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Is Hong Kong Destined to be the Major Ship Finance Centre in Asia?

Dean A. Young, a Senior Consultant with Mayer Brown JSM, discusses Hong Kong's long tradition of shipping finance in the Asia Pacific region.

Lessons Learned

It is well known that since the global financial crisis of 2008-09 and the ensuing recession, the shipping industry has suffered heavily from overcapacity of ships and insufficient demand for cargoes, leading to downward pressure on vessel values and earnings. The offshore sector continues to be hurt by the drop in oil prices, to the extent that many rig owners will struggle to find funds for re-commissioning or face the scrap yard, alongside hundreds of their support vessels. The KG system of financing ships in Germany has been annihilated, forcing their banks to reduce their lending budgets and take over defaulted ships. Some have had no choice but to sell off their loan portfolios or close down. European owners have gradually lowered their market share from 47%-45% of the global fleet.

Although Asian owners have suffered too, and headline bankruptcies like Sanko Steamship, STX, TMT and Hanjin Shipping are proof of this, the number of loan enforcements has been comparatively small. The majority of owners in Taiwan, Singapore, Japan, China and Hong Kong were able to call on their institutional and private shareholders to provide working capital, they delayed or paid small penalties to cancel their new building programmes, they did not seek public equity through IPOs and shipping funds (preferring to retain control of their assets), they sold off or scrapped their old tonnage, and they cut back expenditure to the bone. Never ones to seek market domination by mass ordering (having learned valuable lessons from the recession of 1985) their traditional method of replacing tonnage only when demand required and generally subject to a period charter party has proved that prudence or 'owning with banking characteristics' does work. Consequently, Asian owners have increased their market share from 38% to 40%, of which PRC owners now control 12%. The PRC leasing companies are competing to grow further and 20% is not an impossible target.

Current Thinking

Lenders are aware that the contraction in shipyard capacity has helped to re-balance the supply/demand ratio, the consolidation in containership owners has reduced speculative ordering, and that values and earnings have either bottomed out or are starting to recover in the dry bulk, container and oil sectors (albeit choppy at times). Despite this background, the appetite for ship lending this year remains cautious. Every bank is analysing whether to remain in shipping or to sell its portfolios and warehoused vessels into a rising market. Debates are raging in-house between risk, compliance, corporate, and commodity departments about the technical complexities of ship finance, fluctuating earnings, volatile values, the cyclical spikes and troughs. Added to these are the on-going risks of obsolescence for non-compliance with environmental legislation designed to reduce shipping's carbon footprint, low profitability and, perhaps most serious, the high risk weighting of ship mortgages and long terms loans for capital adequacy purposes.

Tier 1 for Asset Finance: Shipping finance (Hong Kong)

- *The Legal 500 Asia Pacific* (2010-2013 & 2015-2018)

Band 1 for Shipping Finance (China)

- *Chambers Asia Pacific* (2008-2016)

"Finance Deal of the Year 2016: Insolvency - PT Berlian Laju Tanker $2 billion senior notes restructuring deal"

- *The Asian Lawyer's Emerging Markets Awards*

International Shipping & Maritime Firm of the Year

- *China Law & Practice Awards* 2015

Ship Finance Award

- *Seatrade Maritime Award Asia* 2015

Signs of Positiveness

To counter these perceived difficulties, there are signs that banks can see as a window of opportunity, especially in the Far East.

1. Global seaborne trade is experiencing steady annual growth and is forecast to grow further by 3.6% year on year in 2018. New buildings and refinancings are expected to require US$80-100bn p.a. There is a huge market demand and Asian banks have the funds.
2. The lending climate in 2018 is very different from the previous 5 years. There is less competition from European, UK and Scandinavian banks. The private equity funds have realised that charter hire rates are not nearly enough to reach their expected return on equity, so have turned their attention towards buying bad debt portfolios from banks rather becoming owners themselves. This presents an opportunity for ship lenders to increase their market share with the possibility of higher margins and fees.
3. The leasing market has grown substantially in Asia, particularly in China. This can be seen as beneficial to Asia, especially Hong Kong and Shanghai, by providing a type of tier 2 support for vessel values. The reason for this is because their shareholders are either financial institutions or state-owned enterprises, which makes their forced exit from this sector for financial reasons unlikely.
4. Similarly, the competition from PRC banks who are lending to these lessors can be seen as beneficial because of their balance sheet strength and their contribution to the development of sophisticated financial services and products. The combination of PRC lessors and banks presents an opportunity for Hong Kong to become a major ship finance centre in Asia.
5. Under the 13th Five Year Plan (2016-2020), the PRC Government has expressed support for Hong Kong to become an international transportation centre, in tandem with a separate scheme to promote Shanghai as a world class maritime centre. Both schemes create opportunities for the two cities to complement each other and to generate more business, and not just from China's 'Belt and Road' initiative. Out of a total of 30 maritime cities, Shanghai now ranks 4th and Hong Kong 7th, and banks with branches in both cities may find synergies between their customer bases.
6. The HK Trade Development Council has been raising the profile of the shipping sector for some time, but other business groups are now speaking from the same page. Recently, the HK Financial Services Development Council (FSDC) has suggested that tax incentives would encourage greater competition by Hong Kong companies in the region, and particularly compared with Singapore which continues to draw businesses and manpower away from Hong Kong. A precedent has already been set in 2017 in the aviation sector by an amendment ordinance that reduces the rate of profits tax for qualifying aircraft lessors and leasing managers. If a similar tax reduction is introduced for the ship leasing sector, Hong Kong could see sizeable offices being established in Hong Kong by PRC leasing companies. The more economic activity in Hong Kong, the easier Hong Kong can refute OECD claims that base erosion and profit shifting to low tax jurisdictions like Hong Kong is a harmful tax practice.

