ECSA

European Community Shipowners' Associations

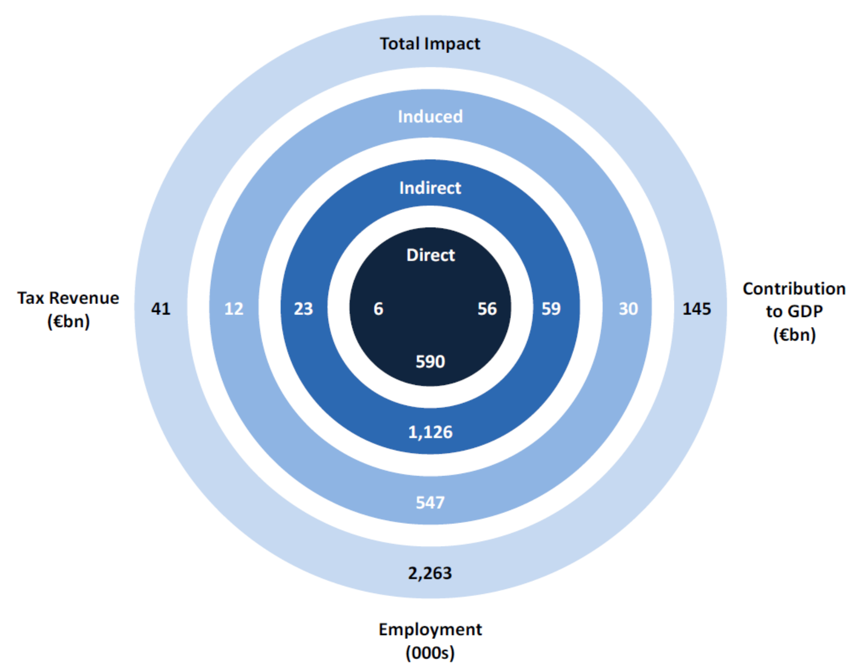
Revisions to the standardised approach for credit risk - consultative document from the Basel Committee on Banking Supervision

Contribution by ECSA

(i) <u>Preamble:</u>

Shipping and Maritime Transportation play a relevant role for development of EU Countries and the rest of World hereafter described in the Study "Oxford Economics Research 2015"[1]:

The total economic impact of the European shipping industry, 2012



(ii) <u>Technical Issues:</u>

First Lien Mortgage on Shipping Assets (typically Commercial Vessels) are considered by Basel Rules as "high quality physical collateral" whereas are met the following conditions:

Credit institutions may use <u>other physical collateral</u> (including ship mortgages), whereas the conditions indicated in articles 199, 210 and 230 of CRR are met. Specifically, according to paragraph 6 of article 199 of

[1] Oxford Economics, 2015, http://www.ecsa.eu/images/Studies/150220%20European%20Shipping%20Update.pdf

CRR, competent authorities permit a credit institution to use as eligible collateral physical collateral of a type other than immovable property collateral, where all the following conditions are met:

a) *There are liquid markets, evidenced by frequent transactions taking into account the asset type, for the disposal of the collateral in an expeditious and economically efficient manner. Credit institutions shall carry out the assessment of this condition periodically and where information indicate material changes in the market*.

To this effect the evidence shows that shipping amply fulfils the market liquidity requirements, since more than 6% on average (and approximately 10% in peak market conditions) of the existing fleet is traded annually on the second hand market i.e. approximately 1.300 ships and 22.5 bn. $ in terms of value.

b) *There are well-established, publicly available market prices for the collateral. Credit institutions may consider market prices as well-established where they come from reliable sources of information such as public indices and reflect the price of the transactions under normal conditions. Credit institutions may consider market prices as publicly available, where these prices are disclosed, easily accessible, and obtainable regularly and without any undue administrative or financial burden*.

Within the shipping industry, market price data have been available for decades through reputable and reliable sources.

c) *The credit institution analyses the market prices, time and costs required to realise the collateral and the realised proceeds from the collateral, and*

d) *The credit institution demonstrates that the realised proceeds from the collateral are not below 70 % of the collateral value in more than 10 % of all liquidations for a given type of collateral. Where there is material volatility in the market prices, the institution demonstrates to the satisfaction of the competent authorities that its valuation of the collateral is sufficiently conservative.*

Records over the past ten years show that the realised proceeds from the collateral when this became necessary were within the foregoing parameters.

