Basle II because of the sensitivity to economic turbulence and the insular nature of business practices that define the industry as a whole. The competitive dimension of contemporary shipping finance is most apparent in the growing trend among most major lending institutions toward eliminating ship finance debt from their portfolios. For those lenders who, in the immortal words of Victorian maritime historian Lindsay, “cast their bread upon the waters and expect it to return buttered on both sides,” prudence and good business sense are redefined in ways that will benefit the international banking sector as a

* Partner, Curtis Davis Garrard, International Lawyers at London Heathrow, London, United Kingdom.

** Associate, Trygstad, Schwab & Trygstad, Los Angeles, California. B.A. *magna cum laude*, University of California at Los Angeles; J.D., American University, Washington College of Law. The author wishes to thank his co-author for his invaluable guidance and inspiration, and William F. Kroener, III, General Counsel, Federal Deposit Insurance Corporation for his input and critiques during the formative stages of the article’s composition. This article is dedicated to Goose.

whole, but not the shipping market. The shipping concerns that remain on the lending rolls will be those with the financial muster and corporate transparency demanded by Basle II, leaving the rest to find new and innovative ways of obtaining capital.

This article serves a dual purpose: one, to provide the reader with a basic education of the mechanics of ship finance, both traditional and innovative in light of recent economic events; and two, to shed light on the effect of Basle II on the flow of capital from creditor to debtor and the consequences of the new regulatory scheme. This is very much an analysis of the relationship between the banking industry and the shipping industry. Section I of this article identifies basic concepts necessary to understand the lender-borrower dynamic within the context of ship finance and illustrates the notable economic and political factors that have contributed to the international banking sector's gradual shift toward a more stringent borrower-evaluation regime of the sort Basle II will create. Section II then discusses the consequences of Basle II on institutional lending in ship finance transactions, with special emphasis laid on which borrowers will be affected most significantly. Finally, Section III identifies finance techniques that may potentially serve as a viable, and in some cases essential, alternative to the traditional institutional finance.

SECTION I

The Evolution of Contemporary Ship Finance

The central consideration of any ship financing transaction is the cost of the vessel over its estimated operational lifespan. Identifying this critical variable allows an appropriate debt-based mechanism to be employed for the financing of the vessel(s) concerned. Ship finance is typically carried out in two segments. A shipping company will put up one-third to one-half of the vessel's cost from its own capital, investment syndication funds, and/or owner's equity. A lending institution has traditionally provided the remaining portion of necessary capital, with the resulting debt being secured by a mortgage on the vessel.¹ In the past, the majority of banks have been disinclined to apply rigid, pre-fabricated borrower evaluation criteria when dealing with ship finance transactions. Instead, borrowers have been screened on a case-by-case basis.² However, the parameters of institutional ship finance have changed over the past decade due to two crucial influencing factors:

¹ See Herbert Fromme & Katrin Berkenkopf, *Storm Waiting to Hit Shipping Warns Bank*, LLOYD'S LIST INT'L, June 13, 2002, available at 2002 WL 21045943 (describing the finance process).

² See John Simpson, *The Banker's Perspective*, in SHIPPING FINANCE 77 (Stephenson Harwood ed., 2d ed. 1995) (discussing the shipping market's effect on the finance process from the banker's perspective).

institutional consolidation and financial upheaval on a macroeconomic level. The result of these factors has been an increased gravitation toward a more prudent method of risk evaluation.

The contemporary quest for financing has taken place “against a background of consolidation on a major scale,”³ a trend that has become increasingly commonplace in the world finance sector over the last few years.⁴ A re-evaluation of the worth of shipping portfolios in relation to the risk and return involved compromises the future relationships between many shipping operators and their institutional lenders. Certain of these consolidations have been surprising because many of the institutions with previously strong shipping portfolios have been shoring up their operations.⁵ A number of notable mergers have occurred in areas with strong links to shipping.⁶

³ See Tony Gray, *Who Will Be the First to Take the Plunge into Tanker IPO?*, LLOYD'S LIST INT'L, Oct. 19, 2000, available at 2000 WL 28704389 (describing the increasing trend toward the merging of banking institutions).

⁴ See Alison Smith, *Dedication May Pay Off*, LLOYD'S SHIPPING ECONOMIST-SPECIAL ISSUE: SHIPPING FINANCE IN LONDON, Dec. 1999, at 5 (describing a trend of banking withdrawal from the shipping finance practice).

⁵ See generally John McLaughlin, *Borrowers Face Rude Awakening from Changing Face of Banking* LLOYD'S LIST INT'L, June 26, 2001, available at 2001 WL 19252021 (illustrating the difficulties associated with borrowing from major financial institutions); Tony Gray, *Banking Mergers 'Threat to Liquidity'*, LLOYD'S LIST INT'L, Sept. 26, 2001, available at 2001 WL 25601817 (describing the withdrawal of banking activity from the shipping sector as detrimental to the financial health of same).

⁶ In Scandinavia, a geographic region with a strong maritime heritage and an equally strong penchant for shipping finance, financial institutions have banded together, reducing the number of institutions offering finance to the shipping industry. The late 1990s saw an increasing trend toward consolidation by Scandinavian banks. In September 1999, the Swedish-Finish banking group Merita Nordbanken initiated a takeover of Christiania Bank og Kreditkasse, a major Norwegian player in the shipping finance sector. The merger was driven by pressure placed on loan margins, a commonly hailed ailment of the shipping finance practice, as well as an increased desire for shareholder value. See generally Alison Smith, *Christiania at Risk From Regional Bank Buy-up*, LLOYD'S LIST INT'L, Sept. 21, 1999, available at 1999 WL 21568936 (providing a synopsis of the initial takeover bid of Christiania by MNB and illustrating the factors that influenced the merger activities). This group further expanded the following year when Unidanmark of Denmark was brought into the fold; the result was the banking conglomerate known today as Nordea. See Rajesh Joshi, *Nordea Abandons Stock Option Programme*, LLOYD'S LIST INT'L, Apr. 16, 2002, available at 2002 WL 8248560 (illustrating the structure of the Nordea group and its ownership), “Nordea” is a truncation of the phrase “A Nordic Idea.”

In Britain, the grand old patriarch of shipping finance has long been the Royal Bank of Scotland; for the past two centuries, ship lending has been a core activity for the institution. In 1999, The Royal Bank began a takeover process of National Westminster (NatWest), an ultimately successful

Larger banks cater to shipping operations that likewise are of substantial size, often consolidating with other shipping operations and requiring large-scale banking needs.⁷ From the perspective of the banking institutions, the move to consolidate is beneficial in that size translates into power with which to compete in the international banking market.⁸ In the process of consolidation, shipping portfolios are evaluated and, in some cases, determined to be an unnecessary risk. While this does not typify the concerns of shipping operators with substantial fleet size and substantial cash flow, it is a concern for smaller operators.