"They are responsive and able to provide commercial advice."

"excellent," providing "good response times, business acumen and industry knowledge."

- *Chambers Asia Pacific* 2018

Mayer Brown JSM's "exceptional" asset finance team benefits from "unrivalled industry and subject-matter knowledge" and "highly commercial".

- *The Legal 500 Asia Pacific* 2018

"They are excellent – professional, diligent, punctual, innovative – and they are problem solvers."

– *Chambers Asia Pacific* 2017

"The firm is a go-to for shipping finance."

– *Chambers Asia Pacific* 2016

"They are experts in ship finance; they are commercial and proactive to find solutions for their clients."

– *Chambers Asia Pacific* 2016

7. In addition to tax incentives, the FSDC has proposed to the HK Government that more support for shipping banks and their financial products should be provided by establishing a sovereign-rated financial institution or export credit agency. Such organs could provide insurance or guarantees against default, or they can purchase and package shipping loans into securitized bonds which would free up more capital for banks to lend on new facilities.
8. Hong Kong financial institutions are likely to be the first port of call for users of the Hong Kong Shipping Register, which maintains its status as a world class registry currently ranking the 4th largest in the world. They are ideally placed to act as leaders in syndications and club lending where the HK ship mortgage is the primary security, and can be reassured by opinion letters from law firms as to its enforceability given the history of court cases allowing holders of a mortgage to take back and sell ships if their owners cannot repay the debt. China has been supportive of PRC owners registering their ships in Hong Kong, not just because it is one of its special administrative regions but also due to its advantages over PRC ports of registry such as its USD based banking sector, there being no capital and exchange controls, its tried and tested legal system based on English law, and an efficient shipping register.

Further Steps

Hong Kong has a long tradition in providing shipping finance but the number of HK born and bred owners in its sphere of influence is reducing. There needs to be a boost of measures to keep its existing owners and managed fleets in the territory, beyond looking at the numbers of ships registered under HK flag. And new measures have to be introduced to attract new owners, leasing companies and managers to set up business in Hong Kong, which in turn will attract more business for the ship lending community. The 2018 Report from the Xinhua-Baltic International Shipping Centre shows that Singapore still is the world's No. 1 port city, but Hong Kong has taken over London's position at second spot for the first time. This shows that the groundswell is beginning and it would be a wasted opportunity to look back in 12 months time and see that none of the measures suggested to the HK Government have been introduced.

"They are very good on client care – they always put in extra work to accommodate timelines and challenging ideas and structures."

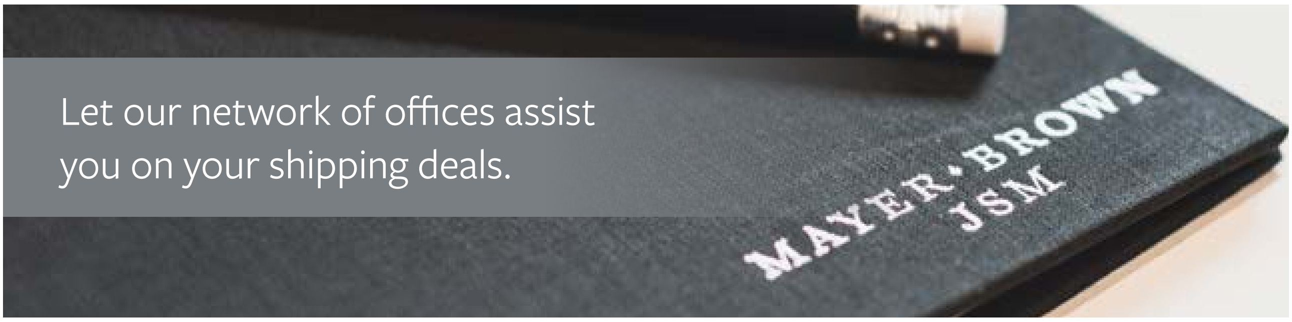
– *Chambers Asia Pacific* 2016

"The team takes commercial considerations into account to give us comprehensive advice."

– *Chambers Asia Pacific* 2016

"They are very efficient and the transactions are quick and smooth."

– *Chambers Asia Pacific* 2016



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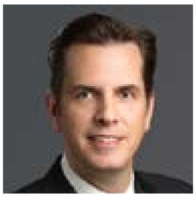

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