

Testimony of Roy G. Bowman
Before the Subcommittee on Sea Power and Expeditionary Forces
Of the
House Armed Services Committee

Federal Ship Financing Guarantee Program

March 15, 2007

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Good afternoon, Mr. Chairman and members of the subcommittee. It's an honor to appear here today to comment on the Federal Ship Financing Guarantee Program contained in Title XI of the Merchant Marine Act, 1936. My comments here this afternoon reflect only my own views, formed over a number of years of observing the Title XI program and the shipping industry. My introduction to the Title XI program came in my capacity as General Counsel of the Maritime Administration in the period 1969 – 1971. After my service at MarAd, I practiced law in Washington, D.C. for the many years between then and now. I also served recently as Vice President for Government Affairs of American President Lines Ltd., a large international container operator that operates 11 U.S. flag vessels in the transpacific trade of the United States. I am now a partner in the law firm of Thompson Coburn LLP.

In my capacity as a practicing lawyer I have represented both shipyards and shipowners and have been involved in numerous vessel financing projects using both Title XI and loans made by commercial lenders. In addition, I was very substantially involved in the amendments to Title XI in 1995 which introduced the availability of Title XI guarantees for vessels built in the United States for export to shipowners outside the United States.

It's worth taking a moment to put the Title XI program in the historical context of world events during the 1970's through this first decade of the 21st century. For instance, when I first dealt with Title XI in the 1970's oil was \$3 a barrel. As a result, consumption soared and the tanker market was at all time highs. VLCCs were paid for in one or two voyages from the Persian Gulf. In the U.S., there were thirteen subsidized lines in the foreign trade of the United

States running 250 or more U.S. flagships serving U.S. trade around the world. Most of these U.S. flagships were financed with the aid of Title XI.

With the Arab oil embargo of 1973, the tanker market collapsed and many a tanker was laid up. The United States, however declared a drive for energy independence and shipyards turned to the construction of LNG ships, drilling rigs and oil industry service vessels. Again, most of the projects were financed with Title XI.

During the 70's and 80's Title XI was critical to U.S. ship finance. Title XI was created because it was generally thought that shipping was highly risky and therefore not suitable for commercial loan financing. Most commercial banks would not readily accept the risks inherent in shipping. Bond investors seeking long term fixed returns were even more reluctant to take a chance on shipping. Title XI was originally created to address this problem to ensure that the foreign trade of the United States and the shipbuilding industry would continue to make the United States a force in world trade.

The 1970 Merchant Marine Act expanded various maritime promotional programs to all sectors of the U.S. fleet. Programs were available to defray the cost of operating and constructing U. S. flag ships which were then financed at fixed rates for periods of 20 to 25 years. During this period U.S. yards constructed 4-8 large ocean going ships a year. Title XI was also used for drilling rigs and service boats. As a result, the Title XI program had within its customer base a variety of vessel types and credits. This large base of ship types and customers assured that the Title XI default risk was spread among all sectors of the industry and among

various credit risks. During this period, the program was largely self-sustaining, that is defaults were covered by premiums charged for the guarantee.

As we will see, overarching economic events intervened to make the Title XI program vulnerable to high default rates just as the same events produced large losses in the commercial loan sector. For instance, in early 1980 the price of oil collapsed after a large run up following the Arab oil embargo. Because of the long lead time in ship construction, a number of projects in the drilling rig industry and service boat industry which were approved based on the higher oil price, were delivered after the price collapse and could not find employment at earnings level sufficient to avoid default. These defaults were not the result of inadequate credit judgment at MarAd but rather stemmed from MarAd's agreement with the widely held view of government and industry that demand for oil would steadily increase.

Although this system of promotion for the ship operating and ship building industry worked reasonably well in the decade of the 70's, the Reagan Administration terminated funding for construction differential subsidy in the early 80's with the result that increasingly fewer vessels were built in American shipyards for international trade. Unfortunately, since the use of wood gave way to steel in the construction of ships, U.S. yards have been largely priced out of the international ship building market. The significance of the end of U.S. vessel construction for foreign trade is that the number of vessels that are potential entrants in the Title XI program is far fewer than had previously been the case thereby limiting the ability to spread risks over a larger population of vessels.