As the banking consolidation escalated, the banks left out were those with smaller market capitalization and smaller shipping portfolios, yet with the same amount of risk in most ventures. The differentiating factor between large and small institutions is the ability to absorb the shock of write-offs.⁹ Market downturns caused a great number of shipping operations to slide into extreme indebtedness without much prospect for maintaining regular repayments. Banks on the margins were hit the hardest, while the larger institutions were able to ride out the losses by virtue of larger flows of income. A primary consequence of this is that future lending to smaller ship owners becomes tighter and more difficult to obtain. With a reduction in the smaller institutions, risk cannot be spread across a broader playing

undertaking that doubled the Royal Bank's asset pool. *See also* Alison Smith, *Bid for NatWest May Trigger Ship Loans Expansion*, LLOYD'S LIST INT'L, Nov. 30, 1999, available at 1999 WL 29121423 (discussing the bid for NatWest and its potential consequences).

In Germany, banking powerhouse Deutsche VerkehrsBank and Nedship Bank, a division of Rabobank Netherland joined forces, beginning in 1999 and formally completing the takeover in May 2000. The union created a shipping portfolio valued at over \$4 billion. *See* DVB Group, *DVB Group History*, available at <http://www.dvbgroup.com/en/Content/36/index.html> (last visited August 3, 2002) (providing a chronological history of DVB's activities since its inception); Herbert Fromme, *Deutsche VerkehrsBank and Nedship set for merger*, LLOYD'S LIST INT'L, Oct. 22, 1999, available at 1999 WL 29118948 (discussing the initial stages of the merger between DVB and Nedship).

An estimated forty Greek banks remain out of the eighty that were involved in Greek shipping finance scene in 1997. Likewise, the number of foreign banks doing business in Greece has declined from twenty-one in 1997 to twelve in late 2001. *See* Kerin Hope, *Alive on the Ocean Waves*, THE BANKER, Nov. 1, 2001, available at 2001 WL 12510653 (describing the waning number of Greek banks lending to the Greek shipping sector).

⁷ *See* Editorial, *Burning issue for ship finance is the dwindling number of banks*, LLOYD'S LIST INT'L, May 29, 2002, available at 2002 WL 21045320 (describing the pros and cons of consolidation).

⁸ *See id.*

⁹ *See* Gray, *supra* note 3 (analyzing the market downturn in shipping and its effect on finance methods).

field, and the newly formed banking groups often exercise greater discretion with regards borrowers.¹⁰ The risk-evaluation exercise is the subject that raised the most concerns in the international banking industry following the Asian market crisis and its ripple effects throughout the world financial markets. These concerns are embodied in Basle II. The shipping banks had operated a system of lending that was all about relationships and market share, but without much regard to the cyclical nature of the shipping business and particularly the volatility of certain sectors such as tanker rates (currently at an all-time high).¹¹

The need for capital remains paramount (new building orders are high and fleet renewal has become increasingly overdue, particularly as new regulations drive out older tonnage). The emphasis now is on a more corporate approach to lending for shipping, and this will continue to drive the (long-term) need to consolidate within the industry and to produce efficient businesses within sectors that have recognition in the world economy, such as the energy sector. While internal banking policies have been shaped in part by a voluntary desire to avoid the unique risks of ship finance, the official policies of the Basle Committee on Banking Supervision stand to impose a mandatory modus of risk evaluation that transcends the use of particular models.

SECTION II Basle II and its Consequences

The Basle Committee

The Basle Committee on Banking Supervision¹² has been dedicated to the promotion of stability in the international banking community. An informal, harmonious union of central bank governors from the G10 nations, the Basle Committee's primary objectives are twofold: to create an operational framework that supports and strengthens the international banking system; and to have that

¹⁰ See generally McLaughlin, *supra* note 5.

¹¹ See Smith, *supra* note 6.

¹² The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central-bank Governors of the Group of Ten (hereinafter the "G10") countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. As its name suggests, the Committee usually meets at the Bank for International Settlements in Basle, Switzerland.

framework transcend variant national banking systems in such a way that competitive inequalities on an international level are minimized.¹³

The first (and currently applied) Capital Accord of the Basle Committee was promulgated in 1988 and was intended to establish a minimum standard for capital adequacy in international banking operations.¹⁴ While not mandatory, the first Accord provides a mechanism for gauging credit risk and properly handling that risk.¹⁵ While workable, turbulence in the international banking sector over the past decade has placed the current Accord's sufficiency at issue. The Second Capital Accord has been shaped by regulatory concerns over too loose a flow of money and not enough prudence being exercised with respect to riskier investments.

The objectives of Basle II focus on a more risk sensitive system of regulation. The first pillar of the new Accord, concerning minimum capital adequacy is tied to two crucial processes: risk evaluation, and its corresponding translation into the required amount of capital that must be held in accordance with the new requirements. In broad terms, the challenges that Basle II will present will result from requirements that companies exchange internal capital assessment programs when it comes to evaluating risk. Stacking a portfolio with lucrative, high-risk investments without regard to capital sufficiency requirements will no longer be feasible.¹⁶

Basle II is organized around three conceptual "pillars": one, minimum capital adequacy—money that must be held as a safety margin should the investment fail; two, supervisory review to insure sound internal evaluation mechanisms in banks that are internationally active; and three, enhanced disclosure requirements to promote market discipline. Whereas the first Accord provides general guidelines for risk management and focuses on the total amount of bank capital, Basle II will provide for a greater degree of micromanagement with regards to internal control

¹³ See generally Basle Committee on Banking Supervision, Int'l Convergence of Capital Measurement and Capital Standards, (July 1988), available at <http://www.bis.org/publ/bcbs04A.pdf> (last visited Oct. 26, 2004).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See generally BASEL COMMITTEE ON BANKING SUPERVISION, OVERVIEW OF THE NEW BASEL CAPITAL ACCORD, 1 (2001) (providing a general overview of the New Accord and its intended effects); GEORGE ALEXANDER WALKER, INTERNATIONAL BANKING: LAW, POLICY AND PRACTICE 569-603 (2001) (analyzing the provisions of the Capital Accord in relation to its 1988 predecessor).

and management.¹⁷ Similarly, where the first Accord focuses more upon single risk measurement in terms of a bank's operations taken as a whole, Basle II will place greater emphasis on the bank's internal methodology and the market discipline it exercises with respect to lending. With more stringent capital adequacy requirements, the cost of lending will increase, and that increase will be passed on to the borrower in the form of higher margins.¹⁸

Shipping is a risk-laden enterprise, intimately tied to the fluctuations of regional and global economies. Where many institutions were previously willing to assume these risks in periods of economic prosperity, institutional consolidation and economic slowdown translate into an increasing unwillingness to assume the risks inherent in ship finance. Basle II's capital requirements place additional pressure on a shipping concern to justify institutional investment given the high-risk attributes of shipping. From a banking perspective, the approach is pragmatic and almost tautological: if significant capital must be held as a contingency, then the reasons for that contingency (default) should be avoided as much as possible. For small to mid-size shipping operations, the risks inherent in a volatile market carry the risk of default and lessen their attraction to institutional lenders.¹⁹ Thus, the need for institutional prudence under Basle II stands to exclude many such operations from the market for institutional financing.