In addition to the above, article 129 of the CRR implicitly recognizes the high quality of first lien shipping mortgages given that such assets can be used to guarantee covered bonds, together with (only) prime residential/commercial mortgages and public sector loans. However, unlike these last two asset types, shipping mortgages do not benefit for any preferential treatment.

Abstract: Characteristics of Naval Asset Risk respect to the Real Estate Asset

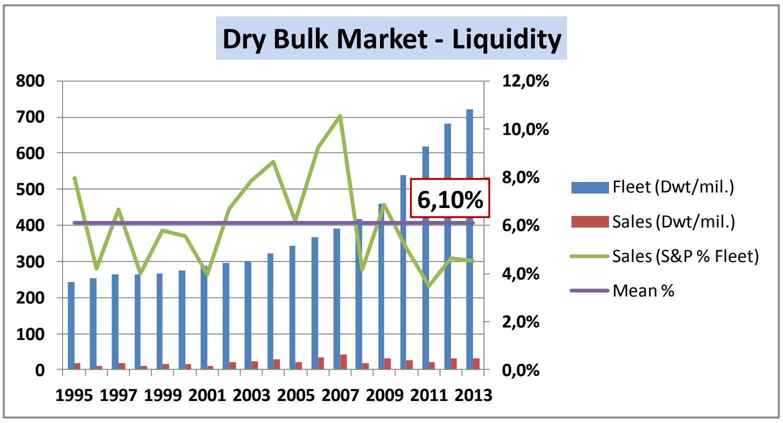
With regard to the enforceability of collateral real estate mortgage, Basel Rules framework lifts the attention about some basic features , including:

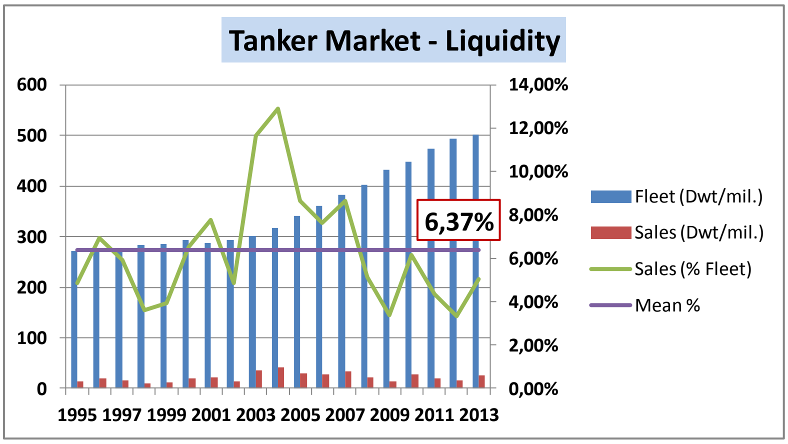
- Asset Liquidity
- Existence of widespread Local Markets
- Verifiability of market values with periodicity
- Coherence between funding and Market Value of Asset

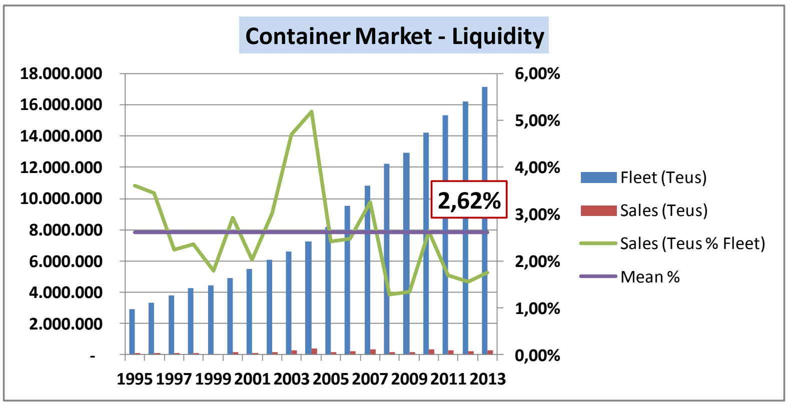
These qualitative features, all present under the naval warranty Mortgage and widely proven, would justify the eligibility both to improve the weighting in the determination of the RWA, that for the purposes of improved specific recognition as part of the CRM.