With this background in mind, let us now turn attention to the events of the last ten years. The development of China as a major source of imports to the United States and the displacement of nearby suppliers such as Mexico and Latin America created an enormous increase in the ocean transportation required to satisfy America's appetite for imported goods. The computer that might have been assembled in Mexico ten years ago now comes from China or other far flung Asian factories. Similarly, the demand for raw materials and energy in China to supply these products and fuel China's domestic growth means more tankers and ore carriers are needed. Although this period was punctuated by the dot com collapse in 2000 and 9/11 in 2001, growth resumed with a remarkable intensity in the last four to five years.

As a result, the last several years have seen amazing growth and profitability in every sector of international shipping. Be it liner, tanker or dry bulk, every shipowner has experienced a level of profitability seldom seen in the last thirty years. In addition the price of oil is up to \$60 a barrel which stimulates off-shore drilling activity and creates markets for the employment of drilling rigs and service vessels that can only be described as red hot.

During the last quarter of the 20th century, interest rates also displayed remarkable fluctuations. In the 1980's double digit interest rates on Treasury bonds were often found. Treasury bonds sold for 13%. Contrast that with today's 30-year treasury bond which carries a coupon rate of less than 5%. These remarkable fluctuations in interest rates impacted the market for shipping finance.

The growth and profitability in the shipping sector also had a remarkable impact on the financial community. Plenty of money is available today to finance sound new shipping projects

whether it be the issuance of initial public offerings of stock through the New York or Oslo exchange or bank or bond debt for every kind of shipping projects. Just last week a commentator on economic conditions stated that there has been an 18% compound annual growth in the global money supply over the last four years. A not insignificant portion of this money has found its way into the shipping industry. Under the current conditions, the international shipping community can readily obtain money for projects from the commercial markets.

Not only has the money supply increased but the willingness to accept risk has also substantially expanded. Paul Krugman, the economist and New York Times commentator, stated in his column of March 2, 2007 that the risk premium, as reflected in the difference between the interest paid on junk or risky bonds in comparison to safe bonds, has declined from 10% to a little more than 2 percentage points today. That is the interest cost of borrowing money for a risky credit was 10 percentage points more than the high credit quality borrower had to pay in interest in 2000. Thus we see a dramatic increase in the willingness of lenders to make loans to what would have been called risky credits. Indeed shipping can no longer be classified a high risk since good shipping credits can be financed in today's world at small margins over the London Interbank Offered Rate, or Libor, which is the base rate on which loans are quoted. Margins of $\frac{3}{4}$ - 1% over Libor for good credits are achievable.

The importance of this appetite for risk and the resulting lower spread is that the interest rate savings that can be achieved by using Title XI is lower and the cost of using the program comes close to offsetting any benefit achieved. Under these circumstances, borrowers will avoid the cumbersome Title XI program.

One need look no further than Philadelphia to find a fine example of the commercial financial markets rising to the needs of the shipping industry. I refer here to the Aker American Shipyards Project under which ten and perhaps 16 tankers may be built in the Aker Philadelphia Shipyard for charter to Overseas Shipholding Group. A recent news item stated that Aker American Shipping, the owner of the vessels, recently put in place a \$770 million financing for the first 10 vessels in an amount of \$80 million per vessel. These loans were arranged in the international markets through Fortis, an international bank. I understand that the interest rate on this loan is approximately 110 basis points over LIBOR and has been converted into a fixed rate loan at a little over 6% per year. This rate would be quite close to the effective rate of a comparable Title XI financing although the term, that is, the length of the loan is not nearly as attractive as the twenty year term that might have been available under the Title XI program. Just as with a home mortgage a longer term means lower annual payments.

This brings us to a crossroads in the Title XI program. There are at least two views. On the one hand some economists will say that the program has become unnecessary since commercial lenders are now willing to finance creditworthy projects. On the other hand an equally valid but opposite view would hold that guarantee programs are still required to provide a base support for construction of vessels in the United States and should remain in effect since risk premiums may rise once again as they have in the past. Just last week, the declining stock market produced an increase in the risk premium. The difference between high risk loans and high grade credit loans increased from about 210 basis points to about 250 basis points over the

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last week. While not large, this increase is a reminder that risk premiums are not static and can easily revert to the conditions existing earlier in the decade.

There is also reason to believe that the existence of a robust financing market for international shipping may not translate in every case to the financing of U.S. built vessels. It is a sad fact that U.S. built ocean going vessels often cost twice as much as the same ship built in the international markets. While there is a huge international market for vessels of the type that might be built here for Jones Act employment, these ships cannot be readily deployed in international markets at rates necessary to repay the high cost of construction. Thus in the event of the deterioration of the Jones Act market, the ability to realize on the value of the vessels may be more limited than would be the case for a vessel built internationally. A vibrant Title XI Guarantee program would provide a backup to the international finance markets.