The analysis of ship finance as a test case of Basle II's effects is premised on two main points: first, the ability of a bank to ascertain risk, and a ship owner's ability to prove fiscal reliability will be tied to a simple determination of whether or not the potential borrower can survive a more stringent risk-assessment process; second, the cost of money will increase due to both macroeconomic pressures and the new Accord's capital adequacy structure. The *raison d'être* of Basle II can be articulated simply as an effort to address the increasing globalization of international

¹⁷ See generally Secretariat of the Basel Committee on Banking Supervision, *The New Basel Capital Accord: An Explanatory Note* (Jan. 2001), at <http://www.bis.org/publ/bcbsca01.pdf> (last visited Oct. 26, 2004) (providing a general overview of the provisions of the new Accord) (hereinafter "Secretariat").

¹⁸ See Paul Bartlett, *Concern on Future Funding at Banks Pull Out of Sector*, LLOYD'S LIST INT'L, Apr. 25, 2002, available at 2002 WL 8249183 (describing the increased stringency on banking lending as imposed by Basle II).

¹⁹ See Alison Smith, *Dedication may pay off*, LLOYD'S SHIPPING ECONOMIST-SPECIAL ISSUE: SHIPPING FINANCE IN LONDON, Dec. 1999, at 5 (describing a trend of banking withdrawal from the shipping finance practice, and describing the separation of larger and smaller companies into a "two-tier market" configuration, whereby attractiveness of investment attaches to larger shipping entities with greater stability and stronger economic clout).

banking and promote stability by addressing the crucial areas of credit, market, and operational risk in a manner that transcends geography and industry.²⁰

Risk Assessment Methods

The risk evaluation model of Basle II contrasts with the currently implemented Accord by encompassing micro-managerial mechanisms to stability in banking through the selective assumption of risk. Whereas the current Accord paints broad strokes with respect to risk management, Basle II contains mechanisms for grouping risk into specific categories and attaching a capital charge appropriate to each specific category.²¹ Basle II will allow a multitude of risk assessment techniques to be employed by internationally active banks in evaluating potential lending relationships, including the use of external credit ratings or alternatively, internally defined benchmarking systems—subject to certain regulatory guidelines as imposed by the Basel Committee.²² Regardless of the procedural flexibilities, the stringent capital adequacy requirements stand to affect the cost of lending in that interest rates stand to increase; that increase will be passed onto the borrower in the form of higher margins.²³ Consequently, a prominent fear among ship owners is the rise in interest rates that will result from the regulatory stringencies of Basle II.²⁴

In basic terms, the Basle II Accord requires banks to rate the risk of their loans in line with regulatory expectations. To evaluate borrowers, banks will have two options. First, a standardized approach to credit evaluation may be employed, such as the corporate rating systems of Moody's or Standard & Poor's. Second, banks may formulate and utilize their own internal systems of gauging creditworthiness.²⁵ Assets in a bank's portfolio are evaluated according to their risk

²⁰ See Steve Farr, *Don't Be Basel Faulty – Start the Ball Rolling Now*, LLOYD'S LIST INT'L, June 26, 2003, available at 2003 WL 63938314.

²¹ See Secretariat, *supra* note 17.

²² This position first appeared in a 1996 amendment to the current Capital Accord. *See id.*

²³ See Rajesh Joshi, *Equity Markets Hold Key to Future*, LLOYD'S LIST INT'L, Apr. 25, 2002, available at 2002 WL 8249139 (illustrating the tightening up of credit facilities in institutional banking, prompting the pursuit of alternative sources of financing).

²⁴ See Katrin Berkenkopf & Herbert Fromme, *World's Biggest Ship Lender Out to Stretch Itself*, LLOYD'S LIST INT'L, Sept. 5, 2003, available at 2003 WL 63941062 (illustrating in general the predominant concerns of ship owners in light of Basle II's implementation and the run up thereto).

²⁵ See Secretariat, *supra* note 16, at 3-4 (discussing the different evaluation criteria applicable by banks under the new Accord). *See also* Sandra Speares, *Owners Warned of Dearer Ship Finance*, LLOYD'S LIST

and assigned a risk weight (typically 50%, 100%, and 150%), which will determine the capital charge that will attach to that particular lending arrangement, which will in turn affect the cost of financing in the form of loan margins and lending fees.

For example, assuming that the Standard & Poor's evaluation gauge is employed, commercial loans and loans to corporate clients with BBB+ to BB- credit ratings will require a risk weight of 100% under the new Accord.²⁶ For those clients with less than a BB- rating, 150% risk weight will be required.²⁷ Among the benefits of such a program is a reduction on the volatility of earnings.²⁸ Capital charges at present levels equate to a capital charge of 8% for a risk weighting of 100%.²⁹ If the loan exposure is 150%, then a capital charge of 12% is appropriate.³⁰ This form of regulatory control has existential benefits to the lending institution in that capital and resources are forced away from overly risky investments with little quantifiable return expectations.³¹ As the loan exposure increases, capital charges will increase.³² Remuneration thus becomes crucial to the lending process.³³ The detriment of such an arrangement obviously flows to would-be borrowers, especially those engaged in shipping; most shipping companies, if rated, likely would fall below the BB- minus

INT'L, May 29, 2002, *available at* 2002 WL 21045325 (commenting on the changing banking environment).

²⁶ See Editorial, *supra* note 7.

²⁷ *Id.*

²⁸ See KPMG Consulting, Solution Definition – Basle II – New Capital Adequacy Framework: Gearing Up to Adopt the Directive, *available at* http://www.kpmgconsulting.co.uk/service/solutions/fs_Basle.pdf (last visited Aug.20, 2002).

²⁹ See Editorial, *Shipping Bankers Were Already Bracing Themselves for a Grim Couple of Years when the Attacks of September 11 Stunned the World*, LLOYD'S LIST INT'L, Oct. 12, 2001, *available at* 2001 WL 25602788 (describing the effect of the September 11 terror attacks on the overall conditions affecting the shipping industry).

³⁰ This differs from the pre-set, universal 8% charge imposed by the first Capital Accord. At 12%, financing begins to approach unaffordable levels. *Id.*

³¹ *Id.*

³² Lambros Varnavides of the Royal Bank of Scotland, the grand ecclesiarch of contemporary shipping finance, has said that margins will have to increase by at least 50% in order to maintain a viable shipping portfolio. *Id.*

³³ Approximately 100 new single dollar loans at a 1% margin are required to compensate for each dollar of bad debt lost. See Simpson, *supra* note 2 and accompanying text (providing economic analysis of the shipping loan default, taking into consideration overhead, banking administrative costs and bad debt allowances).

rating.³⁴ Aside from the deficiencies suffered by many shipping concerns with respect to all that is corporate and publicly accountable, external benchmarking of the Standard & Poor's variety is often only applied to the shipping finance exercise from one step's distance. Ratings can be, and often are, applied to measure the fortitude of Protection & Indemnity ("P&I") clubs, whose concerns relate to the asset that generates capital as opposed to the capital itself.³⁵ In contrast, capital is increasingly becoming the focal point for banks evaluating the worthiness of a shipping concern as an investment.

Internal benchmarking schemes will be progressively more tied to variables such as cash flows and less on the underlying asset. The utility of such criteria is attributable to the increasingly investment-oriented mindset of most institutional banks. Cash flow connotes stability, which in turn implies an inverse relationship to risk. This form of fiscal consciousness diverges from that of most ship owners, who have an almost romantic attachment to their vessels. External ratings schemes are available, yet most systems are not useful to the shipping finance exercise given the need for a corporate structure, and the un-corporate nature of shipping as a whole.

