Shipping Finance Examination, November 2022: Examiner's Report.

The general standard of answers for this sitting of the Shipping Finance Exam was high, with students demonstrating an ability and willingness to draw across different but interlocking issues connected to specific topics when relevant. This gave a good degree of depth and practical context to answers. Some answers, particularly for question 4, lacked detail, with students providing one or two sentences which gained low or fail marks as a result. Students also showed continued lack of awareness of standard terms and conditions in typical shipping finance products, including guarantees and types of loans. Diagrams for syndication and securitisation were generally good, but with some students losing marks because of a lack of arrows showing direction of cashflows. These are the general observations: there will now follow feedback for each specific question.

Question 1.

This question was about the prerequisites of cashflows for securitisation for a typical shipowner which has multiple earnings. It was well answered, with most students who attempted it achieving good pass marks. Several common errors were made, and these were as follows.

First, the question required a diagram in support. Some of the diagrams provided by candidates were far too small to identify the main components: it is important that when a question such as securitisation or syndication requires a diagram, this should be well presented. Also, and a more significant failing, some students did not indicate the direction of cashflows. Instead, there were just lines between participants. It is vital to show these: for example, the payments from investors to the SPV and then through to the originator, and the payment of cashflows from the originator through the SPV to investors, and of course the issuance of bonds or floating rate notes in this direction. In not putting in the directions with simple arrows, students lost marks.

Second, students did not set out clearly the three criteria of cashflows before they can be securitised. Now this was important because it helped a student identify the suitability or otherwise of cashflows in the scenario given. In this question one of the cashflows, the contract with the Middle Eastern oil producer, could not be securitised because it was already subject to a charge in favour of a previous lender. Securitisation requires a legal right to assign a cashflow to the SPV: in this question, regarding this specific cashflow, this was not possible and yet several students missed the point. In your answer you should start by setting out the criteria and it will help guide the answer when addressing specific facts in a given scenario.

Third, most students said that the financial product which would be issued would be a 'bond', without giving any further detail. Shipping finance is about being concise: here, there should have been mention that typical securitisations result in a floating rate note being issued, the coupon floating over a recognised benchmark such as Libor or an oil index.

Fourth, some students looked at the revenues from the oil storage service and concluded that, as these were volatile (and not stable and predictable), they could not be securitised. This was correct, but that does not mean to say they should be completely disregarded. Some students mentioned that the cashflows, although erratic, could be built up in a ringfenced sinking fund to pay towards principal on maturity of the FRN. This gained additional marks because it demonstrated 'thinking outside the box'. From a practical perspective, this

additional source of reassurance to investors should result, all things being equal, in a slight reduction in the basis point spread on the FRN.

The final point which was missed by some but not all candidates was that the originator was based in west Africa, which raised the issue of piercing the sovereign ceiling. All cashflows should be accumulated in a SPV offshore account administered by a reliable third party such as an international bank. Payments as coupons are first made from revenues to investors, with the balance being remitted to the originator. In this way the spread on the FRN will not be affected by the sovereign ceiling, and will be lower than would otherwise have been the case if the issue was made directly onto the market by an originator from a west African location.

Question 2.

This question was popular with candidates. Most answers were excellent in terms of identifying the correct type of loan in each circumstance, for example a moratorium or back-ended loan. This was well done. Answers then became weaker with the next requirement in the question: identify the typical covenants in each type of loan. This question raises the vital importance of students making sure they are fully familiar with loan documentation and the usual terms. The same applies when answering a question about terms in a typical mortgage, or a corporate guarantee. This exam has frequently asked for standard terms in all three documents: it is vital that students prepare well by familiarising themselves with these. Covenants which are relevant to protecting the lender's position can be provided in the answer: for example, maintenance of minimum levels of liquidity, not to dispose of assets, to keep assets maintained and insured. It's up to the student which he or she chooses. The last part of the question, the discussion of risks associated with each type of loan, was badly answered in most attempts. Risks would include asset depreciation during a cyclical sump, undermining loan collateral, currency exchange risk, borrower default on insurance premiums, and others. It is vital that students pull together all three features- the type of loan, the usual covenants connected with it, and the risks to lenders who provide the facility. This demonstrates all-round thinking by students, and appreciation that the lending decision, particularly regarding type of loan, raises many interconnected issues. Even if a question does not specifically ask for these points, they should be included in an answer anyway.

Question 3.

This was a straightforward question about types of leases, specifically operating and finance. For those students who knew the detail, there were full marks awarded. Again, this question asked for duties of a lessee under a typical ship finance lease: this reinforces the earlier point in this report that students must ensure that they are familiar with the standard documentation, including covenants and duties and rights of both parties. In revising for this exam students should go through typical contracts for these products: standard examples are available through a google search. For completeness of this report, answers could have included the following, although there are many others which could have been selected:

i. Describe the main duties of a lessee under a typical ship finance lease.

Duty to insure

To provide information

To trade only on specific routes

To maintain asset in a good state of repair

To return vessel at the end of the lease in an acceptable pre-stipulated condition.

ii. Describe the main rights of a lessor under a typical ship finance lease.

To take possession upon non-payment by the lessee.

To take back possession of the asset upon expiry of the lease.

To sell the leased asset.

To demand documentation regarding upkeep of the asset, including insurance.

Question 4.

