ICS Examiners Report

Shipping Finance 2011

Overall Comments

The general standard of candidates' papers for this subject was high, with a very satisfactory pass rate. Some candidates exclusively used descriptive material from the ICS textbook, and this was fine. However, some drew from the current shipping market where appropriate, discussing trends and events in specific markets; this was a better approach because it showed a willingness to apply concepts to the practical environment. Some candidates also used diagrams to illustrate their answers even when not specifically requested to do so, for example, with regard to the question on KG finance. This was perfectly acceptable and in several cases gained additional marks. Shipping finance is largely a practical subject, so an ability to 'think outside the box', and to relate materials to practice, always gains additional discretionary marks. That said, a few candidates failed to give the degree of detail required for several of the questions. Shipping finance is a precise subject and accordingly answers which are 'detail-lite' tend to lose marks. At the back of the ICS book there are a number of very useful precedents showing, for example, standard clauses in a mortgage, an assignment of insurances, value maintenance clauses, and so on. Candidates should draw upon these documents, even if briefly, to supplement their answers and in this way get high grades as opposed to simple passes.

Question One

Nearly all candidates who answered this question passed, principally because they were able to identify the distinct stages of the shipping cycle (even though in practice they overlap). Candidates could also have mentioned that the cycle is an example of derived demand. They should also have discussed the principle of 'lag'- that the cycle invariably runs behind what is happening in the wider economy. For additional discretionary marks candidates could have referred to the practical current state of the cycle: what is happening 'in the news'. Reference could also have been made to the fact that Indian and Chinese industrialisation has been one of the most important drivers of the cycle in recent years, when Europe in particular has been fairly stagnant economically-speaking. Candidates were also required to discuss how the cycle, more specifically the downturn, affects the lay-up or scrap decision, and factors which are taken into account by Shipowners.

Question Two

This answer should have been presented as a memorandum presented by the Managing Director to the Chief Finance Officer; this small point was missed by some candidates who simply launched into their answer without complying with the format requested and lost marks as a consequence.

Candidates were required to show an appreciation of the differences between debt and equity financing, linking this in to the terms of the question. Here the company is already heavily debt-burdened; how would this affect the decision on the debt-equity mix in the capital structure? Some candidates said that equity would be preferred because shareholders have no 'right' to a dividend payment, unlike bond holders who must be paid their interest regardless of how the company is performing. But this missed an important point; if equity holders are not happy they may sell, driving down the share price in the process, and of course the value of the company. Furthermore, if the price falls and the shares are in part providing security for loans, then this may result in a default in existing loan covenants, entitling lenders to either call in existing loans or alternatively demand that fresh security be made available by the borrower. So, it is not the case that shareholders can simply be ignored.

As mentioned, the company in this question is holding considerable debt; some candidates simply ignored this fact. In this exam facts are given for a reason and are not superfluous; when answering a question all facts must be considered. Here, since the company is already debt-burdened the chances of bankruptcy become even greater when more debt is taken on. Some candidates gained additional marks by referring to the case studies given in the ICS book of Tidal Marine, Atlas Shipping, and Eastwind Maritime as companies which were in part brought down by excessive levels of debt.

With regard to the funding options mentioned in the terms of the question, unfortunately few candidates proceeded to discuss, even if briefly, how interest rate risk could be reduced or managed via interest rate swaps. A few candidates who had mastered this topic gained additional marks by discussing the role of swaptions, and the premium charged for these.

As a possible form of financing which does not commit to debt or equity, some candidates rightly discussed convertible bonds. A lot of detail was not required, just evidence of an awareness of this form of financing and the possible implications following conversion. For discretionary marks, some candidates also then proceeded to discuss mezzanine finance.

Question Three

This question was well-answered by all candidates. It was entirely descriptive although some reference to case studies, terms from the documentation in the ICS book (appendices), and risk significantly increased the marks for some papers. The importance of referring to terms in standard documentation cannot be stated enough: it is a vital part of applying concepts and techniques to practice. Some candidates also linked the forms of security discussed to various stages of the shipping cycle; this was an excellent example of 'thinking outside the box' and accordingly was awarded additional discretionary marks.

Question Four

This question again was also generally very well answered. It was descriptive but several candidates also proceeded to 'contextualise' the form of loans to Shipowner and lender behaviour at different stages of the cycle. In each case candidates should also have discussed the risk applicable to each form of security discussed.

Question Five

Some candidates provided a very untidy diagram, without properly showing cash flows, or the relationship between each participant in the structure. When drawing a diagram, the general rule is 'take your time'. Better to do this than rush and produce something which is untidy and incorrectly annotated. Interestingly, some candidates overlooked to mention investors and originator in the securitisation structure, and accordingly lost marks for not 'stating the obvious'. As a rule of thumb candidates should always assume that the examiner knows nothing about this subject- don't take knowledge for granted. In this way marks will not be lost for stating the obvious. Candidates with short answers have invariably missed out on the easy 'low-lying fruit' in that they have not started their answers by discussing or describing the fundamentals.

With regard to this question, some candidates gained additional marks by discussing the possibility of changing the nature of the coupon flow to investors by 'bolting on' a swap between the SPV and a third party, located at the head of the diagram in the ICS book. Some candidates also mentioned that cash flows must be homogenous before they can be the subject of a securitisation, but without discussing what this means. Also, covenants in the agreement between the originator and the obligor should legally permit assignment of the cash flow to third parties: candidates should discuss the consequence if assignment takes place in the absence of such advance authorisation.

Some candidates also lost minor marks by omitting to discuss preferred locations for setting up SPV's, for example, the BVI, or Cayman Islands. Issues of the separate legal identity of the SPV, and the reason for this in making the structure 'bankruptcy remote', should also have been addressed.

Question Six

This question was well-answered by candidates, even though some failed to provide a diagram which could pull all the features of KG financing together. Some candidates discussed the historical background to the policy, but also how it can be seen to have distorted the market by going against fundamental economic drivers. Again this showed laterally thinking and was accordingly rewarded.

The tax aspects of KG financing should have been discussed in great detail to obtain full marks for this question. Some candidates had obtained additional information on this aspect and their answers were more detailed as a result. There is plenty of information on the internet regarding this policy, as well as in the ICS textbook; superficial answers were therefore rewarded with low marks, with several failures for this question.

Question Seven

This question was another on the paper which was very well answered, with almost no failures. It was descriptive in nature, but additional marks were gained for mentioning, even if in passing, the various international exchanges in which ship shares can be traded. With regard to the convertible bonds element in the question, a significant amount of detail was required regarding form, and implications for the issuer. Some candidates also mentioned that it is not always the holder who has the right to convert: sometimes the issuer also reserves this right. In each case the impact of the right in terms of cost of borrowing and duration could have been mentioned.

Question Eight

This question was answered by very few candidates, possibly because it contained elements of theory whilst some of the other questions were 'comfortably descriptive'. This answer required a discussion of the role of the Basel Committee, and its recommendations. Basel I, II, and III needed to be mentioned. Candidates were required to discuss in detail the meaning of the capital asset ratio, and its implications for and importance to, shipping companies. The tiers of capital should have been discussed in the context of risk weighting. Although few candidates answered this, the results for those who attempted it tended to be high, particularly for those who also briefly mentioned the Modigliani-Miller irrelevance hypothesis.