The Dilemma of Formulaic Risk Assessment for Shipping

In general, there has been an institutional shift toward using external credit ratings when evaluating shipping companies. The problem with such a practice is that most shipping companies, excepting public companies, do not have existing ratings.³⁶ The Basle Committee has stressed the need for an industry-wide model to be designed and implemented to gauge creditworthiness among shipping interests.³⁷ The necessity for a model-system is due to the variation in accounting systems, currencies under which accountings are prepared, and the resulting need to create a comparative paradigm under which to measure stability.³⁸ Virtues of such a system

³⁴ See Editorial, *supra* note 29.

³⁵ Protection and Indemnity clubs are associations of ship owners who pool the liabilities that exist as a consequence of ship ownership and the operations of those ships. Standard & Poor's has ranked these clubs according to the need to rely on supplementary funding from within a P&I club to help fund claims brought against individual members. See generally Graham Barnes, *The Role of Insurance in Shipping and Ship Financing*, in SHIPPING FINANCE 507, 513 (Stephenson Harwood ed., 2d ed. 1995).

³⁶ See Tony Gray, *Ship Finance: Credit Rating Scheme Urged*, LLOYD'S LIST INT'L, Sept. 28, 2000, available at 2000 WL 22743329 (describing the push toward a homogenous and universal scheme of credit rating for shipping companies).

³⁷ *Id.*

³⁸ *Id.*

notwithstanding, credit availability continues to diminish, particularly to shipping concerns. The trend is toward the more general evaluation of risk rather than the fabrication of many subject matter oriented evaluation schemes. As banks continue to gravitate towards the conservative end of the lending spectrum, borrowers with public profiles and established credit ratings will increasingly dominate loan portfolios.³⁹

The unique risks of shipping will preclude all but the most transparent and stable of shipping operations. Shipping has not always been the most transparent in nature. While many ship owners adopt corporate organizational models, this practice is not necessarily the norm.⁴⁰ Banks gravitate more toward owners with the discretion and savvy to make sound business judgments in selecting tonnage and trade routes, as well as the ability to effectively manage their ships and support infrastructure.⁴¹ This reticence toward lending to smaller ship owners has several implications. First, exposure to individual parcels of risk increases when portfolios are merged, and there is a tendency to shy away from such ventures in the future; therefore business is limited.⁴² Second, with fewer lenders in the market, borrowers are faced with fewer alternatives when it comes to selecting a lender, as a result pricing may potentially be at a premium.⁴³ Third, when the nature of the transaction befits a syndicated loan, there will be fewer available banks, and those with whom the borrower may have had difficulties will be closed out of the deal, leaving the business to the larger banks with the financial power to handle the transaction.⁴⁴ While banks' ability to exercise greater selectivity may spur a converse trend toward

³⁹ See, e.g., Editorial, *The Delivery of Olympia Explorer, the Second New Building from Blohm+Voss to Royal Olympic Cruises, Was Delayed by Problems with the Main Engine Vibration and Ventilation*, LLOYD'S LIST INT'L, Aug. 24, 2001, available at WL 25600164 (describing the effect of the Basle Accord on the affordability of technological improvements).

⁴⁰ Many operations, with holdings of only a few vessels, lack the corporate mentality, and in turn, fall into the category of "non-investment grade" material in the eyes of most investment banks. See generally Nigel Lowry, *Ship Finance: Old and New Banks Divide up Greek Market*, LLOYD'S LIST INT'L, Jan. 12, 2000, available at 2000 WL 6437935 (discussing the shift in attitudes toward contemporary finance services by Greek shipping operators).

⁴¹ See generally Smith, *supra* note 4 (describing the expectation of quality from their customers).

⁴² See generally Tony Gray, *Ship Finance: Consolidation Trend Growing*, LLOYD'S LIST INT'L, Jan. 12, 2000, available at 2000 WL 6437934 (analyzing the consequences of bank consolidation on the structure of debt-based financing).

⁴³ *Id.*

⁴⁴ *Id.*

similar credit and pricing guidelines, the availability of credit will continue to gravitate toward the larger shipping operators, leaving the rest of the borrower's market to contend with increasingly limited banking options.⁴⁵

The Cost of Stability: Rising Interest Rates

For those shipping concerns deemed worthy of institutional financing, the cost of capital will reflect a more cautious reaction to the venture's risk profile and will be evidenced in higher loan margins.⁴⁶ The stability of a lending relationship revolves around the timely repayment of the debt incurred.⁴⁷ This very simple premise is the root consideration of institutions scrutinizing the financial viability of a potential borrower.⁴⁸ Cash flow as indicia of a borrower's ability to contribute substantial equity is eclipsing the previous prominence of asset value in traditional lending relationships in ship finance.⁴⁹ Large banks lend big money to big customers with big cash flows. It is in this context that banking regulation merges with the more obscure practice involved in shipping ventures.⁵⁰

Prudence in risk evaluation translates into reliance upon stable cash flows and projections of long-term stability; this view has become predominant in leaner economic conditions. The mid-1990s were a prosperous time for the shipping industry, and a substantial number of banks participated in shipping finance. Money was relatively cheap and many ship owners made repayments ahead of schedule.⁵¹ As many banks made their exits from the shipping market, either spinning off their portfolios to smaller institutions, or merging their ship finance divisions into partner

⁴⁵ See generally Smith, *supra* note 4 (illustrating the increasing limitations on banking options for smaller shipping operators).

⁴⁶ See Joshi, *supra* note 23 (illustrating the tightening up of credit facilities in institutional banking, prompting the pursuit of alternative sources of financing).

⁴⁷ *Id.*

⁴⁸ See Alison Smith, *Dedication May Pay Off*, LLOYD'S SHIPPING ECONOMIST-SPECIAL ISSUE: SHIPPING FINANCE IN LONDON, Dec. 1999, at 7 (describing a trend of banking withdrawal from the shipping finance practice and the areas of scrutiny in the loan consideration process).

⁴⁹ *Id.*

⁵⁰ See, e.g., Smith, *supra* note 4, at 5 (describing the separation of larger and smaller companies into a "two-tier market" configuration, whereby attractiveness of investment attaches to larger shipping entities with greater stability and stronger economic clout).

