THE SHIP FINANCE PUBLICATION OF RECORD

MARINE MONEY

INTERNATIONAL

HAMBURG ◆ SINGAPORE ◆ LONDON ◆ NEW YORK ◆ OSLO ◆ PIRAEUS

APRIL/MAY 2018 VOLUME 34, NUMBER 3

Still a Slog

The Bankers' Issue

THE SALE OF SHIPPING LOAN PORTFOLIOS/ SHIPPING NPLs

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Despite the various challenges that come with selling a portfolio of loans, we have seen — and continue to see — a flurry of activity in the secondary debt sale and purchase space with non-performing loans (NPLs) and distressed/stressed debt being of particular interest to buyers in the market. Following on from the downturn, post the financial crisis, we have seen in the shipping markets the sale of shipping NPLs seems to be another alternative to the restructuring of a defaulting shipping loan, or refinancing of an expiring shipping loan, or the traditional last resort of enforcing against the collateral. The fact that only a very small percentage of the global pool of stressed/distressed shipping loans was sold last year suggests that there are plenty of further opportunities in the years ahead.

WHAT IS DRIVING THE SELLER TO SELL?

We have seen a number of banks exiting shipping or deleveraging their books. The factors we have seen driving banks to sell include one or sometimes a combination of the following:

- regulatory pressures and changes which directly impact the capital costs for a regulated bank entity and, therefore, their profitability in relation to a loan, particularly with shipping assets being seeing as more risky and, therefore, potentially being required to be backed by more equity capital. Changes such as the recent European Central Bank Guidance and the changes in capital requirement directives e.g. CRD IV, as well as the Basel Committee's proposed changes to capital requirements (sometimes referred to as Basel IV) have been very challenging for some banks

- new accounting standards which require banks to look at the lifetime of the vessel and its performance when discussing impairment considerations

- banks may have inherited loans or portfolios from another bank, either through a merger or a portfolio purchase, and do not want to keep all of the loans they have bought or inherited

- restructuring "fatigue" – lack of resource to spend the time required to be spent on loans/cases which are unlikely to ever be profitable for a bank again, or have reached a stage where there is a breakdown of trust with a particular client as a result of ongoing discussions around defaults

- bank policies to exit shipping

WHAT IS INFLUENCING A BUYER'S DECISION TO PURCHASE?

- Distressed debt will typically sell at a discount, so there may be some room to make a quick return – this can be attractive in particular to the private equity buyers that we are seeing active in this market at present

- It may be another bank or lending institution looking for an opportunity to add new relationships to its books or expand existing relationships

- It may be the case that the seller simply wants to sell a loan, but that the buyer's motivation is to "loan to own" and, as such, the relationship with the owner isn't something that even comes into the equation for the buyer. In this sort of situation, the buyer will need a defaulted loan so that it can enforce on the vessel straight away, and the buyer may even as part of its due diligence ask us to carry out an analysis of the detailed enforcement strategy (looking at all costs involved right up until the end point) prior to purchasing the loan

- A private equity/hedge fund buyer will probably not be constrained by the same regulatory environment when compared to a traditional bank lender, and perhaps it can have more flexibility in how it handles and deals with loans once purchased

- Some large companies going through a restructuring process find themselves having no choice but to divest themselves of some of the equity and, therefore, control in their company to distressed debt holders by converting debt to equity, which can result in buyers picking up control of the company. This may be a motivating factor to certain buyers.

SOME OF THE CHALLENGES WE HAVE SEEN POSED WHEN LOOKING AT PORTFOLIO PURCHASES (THIS IS NOT AN EXHAUSTIVE LIST…)

Depending on the size of the portfolio and the number of loans involved (and to a certain extent the identity of the selling entity), you are likely to find a mix of governing laws, loans in a variety of languages, and a variety of style of documents in terms of format and structure. There may also be a mix of performing and non-performing loans. What the buyer's focus will be depends very much on their strategy post-purchase – they might focus on distressed loans and how and when they can enforce, and sometimes we are asked to map out the enforcement strategy prior to purchase (allowing them to budget for costs and expenses). Alternatively, the strategy might be to negotiate with the borrower for them to buy the loan back from the buyer immediately after the loan purchase, in which case the buyer will need some stress points to create leverage, and so the focus may be on identifying and analysing what those stress points will be. Or the buyer might be intending to on-sell the loan soon after purchasing it, in which case the buyer will want a thorough due diligence exercise carried out so that they have the comfort of knowing that the loan is capable of re-sale and what the problem areas might be for a future buyer.

There may be regulatory issues that need to be considered before the purchase can go ahead – for example a banking licence might be required in order to lend to borrowers in particular jurisdictions.