This question asked students to discuss any four topics from a list of seven. This type of question is useful for students who have revised specific topics, but which have not appeared on the paper, and are now looking for a final question which overcomes the shortfall. This was a popular question with nearly all students passing it. However, some achieved low marks because they did not provide the degree of detail required. Some answers were just a sentence long, which could not have passed because they lacked any meaningful detail. When asked to describe a small topic in a multi option question, it is vital that students give depth and detail. This may involve drawing from across the syllabus, and raising fair points which are relevant to the topic in hand. For example, one of the topics in this question was residual value insurance. Students said that this was a way to place a floor below the asset value offered as security for a loan. This was fine as far as it went, but there was no other detail. For example, RVI is expensive insurance and there are very few providers, hence making it unrealistic. Second, who bears the costs of it? This would usually be borne by the borrower. Why is it taken out in the first place? What is its relationship to loan to value covenants? What happens if the borrower defaults in paying premiums? How would the lender know about the default? These issues demonstrate how, what is a simple topic, is given greater meaning ands depth through more contextualised discussion. When answering a '4 out of 7' style question, it is vital that students provide detail, and not simply one or two explanatory lines.

Question 5.

This question was an interesting twist on the usual mortgage question which often appears in this exam paper. It asked for the factors which a lender should consider when decided where to register a mortgage. This is a practical issue which was dealt with well by students who could place the subject in a legal enforcement context. It then asked for six duties of the mortgagor in a typical ship mortgage, reinforcing the earlier point in this report that students must make sure they are familiar with terms and covenants in typical

documentation for subjects studied. Students who had learnt a list of standard duties gained full marks for this question, which was predictable given the importance of ship mortgages to the entire area of collateral and loan security. The final part of the question was not dealt with by students as well as the earlier parts; it asked about the ranking of lenders on an insolvency of a borrower. Again, this is an issue of high practical relevance and importance to those involved in making loans to shipowners. Several students achieved full marks in this highly descriptive question which in effect simply asked for a list. Know your documentation!

Question 6.

This question asked about the components of, and reasons for, syndication. It was surprising how few of the answers managed to give a comprehensive list of factors considered when deciding between banks as to which should be awarded the mandate to lead manage an issue. There are a number of factors which will be reproduced below, to make this report comprehensive. It was surprising how many students did not mention cost as an important factor. In this context it is vital that students who revise syndication know the different types of fees which are payable by an issuer; several answers simply mentioned 'fees', and as a result lost marks because of the lack of detail; it begs the question, how are fees structured?

a) Explain the factors which are considered by a shipowner borrower when deciding between competing financial institutions as to which one of them it will award a mandate to lead-manage a syndicated bond issue.

Answer.

Placement power.

Financial resources.

Complexity of the issue.

Investor base.

Have the parties dealt with each other previously?

Ability to put a management group together.

Reputation in the market.

b) What are the usual costs to a borrower when raising finance through a syndicated bond issue?

Answer.

Margin fee

Facility fee

Arrangement fee

Legal fee

Commitment fee.

Regarding the reasons for raising finance through a syndicate of banks rather than with one alone through a bilateral loan, some students wrote about spreading risk between participants, which was correct, whilst others delved into this in more detail., briefly mentioning that a large loan to one shipowner would raise issues of Basel capital adequacy rules, as well as risk weighting, for a lender's loan portfolio.

Question 7.

This question raised the issue of one ship companies. Students rightly discussed the main reason, this being the avoidance of sister ship arrest, although others followed this through with more detail by considering the albeit rare situations in which a court may be willing to look behind the corporate veil, as seen in the foundation case of Solomon v. A. Solomon and Co. Ltd (1897).

Most students took this one-sided approach: they considered the corporate structure only from the shipowner's perspective, and did not consider how lenders, potential lenders, and investors may react to it. Regarding existing lenders, there will inevitably be a clause in loan documentation that corporate restructuring in this way, to hive off or hide assets in new one ship companies, is expressly prohibited and will be a breach of the loan agreement. Prospective lenders would also baulk at such a structure: they need to be sure that they can arrest several vessels, and not just the one subject to the mortgage, in the event of borrower default. This raises the issue of intra group guarantees, which could be mentioned as a tangential point. Investors also do not like such structures: they open the door to creative accounting, hiding of assets, and generates a sense of opacity when investors require transparency as a prerequisite to good corporate governance. Practical steps which will be insisted upon by a prospective lender is that all assets must be transferred into one company, registered in an acceptable jurisdiction in terms of recognition of mortgagee rights.

Question 8.

This question was straightforward for students who knew their way around the typical terms of a corporate guarantee. It required five standard terms: students who attempted this achieved full marks because of its descriptive nature. It also asked the practical question regarding the difference between primary liability – 'Give the money to ABC Ltd and I will service it', and secondary liability such as a guarantee: 'Give the money to ABC Ltd and only if it defaults in its payments can you call upon me to make up the shortfall'. In legal terms, the first scenario can be oral, in contrast to the second, specifically guarantees, which must be evidenced in writing or they will be unenforceable.

This report reinforces the need for students to provide detail in answers: shipping finance is about being concise, thinking outside the box, and being able to recognise particular products, particularly types of loans, within a wider fabric of factors. It also emphasises the need to know terms and covenants in standard documentation, and to be able to raise these in answers even if not specifically asked for.