⁵¹ See generally Herbert Fromme, *SHL Expects Drop in New Business*, LLOYD'S LIST INT'L, June 18, 1999, available at 1999 WL 6179958 (illustrating the change in the ship lending environment as banks merge).

banks, margins began to rise.⁵² In the late 1990s, many shipping deals were conducted at forty basis points above LIBOR,⁵³ leaving little to the profit columns of many bank balance sheets.⁵⁴ In terms of overhead and other costs associated with lending capital, thirty-five to forty basis points constitute the operational costs of a shipping finance department in a large bank and with other subsidiary expenses and write-offs, overhead in excess of 1% is not unrealistic.⁵⁵ Given the slim margin for profit, many banks have bowed out and prices have risen.⁵⁶

The rising cost of borrowing reflects both a pragmatic reaction to the mistakes of the late 1990s and a modulation of lending behavior that anticipates regulatory constraints of the sort Basle II will impose. From the perspective of the ship owner, there is a burden to generate an attractive financial profile as defined by the institutions from whom financing is sought; the adoption of a corporate infrastructure and maintenance of a creditworthy status both in terms of cash flow and long-term sustainability are crucial. However, these concessions involve a degree of transparency that is easily amenable to external ratings criteria and, in turn, an engendering of confidence in the institutional lending community. Accordingly, most institutions that continue to participate in ship finance have chosen to concentrate their lending activity on the top corporate names and to disregard the rest.⁵⁷ With the definition of a precise and relatively manageable client pool, various finance products can be sold with greater ease. These products include treasury-related currency swaps⁵⁸ and options, interest rate and bunker swaps and the like—

⁵² A typical lending profile is based on a 1% margin above LIBOR and a twelve-year financing term. See Fromme, *supra* note 6 and accompanying text. In 1999, Citibank estimates suggested that an average rise of .25% over the current rate of lending (LIBOR + Margin) constituted the standard. *Id.* In contrast, it is rare at present to find a deal secured at below 100 basis points above LIBOR; most deals are secured with a 100-200-point margin. See generally Editorial, *supra* note 29 (describing the effect of the September 11 terror attacks on the overall conditions affecting the shipping industry).

⁵³ London Interbank Offering Rate. BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS, (5th ed. 1998).

⁵⁴ See Gray, *supra* note 3 (describing the increasing trend toward the merging of banking institutions).

⁵⁵ *Id.*

⁵⁶ See generally Alexander Lennane, *Sailing into Troubled Waters*, ASSET FINANCE INT'L, Apr. 2001, at 29 (illustrating the less than rosy complexion of a shipping market affected by economic slowdown).

⁵⁷ *Id.*

⁵⁸ Swaps are, in a traditional sense, an exchange of one security for another, compelled by changing investment interests. In the context of currency, swaps create a transaction whereby both parties agree to sell each other a currency with an agreement to buy back the principal amount of those currencies at the deal's maturity. See BARRON'S DICTIONARY, *supra* note 53, at 612 (defining "Swaps").

services that smaller operations neither need nor want.⁵⁹ Below the top corporate clientele, a bank's opportunities for a hearty return are severely diminished, and any foothold that the smaller ship owners had amongst the top banks is precarious at best.⁶⁰

Borrowers obtaining ship finance from a major institution will pay a premium. Between 2001 and 2002, basis point costs increased 25-40% in a typical shipping deal.⁶¹ As margins increase, the cost of capital increases, and the market for participating in shipping transactions is mitigated severely.⁶² The burden therefore falls upon the ship owner and its own clients to convince banks of a deal's attractiveness and stability.

One unfortunate manifestation of this phenomenon likely will emerge in relation to the "increased cost" clauses in ship finance loan agreements.⁶³ Such clauses address situations in which a change in regulations after a loan agreement has been signed would increase the cost to the lender of making the loan. Basle II likely will make this clause the source of a sliding scale cost assessment, with potentially negative repercussions to the borrower.⁶⁴ A ship owner's level of unwillingness to spill his proverbial guts in the name of full corporate transparency will be directly proportional to the costs of finance.⁶⁵ Banks have tightened up their lending criteria,

See also Graham Burns, *Introduction*, in *SHIPPING FINANCE* 19 (Stephenson Harwood ed., 2d ed. 1995) (discussing multi-currency options as an alternative to currency swaps).

⁵⁹ *Id.*

⁶⁰ This ascent in the cost of lending, when coupled with banking consolidation, is embodied by the approach of Den norske Bank (DnB). DnB has been gearing up for the Basle II implementations as well as helping to fuse ship owning operations together; its representatives have acknowledged that financing for small-scale ship owners will become increasingly difficult while also conceding that those larger entities, borne out of merger or simply large-scale in their nature, are unlikely to suffer from want of bank financing. *See generally* Rajesh Joshi, *Scandinavian Drought on Equity Puts Big Players in the Field*, LLOYD'S LIST INT'L, Apr. 25, 2002, available at 2002 WL 8249179 (describing DnB's participation in the consolidation of several Scandinavian shipping companies).

⁶¹ Burns, *supra* note 58.

⁶² *See* Editorial, *supra* note 29 and accompanying text.

⁶³ *Id.*

⁶⁴ *See* Rajesh Joshi, *DnB Gives Lower Debt Cost Trips*, LLOYD'S LIST INT'L, Apr. 14, 2000, available at 2000 WL 6441099.

⁶⁵ *Id.*

becoming increasingly reluctant to extend loans below \$15 million.⁶⁶ This means that new entries into the market must be substantially capitalized; ruling out former officers wishing to strike out on their own small ventures, as well as regional businessmen seeking to diversify their interests.⁶⁷

The Basle II agreement articulates an objective of enhancing “competitive equality” in the banking sector.⁶⁸ While the concerns of corporate creditworthiness that are uppermost in the collective consciousness of the Basle Committee are legitimate, Basle II threatens ship finance in terms of the scale of lending.⁶⁹ Capital flows that fall under the regulatory purview of the new Basle Accord will go to the biggest and brightest stars in the shipping galaxy, while the remaining institutional capital upon which the smaller operators had previously drawn will continue to diminish. Large institutions are bound by the requirement that a substantial profit be made from each transaction with few exceptions.⁷⁰ In many cases, shippers place emphasis on asset values, while bankers increasingly are paying attention to operation-driven revenue flow.⁷¹ The overall benefit of Basle II runs to the stability of the banking industry as a whole. For the smaller ship owner, much contortion is required in order to live up to the standards set forth in the new Capital Accord. When banks are driven toward lending relationships with other corporations, the critical steps for small to mid-size ship owners toward viable institutional lending relationships must be taken in corporate shoes. Opacity and accountability are the virtues to which decades of insular business practices must be reconciled. Cash flow must be ascertainable, viable, and sustainable.⁷² While the securing of several stable, long-term charters will work wonders for a shipping operator’s profile in the eyes of most institutional banks, few operators can claim to have secured such arrangements.

Abstract discussion of banking regulations aside, the real-life implications for many smaller operations in this sector are severe, with the size of a shipping concern

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ See Basel Committee on Banking Supervision, *supra* note 13 and accompanying text.

⁶⁹ *Id.*

⁷⁰ See generally McLaughlin, *supra* note 5 and accompanying text.

⁷¹ See Lennane, *supra* note 56 (discussing the divergent points of reference from which bankers value the assets financed).

⁷² *Id.*

being inversely proportional to the investment risk that concern entails. The result of these factors is a division of smaller shipping operators from their larger brethren, with the latter possessing far greater attraction as an investment.⁷³ Compounding the difficulties posed by a sustained downturn in the shipping market is the significant gap that exists between the supply and demand for shipping finance capital.⁷⁴ From the banking perspective, demand is directly proportional to the ups and downs of global and regional economies, and supply is contemplated in terms of increased profitability during times when financing is scarce.⁷⁵ For owners of fleets amounting to only a few vessels, the gap between supply and demand is readily apparent and, taking the smaller borrower into account, imbalances between supply and demand cannot be cured by retracting the amount of capital available, though Basle II will operate to this end. It therefore becomes imperative to identify alternative vehicles of finance for those concerns with cash flows that fail to turn the heads of larger institutions.