<u>Naval Asset Liquidity - Size of the Market – Market values Verifiability</u>

The best proxy to identify the width of these characteristics is the size of the Secondary Market related to the number and the relevance of transactions vis a vis the existing fleet. It was then proceeded to the verification of such a ratio measured in load capacity units- DWT / Teus (Container) for the three main sectors of maritime transport : Dry Bulk, Tanker, Container:



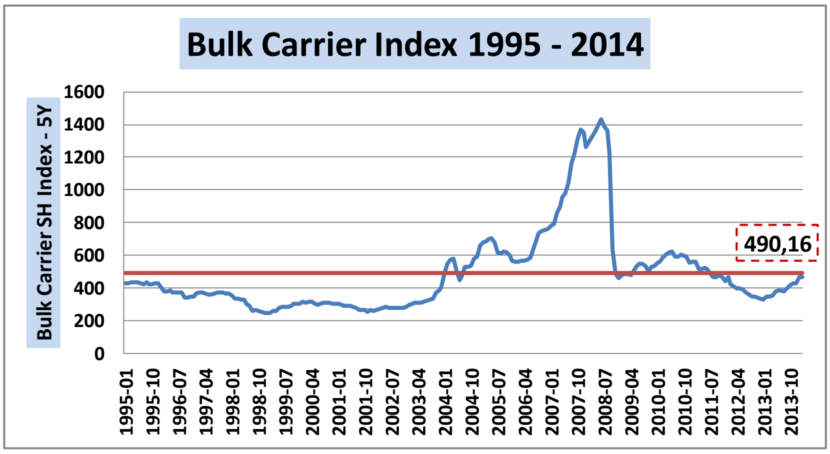




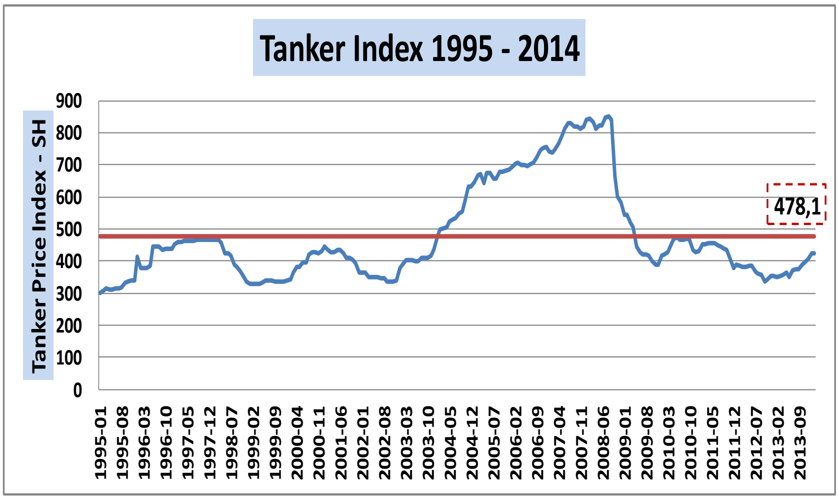
In the two main sectors (Dry Bulk and Tanker), the secondary market amounts to an average of more than 6% of the existing fleet with peaks that reach and exceed 10% and, therefore, with very high relative levels deriving also from the characteristics of "mobility "of the asset itself. The absolute size is equivalent to more than 6 bn. for each type of sector (Dry Bulk, Tanker) and about 3 bn. for the Container.

Volatility – Comparison with Real Estate Asset

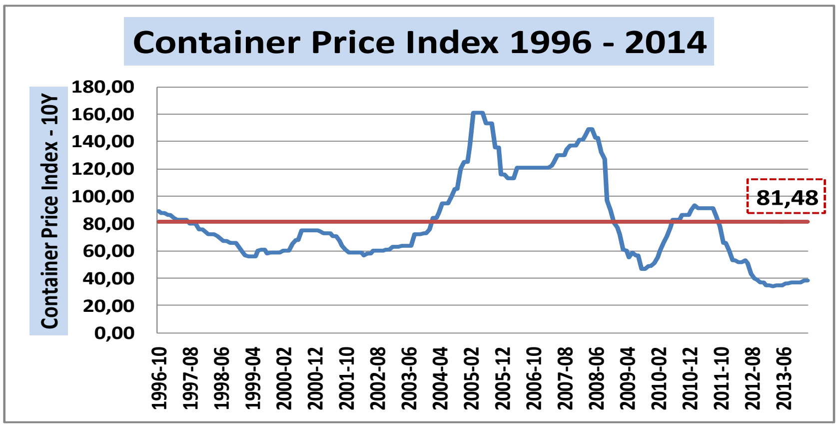
Relevant indications can be found in the measure of the volatility of the price index of the secondary market of the Naval Asset and the relative comparison with the variability of the Prices of the Real estate Secondary Market for an homogeneous temporal period:



