SEPTEMBER 2024

# What Basel IV means for maritime finance

## Background

Since its establishment in 1974, the Basel Committee on Banking Supervision ("**BCBS**") has strived to enhance financial stability by regulating the management practices of financial institutions at an international level. This has taken the form of a series of banking regulations known as the Basel Accords.

In 1988, Basel I set a minimum capital requirement aimed at minimising credit risk. This required financial institutions to maintain a capital adequacy ratio of at least 8%. In 2004, Basel II refined the calculations introduced by Basel I and prescribed the use of standardised measurements for credit risk, market risk and operational risk. Banks still had to maintain a capital reserve of 8%, but 4% or more of that had to be Tier 1 capital. In response to the 2008 financial crisis, Basel III increased the 4% capital requirement for Tier 1 to 6% and introduced additional capital buffers that banks were required to maintain. As a result, the total capital requirement was raised to 13%.

In 2017, the BCBS agreed on some amendments to Basel III to increase the standardisation of the banking system worldwide. These were originally named Basel 3.1 but because the changes are very comprehensive, they are often seen as a new framework referred to as Basel IV. Its incremental implementation started on 1 January 2023. The compliance deadline for all eurozone banks is 1 January 2025. In the UK, the rules will be introduced from 1 July 2025 and will be phased in over 4.5 years to ensure full implementation by 1 January 2030.

This article focuses on the key changes introduced by Basel IV and their impact on the ship finance market.

## Basel IV changes

According to the BCBS, the aim of Basel IV is to "*restore credibility in the calculation of Risk Weighted Assets ("**RWAs**") and improve the comparability of banks' capital ratios*". This is achieved in a number of ways, the most important of which are summarised below.

First, the capital requirement for Tier 1 capital will be increased. In the UK, the Bank of England has estimated the increase to be around 3.2% once fully phased. In the EU, the increase is estimated at around 10%, while in the US, the estimate is at around 16%.

Basel IV also restricts the use of sophisticated internal risk models to calculate a bank's credit risk and requires the use of a standardised risk model. This change results from concerns that banks using an internal risk model underestimate their portfolio risk and their capital reserve requirements.

In addition, Basel IV introduces an output floor for the calculation of RWAs which requires banks' internal risk measurement to yield at least 72.5% of the amount calculated under the standardised model.

There is also a new risk rating for different types of assets, as well as changes and improvements to the existing standardised approaches to assessing and calculating credit risk and operational risk.

Finally, international banks which play a significant role in the world's financial system (Global Systemically Important Financial institutions) are required to maintain additional capital reserves to limit their leverage further.

## Impact on ship finance

The impact on banks with ship finance portfolios will vary depending on where a bank is located and the type of financial institution. European and Nordic banks are expecting to be affected strongly by the application of an output floor, as many use internal models and their exposure is often concentrated heavily in areas with lower risk weightings.

Many European banks will therefore need to revise their calculation methodology in relation to their capital requirements and adjust their internal processes. This is likely to lead to higher margins for shipping loans (this could be somewhere between 20 and 40 bps).

Because ship finance tends to be allocated a higher risk weightage due to the volatility of vessel income and the variability in a vessel's market value, European banks are likely to reduce their shipping exposure even more and, in certain cases, exit the market.

Banks that choose to continue lending to shipping companies are expected to apply increasingly stringent criteria in evaluating credit risk, such as the residual value of a vessel, the owner's reputation, the chartering arrangements and counterparty risks as well as the quality of the technical and commercial management. This means that European banks are likely to increase their focus on larger long-established shipping companies with better credit ratings according to the standardised model.

It is expected that small and medium sized shipping companies will be affected heavily by Basel IV, as traditionally they have placed strong reliance on bank debt. These changes also come at a time when their need for capital is increasing due to decarbonisation targets they can only meet if they invest in vessels with sustainable fuels (such as low emission methanol and ammonia) and energy efficient technologies such as wind propulsion. In addition, around 15,000 vessels are expected to reach the end of their economic life in the next ten years and will need to be replaced by newly financed vessels.

However, reduced availability of traditional bank finance is not new in the shipping market. It started following the 2008 financial crisis and the introduction of Basel III. Since then, other/alternative financial institutions and products, like Asian banks, Chinese leasing and private equity funds have started to fill the gap as viable alternative sources of finance for shipping. Their role (and the diversity of products) in ship finance is likely to increase even further as a result of Basel IV.

For example, there may be an increasing number of syndicated loans offered exclusively by Asian banks (rather than a combination of European and Asian banks). This may present new financing opportunities for UK and European shipowners looking for lower margins, especially if they manage to stabilise their revenue by employing their fleet on longer term charters.

The role of private equity is also set to become even more prominent and, as a result, financing structures may increase in complexity to broaden credit exposure, with syndicates of UK and European banks providing senior debt finance to equity funds which, in turn, would provide financing to shipping companies.

Finally, sale and leaseback structures are also expected to become more prevalent, whether these are more traditional structures or newer models such as Japanese Operating Leases with Call Options (where operating lease arrangements are funded by an equity investment from Japanese investors and senior debt financing is provided by financial institutions to a special purpose vehicle).

## Conclusion

While Basel IV will present a new challenge for the shipping industry and is likely to restrict access to traditional bank financing, particularly for smaller shipowners, shipping companies and ship finance structures are likely to adapt to face such challenge with creative solutions.

We are here to assist you navigate the market and find, structure and implement the solutions that work for you.

## Authors


### Ian Mace

Partner and global head of maritime, trade and offshore finance, London

T: +44 20 7809 2653
E: ian.mace@shlegal.com



### Dora Mace-Kokota

Partner and global maritime, trade and offshore practice leader, London

T: +44 20 7809 2325
E: dora.mace-kokota@shlegal.com



### Sadhika Shegar

Associate, London

T: +44 20 7809 2635
E: sadhika.shegar@shlegal.com



### Danae Hosek-Ugolini

Consultant, London

T: +44 20 7809 2277
E: danae.hosek-ugolini@shlegal.com




STEPHENSON HARWOOD