SECTION III

Alternatives to Institutional Financing

The contracting availability of capital from institutional sources presents small and mid-size shipping operators with the challenge of securing financing from alternative sources.⁷⁶ In this respect, numerous finance mechanisms have recently developed or risen to a level of prominence that allows for acquisition of capital with deference to increasingly prudent lending patterns.

The consequences of major banks placing central focus on the operator's long-term cash flow projections rather than on the functionality of the object financed places many operators out of the big banking loop.⁷⁷ “[S]hipping is a more

⁷³ See, e.g., Smith, *supra* note 4, at 5 (describing the separation of larger and smaller companies into a “two-tier market” configuration, whereby attractiveness of investment attaches to larger shipping entities with greater stability and stronger economic clout).

⁷⁴ In 1990, the gap between demand and supply available was \$1.830 billion, in 1995 \$4.168 billion, and in 1997 an astonishing \$10.983 billion. See Alan E. Branch, *MARITIME ECONOMICS MANAGEMENT AND MARKETING* (3d ed. 1998), table 3.3 (comparing shipping capital supply and demand, 1990-97).

⁷⁵ See Simpson, *supra* note 2, at 73.

⁷⁶ A small fleet is defined in relation to the number of vessels as well as the total gross tonnage thereof. Typically, a small fleet consists of five or fewer vessels.

⁷⁷ See generally Joshi, *supra* note 6 and accompanying text.

conservative sector than many,” with borrowers favoring traditional finance over the more sophisticated and complex modes of finance.⁷⁸ The primary reason for this is that complicated financing mechanisms typically are accompanied by higher costs and a loss of flexibility.⁷⁹ However, the adaptation to non-traditional methods of finance is compelling given the distance that most banks are putting between the shipping industry and institutional sources of much needed capital. Only the strongest of the smaller shipping operations will be able to secure financing from the traditional banking sources and then only from institutions familiar with their track record.⁸⁰ Hence, a discussion of financing alternatives is essential to understanding the environment of contemporary shipping finance.

Ship Mortgage Indemnities

A finance method of relatively recent vintage and growing popularity is the Ship Mortgage Indemnity (SMI).⁸¹ An SMI ties insurance to shipping finance during the early stages of the project.⁸² In basic terms, the SMI allows banks to exceed their normal lending limit.⁸³ If a normal lending limit were 65%, the presence of an SMI would allow that limit to increase to 85%.⁸⁴ The period of indemnity would typically run five to seven years, with the loan amount decreasing in relation to this timeframe.⁸⁵ A well-rated underwriter would implement such an arrangement.⁸⁶

⁷⁸ See Lambros Varnavides, *The Blind Leading the Blind*, THE BANKER, Nov. 1, 1996, available at 1996 WL 17068299 (illustrating the increased interest in shipping finance that banks have taken over the past ten years).

⁷⁹ *Id.*

⁸⁰ See Hope, *supra* note 6.

⁸¹ See generally Tony Gray, *Special Report – Ship Finance: Insurance Innovations*, LLOYD’S LIST INT’L, Oct 19, 1999, available at 1999 WL 2918688 (illustrating the mechanics of Ship Mortgage Indemnities and Residual Value Insurance); Andrea Felsted, *Converging Markets*, LLOYD’S SHIPPING ECONOMIST-SPECIAL ISSUE: SHIPPING FINANCE IN LONDON, Dec. 1999, 9-10 (chronicling the development of the Ship Mortgage Indemnity and its mechanics as applied to the shipping finance exercise).

⁸² Gray, *supra* note 81.

⁸³ *Id.*

⁸⁴ The newly added 20% is covered by the indemnity at a premium cost of 6.0-7.5% of the sum insured. *Id.*

⁸⁵ See Felsted, *supra* note 81.

The SMI mechanism has been extolled in recent years as an alternative to mezzanine finance, which is the traditional method of bridging a ship owner's shortfall between the amount of equity available to the project and the amount of available debt finance.⁸⁷ An SMI typically is cheaper than mezzanine financing and thus presents a more economical and affordable alternative to a bridging loan. From a banking perspective, there is security in the knowledge that there is less risk of over-exposure; from a shipper's perspective, there is security in obtaining the necessary financing.

In the few short years since its introduction, the SMI has proven itself to be favorable with a great many institutions.⁸⁸ The element of promise that the SMI holds for smaller ship owners is that a finance package involving an SMI may be arranged when a specific ship has secured long-term employment from a reputable charter, despite deficiencies in long-term cash flow projections.⁸⁹ If a small fleet owner has good customers, smaller operational size and the instabilities associated therewith will not necessarily preclude the acquisition of competitively priced financing. Also, the fact that no additional collateral need be offered to secure an SMI is attractive.⁹⁰ However, one potential detriment is that the age of vessels financed is a factor in an SMI; older fleets are less likely to attract the interest of a banking/insurance SMI.⁹¹ The generally accepted age ceiling for use of an SMI is approximately ten years.⁹² Even so, for shipping concerns built around young enough fleets, low cost assets can be acquired without injecting an overly substantial

⁸⁶ See *id.* (quoting Peter Spencer of the English law firm Lambert Fenchurch, hailed as the innovator of the Ship Mortgage Indemnity).

⁸⁷ See Nigel Thomas et. al., *Beating the Bank Trend to Abandon Ship Finance*, LLOYD'S LIST INT'L, May 17, 2000, available at 2000 WL 6442227 (describing the various alternatives to traditional ship finance methods).

⁸⁸ The SMI mechanism has curried favor with banks in Western Europe, North America, and the Far East in particular. This method is also increasing in popularity with banks that rushed headlong into the shipping finance practice during the mid-1990s. See Editorial, *Broker Awaits Lift-Off for Ship Mortgage Insurance*, LLOYD'S LIST INT'L, Dec. 11, 2001, available at 2001 WL 31407129 (describing the spread of popularity, or lack thereof, of the Ship Mortgage Indemnity concept).

⁸⁹ *Id.*

⁹⁰ See Thomas, *supra* note 87.

⁹¹ See Editorial, *supra* note 88.

