

The restructuring of non-performing shipping loans – Learning from experience in the real estate crisis

European banks account for approximately three-quarters of the global ship financing market of approximately USD 475 billion, with German banks having by far the highest exposure compared to their European competitors. Banks in Scandinavia and the United Kingdom follow. As a result, German banks are particularly exposed to any negative market developments in the shipping industry. Although, there are signs of recovery in shipping markets, this only applies to certain sectors.

For lending banks the question arises whether there are other methods of portfolio management besides the traditional methods, such as refinancing of an expiring shipping loan or enforcing collateral. From a strategic and risk management point of view as well as with respect to liquidity and equity management, it may be an interesting option to sell shipping loan portfolios as a whole to investors.

Basel III and CRD IV burden ship financing

The stricter capital requirements under CRD IV will make the sale of ship-related loan portfolios more attractive because risky assets such as shipping loans will need to be backed by more equity capital to reflect the current market risk. In particular, the proposed leverage ratio will limit a bank's volume of overall business, without distinguishing between risky and less risky assets, thus limiting the growth potential for new business. As a consequence, it may make sense that banks sell long-dated loans in whole or in part in the secondary market to investors outside the banking sector.

Apart from the regulatory aspects, there are other reasons to make changes to the ship finance market. The majority of the German ship funds are in crisis, many being in insolvency or under restructuring outside of formal insolvency proceedings. For the foreseeable future, tax-advantages for shipping funds will no longer be available. In addition, the industry is struggling with cost problems. The shipping industry in Germany is fragmented, the fleets of most ship owners are small and ship owners struggle to operate on a profitable basis. Rising fuel prices and additional costs due to the new emissions standards of the International Maritime Organization (IMO) adopted in 2008, which have to be implemented gradually by 2020, also exert pressure on the shipping industry. On the other hand, there are high investment needs primarily by foreign private equity investors and the capital markets, demanding new high-return investment opportunities.

The ship financing market crisis favors portfolio sales

Against this background, in an effort to develop new restructuring platforms, German banks have begun entering into cooperation agreements with shipping companies, private equity investors and strategic investors. The current shipping industry situation is very similar to the crisis in the real estate industry last decade, which resulted in many German banks disposing of distressed, sub-performing and non-strategic real estate loan portfolios primarily to international private equity investors.

Through joint venture solutions and the outsourcing of real estate management functions, new structures were created in the real estate finance industry. International private equity investors thus became one of the significant owners of real estate and real estate financings in Germany. This raises the question whether the shipping industry is able to benefit from the experience of the real estate industry in crisis management and whether similar transaction structures and techniques can be applied.

Shipping loan portfolios can be transferred by asset or share deal

Different transfer techniques have been applied depending on the legal situation and the objections of the parties. Under German law loan portfolios can be sold by way of assignment or assumption of contract. These forms of contractual transfers are referred to as "asset deals". An assignment operates to transfer rights only, whereas a transfer of rights and obligations is achieved by assumption of contract. However, asset deals were often impossible or at least impractical: for example, because of assignment restrictions or the lack of cooperation of borrowers or other parties involved. In these cases, as well as in the context of very large portfolio transfers, transactions were designed as "share deals", where loans are hived down, and servicing functions outsourced to independent servicers. The German Transformation Act (*Umwandlungsgesetz*) provides legal outsourcing options by spin-off or hive-down without leading to a legal transfer of the loans and collateral (assets). However, the transformation also has a number of problems, such as a five-year continuing liability of the investor for obligations of the selling company, which exist on the date of transformation. However, that disadvantage can be minimized by additional effort on the structuring of a transaction. The question arises to what extent a transformation under German law is accepted in other jurisdictions. This issue is particularly important because investors normally seek a transfer that provides them with an insolvency-proof claim. Relating to this issue significant experience has been acquired in the multi-billion-euro transfers of non-performing and non-strategic assets into the so-called German "bad banks" (*Erste Abwicklungsanstalt and FMSW*).

Shipping loans are more international than real estate loans

For shipping loan portfolios, the issue of other jurisdictions recognizing transfers is especially relevant because the financing agreements, particularly syndicated financing agreements, are often governed by English law. The governing law of the ship mortgage depends on the flag state, with Panama, Liberia, Malta, Cyprus, Singapore, Hong Kong, Bermuda and the Bahamas playing significant roles. These jurisdictions have recognized ship registers as Germany and the UK have. To what extent non-European countries recognize a transformation under German law, is not an easy question to answer. Therefore, synthetic transfers in the form of guarantees, sub-participations or credit derivatives have been applied. What these solutions have in common is that loans are only transferred economically, the legal ownership remains between the original financing bank and the borrower.

