

Changes to IRB – Position of shipping

Preamble

The consultation paper concerning reducing flexibility in credit risk weighted assets would be a very important burden to the efficient existence of the naval industry.

According to the Oxford Study 2015¹, the overall contribution of the European shipping industry to the EU's GDP in 2013 is estimated to have been €150 billion. In terms of employment, the industry provided jobs to an estimated 2.2 million people. Moreover, EU shipping is far more productive in terms of GDP generated per worker than the EU average. Europe controls the world's largest and most innovative fleet of ships covering 40% of the world's gross tonnage. Moreover, data arising from a survey set up by Italian Banking Association and the Italian Ship-owners association shows that Germany, France, UK, Greece, Italy Finland, Norway and Denmark represent the 70% of worldwide shipping outstanding.

The consultations fostered by Basel committee, over the modification of the Standardised Approach and the IRB, are both highly penalizing for the specialized lending and in particular for the shipping industry.

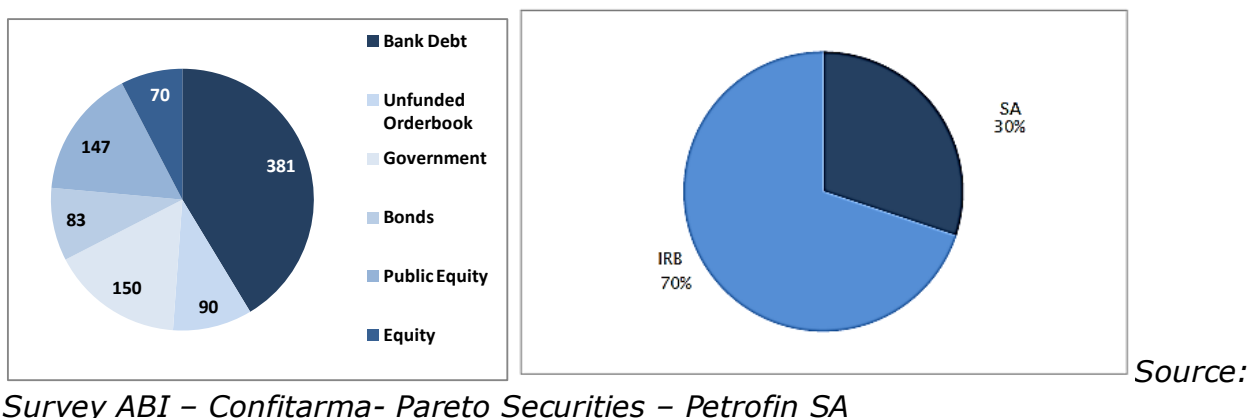
Thus, the treatment of credit risk for specialised lending under IRB cannot be dissociated from ongoing discussion on capital floors of those exposures started with the proposal for the Standardised Approach.

Under the proposal for the modification of the Standardised Approach the specialized lending class is highly detractive for the shipping industry, setting a floor of 120%, applicable even by banks using IRB methods if ship loans are effectively exempted by the IRB.

The international shipping industry is dependent on banking lending – as reported below (bn. \$) - the shipping funding market is backed by banks' loans even more than the worldwide industry and the 70% of those lendings are provided by banks using the IRB.

Hence, it is conceivable what disruptive effects the amendments promoted by the modification of the SA and of the IRB it could bring to the main source of funding:

¹ <http://www.ecsa.eu/images/Studies/150220%20European%20Shipping%20Update.pdf>



The level set for specialised lending risk weights under the SA would be highly penalising, particularly when capital markets are not sufficiently deep and when alternatives to bank financing are therefore limited. As such, the proposed SA is particularly inappropriate for use as the basis a capital floor for IRB banks, regardless of how this floor would be calibrated.

Market evidences

"The low-default nature of the assessed portfolios, and the consequent lack of appropriate data for risk parameter estimation, was likely one of the key factors leading to differences across banks. A survey of bank practices for estimating exposure at default (EAD) also found significant differences [.....] the Committee proposes to remove the IRB approaches for specialised lending that use banks' estimates of model parameters. This reflects its expectation that banks are typically unlikely to have sufficient data to produce reliable estimates of PD and LGD. The Committee proposes to leave only the standardised approach and the current IRB supervisory slotting approach."