⁹² *Id.*

amount of equity.⁹³ A respectably sized deal can generate income capable of covering four-fifths of the loan; the form is pleasing to the banker and the substance is pleasing to the borrower.⁹⁴

Residual Value Insurance

A second finance mechanism, and a cousin to the Ship Mortgage Indemnity, is Residual Value Insurance (RVI). A credit enhancement insurance instrument that has proven successful in aircraft finance transactions, RVI indemnifies the insured against a loss suffered if the sale proceeds of the (properly maintained) vessel are less than the vessel's insured residual value.⁹⁵

Four general points of reference in applying RVI to shipping scenarios bear notice: first, that the vessel's residual value will be between a quarter and a third of the vessel's purchase price at time the policy is generated; second, that the period of coverage will be the duration of—or, if the loan term has already commenced, the remaining period of—the bank loan; third, that the loan term will not exceed ten years; and finally, that the applicable rate will be between 2% and 6% of the amount representing residual value insurance.⁹⁶ The benefit of this mechanism is that insofar as establishing the vessel's future value is concerned, there is some financial definition in place, thus insuring some semblance of security for both borrower and lender.⁹⁷

The benefits of the RVI financing arrangement apply to new buildings and younger fleets. Owners of both large and small-scale fleets can avail themselves of RVI, which, while more expensive than a SMI, is more flexible. For fleets with turnover cycles of approximately ten years, there is the benefit of having a guaranteed sale price on the vessels insured at the beginning of the cycle.⁹⁸ RVI represents a guarantee to buy the vessel, and when it involves reputable insurers,

⁹³ See Alison Smith, *Mezzanine Finance Fills a Gap*, LLOYD'S LIST INT'L, Aug. 13, 1999, available at 1999 WL 21567337 (describing the environment in which Ship Mortgage Indemnities are most desirable).

⁹⁴ *Id.*

⁹⁵ See Gray, *supra* note 81 and accompanying text (illustrating the mechanics of Residual Value Insurance).

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ See *id.* (describing the benefit of having a sale price already defined by virtue of the Residual Value Insurance).

represents a joint venture that poses little or no risk to the bank providing a majority of the capital.⁹⁹ The policy cost is distributed across the life of the loan, which has two potential benefits: one, the amount of owner equity is reduced; and two, the repayments are reduced.¹⁰⁰ These benefits, in turn, translate into increased cash flows for the ship owner, generating increased liquidity that will both benefit the owner and improve the venture's profile in the lender's eyes. With this corpus of benefits, RVI is an advantageous tool that constitutes an effective remedy to the ailments wracking the finance community where shipping is concerned.

Boutique Financing

The withdrawal of banks from ship financing has opened the market for other entities to service the shipping industry and, as a result, boutique investment banks have proliferated.¹⁰¹ Larger banks offer a deep well of resources on an international scale.¹⁰² In terms of scope and resources, internationally active banks are unmatched in potential. However, many of these banks tend to view shipping as a backwater and a training ground for young bankers at the greener end of the spectrum.¹⁰³ As a result, no expertise is devoted to the practice.¹⁰⁴ Experience equals wisdom in the shipping industry, and the lack of experience is visible in the ordeals the shipping finance sector has undergone; experience speaks volumes about the management of shipping portfolios.¹⁰⁵ Regardless, ship owners need banks, and in an atmosphere of profit-driven banking activity, shipping can be lucrative. However, abundant investment possibilities exist in which transparency and corporate accountability are already in place. This places the burden upon ship owners to up their game. Ship owners, however, are attached almost romantically to their asset pool, and consequently are reluctant to open themselves up to the eyes of the world;

⁹⁹ See Smith, *supra* note 93.

¹⁰⁰ *Id.*

¹⁰¹ See Tony Gray, *Boutiques Offer Help to Medium Size Companies*, LLOYD'S LIST INT'L, Oct. 12, 2001, available at 2001 WL 25602796 (describing the increasing role of boutiques in the financing of smaller shipping companies).

¹⁰² See Graham Burns, *The Financing of Secondhand Ships*, in SHIPPING FINANCE 15 (Stephenson Harwood ed., 2nd ed. 1995) (critiquing the approach taken by most institutional banks to the shipping finance exercise).

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ See Varnavides, *supra* note 78.

yet the consequence is that survival will become tougher, regardless of the alternative modes of financing available.

In contrast to major institutions, a niche market has developed among institutions focusing their lending activity exclusively on ship finance. The past few years have been a period of opportunity for boutiques as a result of the gap left by the larger institutions' withdrawal.¹⁰⁶ Given the increasingly limited scope of institutional finance options for many shipping concerns, this period has been a coming of age for many boutique financiers—a phenomenon that even larger institutions acknowledge.¹⁰⁷

The benefits of utilizing boutique services are numerous. Most notable among these benefits is shipping expertise; these boutiques approach the technical, commercial, and financial considerations with far more savvy than many larger institutions.¹⁰⁸ Also, boutiques possess an element of independence that distinguishes them from the shipping divisions of major banks, which are compelled to consider the greater wholes.¹⁰⁹ Boutiques are conservative by nature and do not simply pick up smaller new building projects in order to hawk them to a greedy mob of investors.¹¹⁰ From the boutique sector comes the voice of support for the shipping industry; this independence is alluring to many shipping operators, who often view independence as going to the appeal of boutiques in both their freedom to spot and to capitalize upon a good investment.¹¹¹ Boutiques undeniably have broader license to associate with various brokers and consultants; this

¹⁰⁶ Gray, *supra* note 101.

¹⁰⁷ See *id.* (quoting Lambros Varnavides of The Royal Bank of Scotland, whose comments were positive with regard to the opportunities for financing that exist vis-à-vis boutiques when major institutional funding is scarce).

¹⁰⁸ See, e.g., Katrin Berkenkopf, *New Hamburg Ship Finance Firm Formed*, LLOYD'S LIST INT'L, Sept. 4, 2001, available at 2001 WL 25600605 (describing the background behind the formation of Fonds Haus Hamburg, the union of three young shipping entrepreneurs and a Hamburg ship owner, formed in late 2001, and its activities). See also Gray, *supra* note 101 (describing the integration of services and expertise that shipping boutiques offer the client).

¹⁰⁹ Gray, *supra* note 101.

¹¹⁰ Berkenkopf, *supra* note 108.

¹¹¹ See Gray, *supra* note 101 (quoting Peter Shaerf of Poseidon Capital, extolling the virtues of independence in the context of operating a shipping boutique firm).

conglomeration of services then is marketed to the client as an all-inclusive, integrated service.¹¹²

In addition to the hearty backslapping and encouragement that the larger financial institutions give boutiques, boutiques actually have a great deal to offer large banks.¹¹³ The number of large institutions with expertise in shipping is small, and the need for enlightenment is undeniable; many boutiques will fill this need, advising banks on structuring deals—and will earn handsome fees doing so.¹¹⁴ The boutique is beneficial in that its management often will be on the cutting edge of the financial methodologies of shipping finance. Most indicative of this is the growing emphasis on cash flow generation rather than the quantum of capital asset values.¹¹⁵ This thinking is reflected in the acknowledgement that the differentiation between the scope of an asset's utility and its value is crucial.¹¹⁶

If any single fault can be identified as the crucial internal error that precipitated massive banking losses with respect to shipping finance, it is ignorance of the industry into which capital and resources had been invested. Not surprisingly, banks are the quintessential fair weather friends.¹¹⁷ However, the exit of most banks from shipping finance was by means of sustaining massive loan default. Many banks failed to educate themselves on the intricacies and peculiarities of the industry, blindly venturing into a sector about which they knew little, and suffering substantial losses as a result.¹¹⁸ While larger banks admittedly do not involve themselves with overly speculative ventures, what has kept entities such as the Royal Bank of Scotland in a consistent position of prominence in shipping finance for so long (in the case of RBS, a period measured in centuries) is its ongoing interest in shipping and a continued pattern of investing time, money, and manpower into remaining

¹¹² See *id.* (drawing attention to the ability of boutiques to accumulate services from a variety of services into one package for the client).