Essentially, all transfer techniques used in real estate financing transactions could be applied to transferring shipping loans. However, the differences in the collateral structures between real estate financing and shipping loans need to be taken into account. While, in property transactions, land charges (as non-accessory security) are the predominant security instruments (with mortgages as accessory security playing a minor role) in ship financings the ship mortgage is the principal security device.

In the case of a portfolio sale, it is important to note that under German law, but also in most other relevant jurisdictions, ship mortgages may be enforced only by foreclosure (*Zwangsvollstreckung*), but not sequestration (*Zwangsverwaltung*). Other typical collateral in ship financings such as the assignment of insurance claims and claims arising under shipbuilding contracts, accounts pledges and assignments of charter agreements are often governed by English law and should always be assigned separately. In the financing of new-build ships refund guarantees (*Fertigstellungsgarantien*) play a significant role.

For all collateral, the applicable laws need to be carefully identified in order to achieve an effective transfer. Ultimately sales of ship finance portfolios require extensive due diligence investigation, as is also the case for real estate transactions. This experience can be used, whereby the legal and factual characteristics

of shipping loans require particular industry and legal knowledge, especially outside of Germany. In an asset deal, as well as in a share deal, the transfer documentation has to reflect the specifics of the asset class "ship finance". In this way it differs from the standardized documentation of transactions for real estate loans. In particular, commercial (such as chartering and special reporting) and technical management (such as technical and vessel inspection) have to be considered.

Application of refinancing register is possible

When transferring real estate loans, it is common to enter the receivables and collateral (land charges and mortgages) into the German refinancing register stipulated under the German Banking Act. By registering, the purchaser obtains an insolvency-proof legal position in respect of the registered loan receivables and collateral security without the need for any re-registration in the land register. Entry in the refinancing register is a fast, efficient and inexpensive way of transferring loans and in rem security devices, and non-German loans and collateral are eligible to be registered in the refinancing register as well. The refinancing register is also available for the transfer of shipping loans and shipping mortgages, but there remains the question of recognition under the insolvency law of the states whose law governs the ship mortgage in the event of an insolvency.

Due to amended legislation, which became effective on January 1, 2014, the refinancing register is now available for insurance companies and pension funds. Before this time, eligible users were limited to banks and special purpose entities. Investment criteria of insurance companies and pension funds typically permit investments in shipping loans, so that the statutory amendment now permits insurance companies and pension funds to compete with other investor classes for loan portfolio transactions concerning portfolios in the secondary market.

High demand for joint ventures

The restructuring of shipping loan portfolios requires new restructuring platforms outside of bank balance sheets, where problem ships can be refinanced and newly employed. Emergency sales might be prevented by such platforms enabling banks to preserve the value of their ship finance portfolio and, if necessary devalue and build the necessary provisions over a longer period of time.

Joint ventures have been formed between ship owners and private equity investors in the shipping industry. In structuring such joint ventures, the shipping industry should again look to the experience of the real estate industry (and, of course, other industries). In a joint venture, the shipping loan portfolio is transferred to a joint venture (usually a joint venture company), where the transferring credit institution and a ship owner, and possibly other partners (private equity investors), are involved. Typically, the portfolio comes from the relevant banks by way of contribution in kind (*Sachgründung*) and the investor supplies equity capital by cash contribution (*Bareinlage*). Ship owners or outside third-party servicers are brought into joint ventures in order to contribute specific shipping industry know-how (such as charter and restructuring expertise). A joint venture opens up a variety of structuring options that permit the inclusion of other strategic investors. However, joint ventures are very often fragile structures, where a lot of experience is needed for structuring in order to minimize the risk of premature failure.

Whether in the context of complex joint ventures or straight-forward portfolio sales, the mandatory transfer of labor contracts also needs to be analyzed. Once a portfolio is to be classified as an operating part, under German law the affected employment agreements transfer to the new company, provided that the employees concerned do not object. This is similar to other EU jurisdictions, as Germany's law is based on EU-regulation.

One additional problem in the context of raising fresh funding for the shipping industry from private equity and from the international capital markets is that most German ship owners and charterers are not eligible to take advantage of the capital markets. Therefore, the bundling of capacities and the construction of larger units is necessary. This creates a need for new, independent servicers with specific industry experience in order to provide compliance and reporting structures meeting the standards of capital markets and international investors which allow institutional investors to invest in shipping as a new asset class. Again, experience from the real estate industry may support this development without, however, repeating the mistakes that led to the outbreak of the financial crisis.

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