1995-2014 BC Volatility	1995-2014 whitout boom
52,7%	25,9%

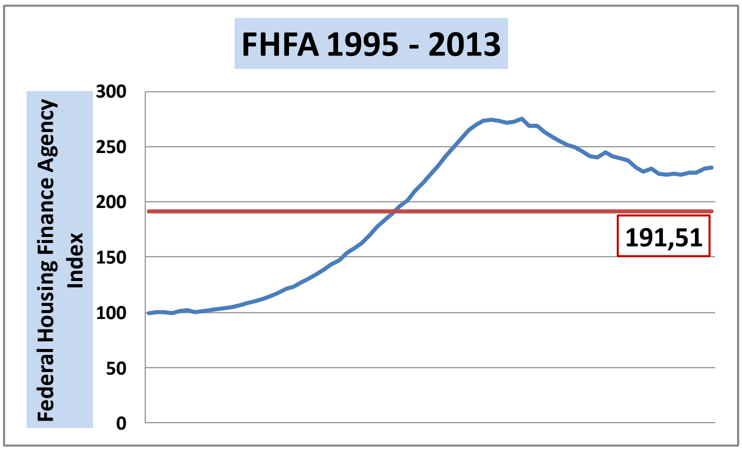


1995-2014 Tanker Volatility	1995-2014 whitout "boom"
31,1%	12,1%



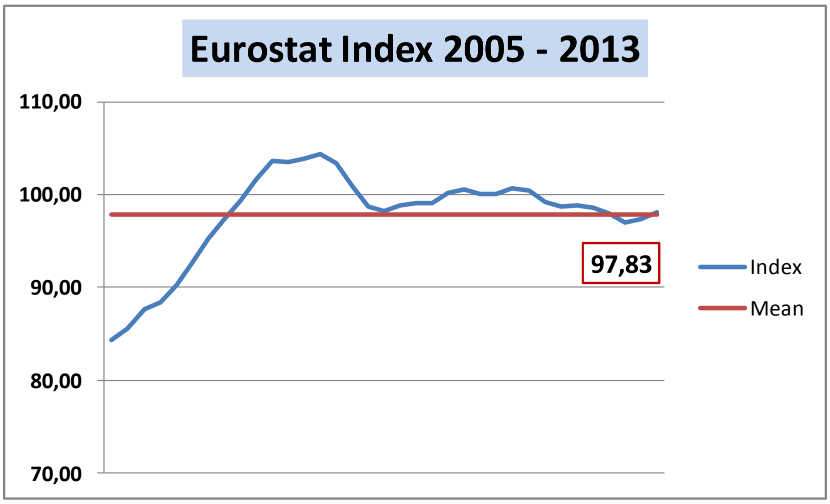
Container Price Volatility 1996 - 2004	1996-2014 whitout "boom"
39,1%	23,9%

The level of volatility ranges from 30% to around 50% in relation to the reference segments; that level assume even smaller figures if we exclude the corresponding periods of "boom" absolutely exceptional and non-recurring, that have characterized the Shipping Market in the previous decade. Moreover, this phenomenon could seriously undermine also the process of validation by those Banks that apply the IRB Method, if one do not use the techniques of "adjustment" and "normalization" of the historical series (override).



Real Estate FHFA volatility 1995 - 2013

32,91%



Real Estate Eurostat Index - Volatility 2005 - 2013

5,1%

Levels of volatility registered for Real Estate on comparable time records are in line with the volatility of the shipping sector. More moderate is the level of volatility on Eurostat data on shorter horizons 2005 – 2013

(iii) Considerations on Consultative Document

Due the aforementioned pre-conditions, Corporate Shipping Exposures cannot be treated as Specialized Lending according to the proposal under consultation and we think that such exposures would be incorrectly evaluated through the following criteria:

Object finance (OF) refers to a method of funding the acquisition of physical assets (eg ships, aircraft, satellites, railcars and fleets) where the repayment of the exposure is dependent on the cash flows generated by the specific assets that have been financed and pledged or assigned to the lender. See paragraph 223 of the IRB approach for further details.