¹¹³ *Id.*

¹¹⁴ See Tony Gray, *Salary-Free Zones Shapes New Company*, LLOYD'S LIST INT'L, Dec. 21, 1998, available at 1998 WL 24523540 (illustrating the structure and modus operandi of the then new HSP Group).

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ See Smith, *supra* note 6.

¹¹⁸ See Varnavides, *supra* note 78 (pointing out the shortcomings of many banks that have become involved in shipping finance).

abreast of developments in the shipping industry.¹¹⁹ Those with experience understand the volatility and cyclical components that define the shipping industry.¹²⁰ In contrast, many banks without the requisite understanding of this very unique economic enclave were simply out of their league—an operational flaw that yielded serious consequences as the Asian market crises began the long slide into uncertainty. In light of this, the prediction that the numerous recent arrivals to the shipping finance practice would regret such an involvement by the end of the 1990s is prophetic in retrospect.¹²¹ While less positive from the shipping perspective, the contractions generally are healthy for the banking community as a whole. Less risk translates into greater stability. Thus, the contractions complement to the implementation of Basle II.

In short, boutiques offer a more flexible alternative to institutional financing. The availing of this breed of service is contingent upon the willingness of shipping operators to sacrifice the powerhouse backing of a major international financial institution for a more industry-wise finance arrangement, or for smaller but strong operations whose size precludes them from a relationship with the major banks. Given the economic exigencies of contemporary shipping finance, the boutique finance house concept is likely to grow in influence and will be a major element of the sector in future periods, be they prosperous or atrophied.

The advent of the aforementioned finance methods heralds in a new age in shipping finance, toward funding bases diversified with the objective of attaining a more balanced capital structure. However, the inescapable reality is that greater transparency is required from ship owners.¹²² This is the expectation, and the prerequisite, for continuing in relationship with financial institutions of any size.

CONCLUSION

The purpose of this article has been to illustrate the problems that Basle II's implementation poses for lending in the shipping industry while pointing to promising methodologies that may soften the blow of diminished lending to certain areas of the shipping industry. The contemporary banking community is globally integrated. With this interrelatedness, financial provision flowing from the banking

¹¹⁹ See Smith, *supra* note 6.

¹²⁰ *Id.*

¹²¹ See Varnavides, *supra* note 78.

¹²² See Lennane, *supra* note 56.

sector is increasingly preoccupied with the risk that previously may have been subject to stronger geopolitical confines.¹²³ Shipping finance epitomizes this practice in terms of its subject matter and the financial mechanics it is associated with. Thus, some simple realities relating to the shipping finance exercise emerge, particularly with respect to the pending Basle II protocol.

First, the Accord is driven by some fairly common sense assumptions about banking; namely, that bank operations should be as balanced and secure as is possible, that equality in competition is a virtue, and that risk should be intelligently assessed. While a successful marriage between a bank and a ship owner hinges upon the conformity of the ship owner to corporate criteria, a bank's sophistication in regards to the subject matter of its potential client/investment is equally critical. While much detriment can be blamed on macroeconomic factors, the fiscal malaise currently plaguing the shipping finance community can be attributed, in substantial measure, to the ignorance of banks as to what the shipping industry is all about. Banks seeking to tap the profitability of the shipping industry must fortify their interests in shipping finance with some degree of sophistication concerning the specific subject matter of the activity. A vanilla-flavored corporate finance approach is woefully inadequate, however a project finance approach that brings to bear the necessary expertise in the relevant subject matter is crucial.¹²⁴ The lack of sophisticated knowledge of the shipping industry has driven many institutions out of the ship finance market. For those who remain, the crucial element to making intelligent banking decisions is an informed group of professionals competent to push funds into an already risky business.

It is a product of unfortunate circumstance that macroeconomic troughs have narrowed the institutional spread in the shipping finance market. While in the abstract Basle II's narrow approach will allow for capital allocation tailored to specific high-profile borrowers in any number of industrial sectors, the risk of significant counter-productivity in this area remains. Under Basle II, banks will be allowed broader license to employ internal risk evaluation criteria. An unsophisticated understanding of shipping, when paired with an internal ratings-based approach, results in an investment strategy that may be highly volatile.

Second, the contemporary shipping market is as tumultuous as it has ever been, and survival depends upon some modicum of openness in terms of fiscal

¹²³ See WALKER, *supra* note 16, at 605.

¹²⁴ See Simpson, *supra* note 2, at 78 (discussing the necessity of subject-specific knowledge in the financing context).

transparency and “corporate” accountability, as these are the virtues in contemporary institutional ship finance. These virtues do not necessarily dovetail with decades of past practice in the shipping business, but today they supplant less stringent criteria previously employed given the Basle Committee’s vision of intelligent lending relations. Big money is required to operate a successful shipping operation. Obtaining institutional financing requires the ship owner to jump through the proverbial hoops in order to prove its financial viability and that its operation represents an acceptable level of risk. It remains to the prudence of the ship owner whether to conform to the business models necessary to curry favor with institutional lenders. Notwithstanding the credit crunch that has defined, and likely will continue to define institutional lending, high yield debt is making a cautious reappearance, with some of the more prestigious operators being able to trap a market which appeared to be all but closed to them in the mid-1990s. This sign of investor confidence suggests that shipping is becoming slightly more respectable again. Nevertheless, the status quo undoubtedly will be more prudent under Basle II.

Third, a multitude of alternative financing vehicles exist and in most cases are complementary to traditional shipping finance. Prudence would dictate that these alternative methods be explored with the objective of securing not only financing but also a long-term financial profile. Banks, in return, would be wise to regard the new guidelines of Basle II as a mechanism through which greater security in lending can be attained. To this end, the requirements should be considered a code of practice and not another tool with which to extract more money from the client.¹²⁵

Finally, the dynamics of institutional lending have evolved from an emphasis on the charisma of the ship owner to a more cold analysis of financial integrity. Those ship owners who fail to move with the pace of contemporary finance methods are likely to be shunted off into the margins. Avoiding such a fate is contingent upon a ship owner’s willingness to be innovative and to force the hand of the financial institutions that are in the shipping market by displaying a harmonious co-existence with the corporate standards that define the international banking climate. The ship finance community would do well to share its data with the keepers of the credit measuring sticks in order to adjust their rating standards to the subject-specific requirements of their unique trade.¹²⁶ Clarifying the structure of operation and increased disclosure would also augment the argument that just

¹²⁵ See Spears, *supra* note 25 (quoting shipping consultant Peter Stowell, commenting on the implementation of Basle II and its potential effect on the lending relationship between bank and borrower).

¹²⁶ See Gray, *supra* note 42 and accompanying text.

because shipping has the aura of being a closed-circle, family-dominated affair, the fiscal mystique need not be maintained.

While the economic state of the shipping industry is often an effective barometer of larger macroeconomic conditions, the future financial status of the industry as a whole depends very much upon its reaction to the pending Basle II requirements. Internationally active banks will modulate their behavior accordingly, however it remains to be seen how the shipping industry itself will conduct itself in the newer and more stringent banking environment that is developing.