The documentation itself could reveal challenges such as:

- The transfer provisions might require borrower consent or the consent of other lenders (the latter typically only in the case of a club deal) – in the case of a distressed loan, that consent is not likely to be forthcoming from the borrower. Some borrowers will go to great lengths to try to prevent a transfer if it feels it is going to face an aggressive counterparty going forward, or if it feels the transfer will have a detrimental effect on its loan. Such consent issues, at least as they relate to the borrower, can be overcome by using sub-participation as an alternative method of transfer, though some buyers or even sellers are not prepared to risk permanent sub-participation.

- Whether or not the buyer meets the transferee criteria in documentation. We sometimes see, probably more so in "older style" documentation and not so much in LMA style documentation, a limitation on transfer to only a "bank or financial institution." This has caused issues in the past when a new SPV company is set up as purchaser of the loans although, under English law, the position has recently been clarified in *Olympia Securities Commercial Plc (In Administration)*[1] which, although only a first instance case, has been welcomed by the financial sector as providing important clarity on the commonly used term "financial institution." The effect of that case was to confirm that the interpretation is very wide and wide enough to include a corporate entity (or partnership) formed solely for the purposes of receiving the transfer of a lender's position under a loan agreement, provided it is properly incorporated and operated in accordance with the laws of the place where it is formed.

- There may be confidentiality provisions, data protection laws, or banking secrecy laws in the seller's jurisdiction which make it impossible or difficult to share all relevant information that would be helpful to or even needed by the buyer as part of its due diligence exercise. In our experience, in situations where not all information can be disclosed, there has to be some sort of mechanism to unwind a sale or carve out a particular loan if it causes major issues for the buyer – typically the sorts of things that would result in such action would be things like sanctions issues, large undisclosed liabilities etc.

- There may be jurisdictional issues related in particular to the ship mortgages and account security that need to be considered. In some jurisdictions, you need the cooperation of the owner to transfer a ship mortgage and so, even if the loan documentation does not require borrower consent, this can be a hindrance to closing. Again, there are ways around this for example, the sub-participation route.

- There may be other aspects or roles within the facility to also think about, such as any hedging exposure and whether that is also being sold and, if it is not being sold, both parties may need to think about whether there are sufficient intercreditor provisions in place to govern the relationship between swap bank and lender. If the seller is a bank exiting shipping altogether, they may not want to keep the bank accounts, and so a new account bank may need to be found and new security put in place. That requires the cooperation of the borrower as well as time to get it all in place and allow for KYC checks to be carried out with any new account bank. Similarly, with an entity exiting shipping, it is likely that they will also want to resign from their roles of agent and security trustee in respect of any of the loan portfolio which again requires

[1] *[2017] EWHC 2807 (Ch)*

a further diligence process, cooperation with various parties and a set of documentation.

- If new security (e.g. account security) has to be put in place then, in the case of a struggling borrower or in the context of a restructuring, there is the risk that such security can be set-aside if insolvency occurs within applicable hardening periods.

- Sanctions can be a difficult subject, as different entities take a different approach and position on sanctions, and any historical breaches or incidents can also create an issue for a buyer that is sensitive to the issue generally. It may not necessarily be the seller that draws the issue to the buyer's attention – typically, a buyer will carry out its own KYC checks on the borrowers and loans it is buying.

- Tax issues in the seller's or buyer's jurisdictions resulting from the sale of the portfolio – this is something that both sides, if they are looking to complete a successful transaction, should get ahead of by having tax advisors on board from early on to avoid any last minute issues which might jeopardise the deal.

CONCLUSION; MARKET PRAGMATISM?

The level of activity we are seeing suggests that sellers and buyers appear to be agreeing on pricing, and there is no shortage of loan portfolios coming up for sale. The complexity of the transaction, the time it will take to carry out due diligence and negotiations, the cost of the exit strategy (particularly if it is through an enforcement process) will all factor into the pricing. If, for example, the timing slips due to some nasty surprises coming up, or too many loans start to be carved out of the portfolio that could impact the economics of the deal for either party and be enough to prevent the deal going ahead. Although, in such situations, particularly where the parties are confident they will find a solution or in situations where simply more time is needed to deal with the sheer volume, a typical solution would be for transfers to take place in two stages, with the first stage being a transfer by way of sub-participation with a view to the loan being "elevated" (i.e. a full legal transfer taking place) at a later stage when the various factors outside of the control of the buyer and seller have been dealt with.

In agreeing to a deal, it will be important for the parties to understand the seller's motivations and the buyer's motivations — see the different factors and reasons set out above — in order to be able to assess the potential pressure points in the deal. To a large extent, these will also determine the timing and structure of the deal.