28. Corporate exposures classified as project finance, object finance, commodities finance, and income-producing real estate exposures will be risk-weighted at the higher of (i) the risk weight applicable to the counterparty, and (ii) 120%.

We consider such proposed framework as unjustified and extremely penalizing for shipping exposures held by banks. As a matter of fact, we believe that revenues don't represent the best way to assess the credit risk of shipping exposures (as reported in the table below). On the contrary, the two indicators that would be most effective, to this regard, are instead LTV (Loan to Value) and DSC (Debt Service Coverage).

Risk weights for senior debt corporate exposures

	Revenue ≤ €5m	€5m < Revenue ≤ €50m	€50m < Revenue ≤ €1bn	Revenue > €1bn
Leverage: 1x–3x	100%	90%	80%	60%
Leverage: 3x–5x	110%	100%	90%	70%
Leverage > 5x	130%	120%	110%	90%
Negative equity(*)	300%			

(*) Note: Negative equity means that a corporate's liabilities exceed its assets.

ECSA believes that, from a credit risk point of view, ship financing exposure are similar to CRE (Commercial Real Estate) ones; therefore, the two applicable prudential frameworks should be aligned.

(iv) Proposal

ECSA believes that same risk assessment method proposed for CRE (Commercial Real Estate), as below pointed out, works better and fits for similar Exposure classes like Shipping Lending:

	LTV < 60%[60]	60% ≤ LTV < 75%	LTV ≥ 75%
Exposures secured by commercial real estate	75%	100%	120%

Considering that LTV represents the best proxy of shipping credit exposures, this proposal for the Standard Approach application combines two relevant parameters, respectively LTV with DSC (Debt Service Coverage Ratio). DSC means the Ratio between Debt Service for Principal and Interests on Free-Cash Flow From Operations (after effective Taxation). Therefore, ECSA supports the adoption of the following matrix to measure the Capital Absorption in application of Standard Approach for Shipping Lending Exposures:

		Loan to Value Ratio		
DSC		<60%	60% <= LtV < 75%	=> 75%
	<= 50%	50%	80%	100%
	<= DSC < 75%	60%	90%	110%
	>= 75%	70%	100%	120%

(v) Conclusion – Summary

— "High Quality" of First Lien Shipping **Mortgages** perfectly fits with Basel rules and is implicitly recognized by article 129 of the CRR.

— Shipping assets fulfill high requirements in terms of : (i) Liquidity, (ii) Large and worldwide market tradability, (iii) Relevant and significant transactions, (iv) Special international legislation which allows for quick enforceability of pledge on ships, (v) Ability to recover the outstanding loans by enforcement of pledge.

— Due to the above mentioned points, shipping exposures are fully comparable with CRE exposures and the two treatments in the Standardized Approach should be aligned (for certain aspects, ECSA is of the opinion that ship first lien mortgages could offer even better protection than CRED, with respect to enforceability).

— ECSA believes that the inclusion of Shipping Lending in the SL (Specialized Lending) class for the application of renewed Standard Approach, as proposed, could unfairly penalize the shipping industry which represents one the most relevant sectors for the global economy. In the end, the ECSA believes that LTV (Loan to Value) and DSC (Debt Service Coverage Ratio) would be the best indicators to correctly weight the credit risk underlying shipping exposures within the Standardized Approach.

The European Community Shipowners' Associations (ECSA), formed in 1965, comprises the national shipowners' associations of the EU and Norway. ECSA aims at promoting the interests of European shipping so that industry can best serve European and international trade and commerce in a competitive and free business environment, to the benefit of both shippers and consumers. The European Economic Area maintains its very prominent position with a controlled fleet of 40% of the global commercial fleet.

Contact:
Lieselot Marinus – Lieselot.Marinus@ecsa.eu / +32-2-510.61.28 / www.ecsa.eu

ECSA - European Community Shipowners' Associations
Rue Ducale 67/2 Hertogstraat - B-1000 Brussels / BELGIUM