The comments that follow address the actions that need to be taken if the Committee's conclusion is to retain and sustain the Title XI program. If the Committee wishes to see the program continued and see it accomplish the objective of providing financial support to shipbuilders that build vessels in United States shipyards, the Committee needs to do more than simply authorize appropriation of the necessary funds to permit MarAd to once again issue Title XI guarantees. While funding is a necessary condition to resuscitation of the program, it is not sufficient.

The Maritime Administration has recently been criticized for its administration of Title XI due to the significant defaults occurring in this decade. In my view, much of this criticism has been unfair. The defaults did not stem from MarAd's credit misjudgments but rather resulted

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from overarching economic conditions such as the downturn in the cruise industry following the 9/11 attacks in early 2000, the collapse of oil prices in the 1980's resulting in extensive defaults through the drilling rig industry, or from the imposition of Congressional mandates to finance specific projects regardless of credit considerations. Unfortunately, these defaults have led to a series of recommendations by the GAO and others that have resulted in the imposition of extraordinary obstacles to the grant of Title XI guarantees. I refer to the use of the Department of Transportation Credit Council to review guarantee commitments proposed to be issued by MarAd. In addition, the authority granted MarAd to seek external advice when necessary in reviewing Title XI applications has become the rule rather than the exception. The result of these and other limitations on the Maritime Administration's exercise of judgment in granting Title XI guarantees has made the process so cumbersome, time consuming and expensive that any shipowner that can obtain financing elsewhere will do so. Witness the Aker transaction.

The result is that the program will become increasingly dedicated to high risk projects that can obtain funding from no other source. This will create a self-defeating premise in which defaults will continue to rise since the pool of projects from which premiums and guarantees are drawn will be the highest risk, most difficult projects. But even the GAO emphasized that spreading the risk among a number of different borrowers is necessary to a viable program. *See* Comments on Concentration of Risk at p. 29 of GAO Report 03-659, June, 2003. The guarantee program worked very well when it had many borrowers and a spectrum of different project types. As in any insurance program, spreading the risk allows the healthy projects to support the less healthy. To the extent that the Title XI application and administration process becomes so

cumbersome that good projects and good credits will go elsewhere, the program becomes increasingly risky. Thus, we have the perverse result that conditions imposed to improve credit judgement have in fact produced the reverse. Failure to broaden the program will only result in this panel reconvening in a few years to revisit the issue of defaults.

In order to achieve this broadening of customer base, it would be my suggestions that this Committee see that the following steps are taken:

1. Eliminate the Department of Transportation Credit Council. This Council is unnecessary and injects a layer of credit review by individuals having no understanding of the shipping industry and little incentive to promote the construction of vessels in United State shipyards. Indeed, they seem primarily focused on avoiding granting of any guarantees. The result is that the expertise that existed in MarAd has been supplanted by a committee with little knowledge and less interest in the program.
2. Return the use of the external consultant to its proper and limited role. The external consultant provisions contained in Section 53708(d) of Title 46 authorize but do not require the use of these consultants in every transactions. It can certainly be conceded that there will be projects in which the external consultant is necessary or advisable. However, the majority of projects coming before MarAd are well within the expertise of the Maritime Administration and indeed its knowledge base is generally greater than that of the outside consultants. Unfortunately the outside consultants have become the rule rather than the exception.

3. Provide MarAd with adequate funding for its administrative functions to rebuild the personnel and the expertise in the agency. Retirements and the lack of activity have taken its toll on the level of expertise at the Maritime Administration. Nevertheless, if the program is to continue there is no better place in which to rebuild the expertise that guided this program for many years.
4. The Committee should continue its oversight of the program at frequent intervals. As we all know legislative mandates to which the administration is not sympathetic are often implemented with less than vigor. Therefore, if the program is to be remodeled so as to be functionally effective the Committee will have to take a continuing interest in the administrative developments at the Maritime Administration.

Finally I cannot close without saying that the shipyards need to bring their construction costs closer to international standards and not use the Jones Act to perpetuate inefficient methods. The United States has struggled with this issue for more than a hundred years and we still do not have a solution to this disparity in costs. A healthy industry must keep striving for a solution.