In truth, many banks have sufficient data to estimate with a good level of certainty the PD and being the features of the collateral also a punctual estimation of the LGD. Moreover, banks involved in operation with the naval industry commonly have been provided with an office specialised treating ship loans and well aware about the functioning of the shipping industry knowing all the main characteristics and incumbents, so that evaluation would be even more reliable.

- 1) Concerning to the proposal set out by the Basel committee we would raise some issues coming from market evidences:

Estimation of the expected loss for the shipping industry shows a really low level due mainly to the small LGD. That is very common for this kind of lending since the nature of the collateral most commonly provided, the ship. In fact, in Italy ship loans figure out a very low LTV – in average well below 80% - and are backed by a first line mortgage in 74% of the cases.

	Default frequency	LGD	EL
Shipping finance	3,13%	13%	0,31%

Sources:

Shipping Finance: GCD; risk free discounting rate, +5% added to historical LGD.

Moreover, ship loans figure out a moderate LTV – in average currently well below 80% - and are backed by a first line mortgage in 80%% of the cases.

- 2) Shipping exposures and the collateral provided shows common features to the Commercial real estate class:

this category of SL is substantially similar to commercial real estate, demonstrating sustainably low credit losses as per paragraph 49 of the proposals - Revisions to the Standardised Approach for credit risk² -, with the same requirements/eligibility criteria in as set out in paragraph 50 being fulfilled. In particular, the legal enforceability of creditors' claims is effective and the valuation of assets is generally appraised independently.

Specialized lending Regulation (EU) No 575/2013 applies to ship loans, even if these loans have specific characteristics that make these exposures sounder than those generally considered in the SL framework and backed by more reliable guarantees than those provided usually in the specialised lending, that are for features closer to those set out to back CRE exposures. Ship loans fulfil conditions set in paragraph 50 for CRE. In particular:

- (i) Ship loans are guaranteed by first line shipping mortgages with a loan-to-value Ratio (LtV) generally well below 80%;
- (ii) Quality of the guarantees is good. The ship secondary market is sound and liquid. On average every year a percentage between 6% and 10% of the ships in terms of world tonnage is traded on the secondary market;
- (iii) Ship loans are more granular and less volatile than commercial real estate loans;
- (iv) According the Consultative Document, the approach by due diligence is viable for shipping considering this industry is usually audited by relevant specific Authorities/Regulators deputed to apply the International Maritime Organization (IMO) code.

Ship loans guaranteed by first line shipping mortgages should be weighted as Commercial Real Estate exposures (CRE) in the SA, establishing risk weights according to the LtV (Loan to Value Ratio). Risk weights considered in tables 11 and 12 of the consultation document concerning the Standardised Approach related to CRE could be applied based on whether the repayment is materially dependent on cash flows generated by property or not.

Since ship loans comply with requirements set for CRE and are in most of the cases endorsed by a guarantee sounder than those usually involved in CRE, the European Commission, under article 129 of the CRR, has allowed ship loans to be eligible for the

² Revisions to the Standardised Approach for credit risk: <http://www.bis.org/bcbs/publ/d347.pdf>

covered pool of a covered bond program, as commercial and residential real estate exposure.

Conclusion

The European Community Shipowners' Associations (ECSA) ask for an equivalent treatment between the exposures guaranteed by a shipping mortgage and those guaranteed by mortgages on commercial real estate. In particular, in order to define the prudential ratios to apply to these exposures, it is required to allow the internal models, as for CRE, for all the banks authorized to estimate credit risk internally and that can demonstrate to have an easy access to relevant information to evaluate the PD of the companies – for instance: good know how of the industry deriving from a relevant track record about shipping lendings.

ECSA asks to confirm the current treatment in respect the IRB Methods to be applied to shipping lending exposures for the banks which adopt the above methods.

Moreover, there is evidence that in average the LGD is very low, and it has a relevant impact in the valuation of the expected loss which stood around 0,13%.

The secondary market is very liquid, so it looks that these exposures are backed by collateral more liquid than those for CRE.

In conclusion, the shipping industry is wide and has a big variety of different sub-markets, hence we can see a granularity of the ship loans higher than the granularity level seen for CRE, reducing concentration risk and offering to banks the possibility to diversify the portfolio.