Shipping Finance Exam, November 2023: Examiner's Report.

Question 1.

This question was attempted by most candidates, with the majority scoring high marks but a small number achieving very low fails. Answers should have started with a definition of securitisation, and the three qualifying criteria. The high marks were achieved by those students who then applied the criteria to the specific cashflows in the scenario. One of the criteria is that there must be a legal right to assign future cashflows to the special purpose vehicle (SPV); in the scenario the charterparty with the Middle Eastern producer has already been previously charged in respect of a prior loan and as such cannot be assigned to the SPV. Regarding the earnings in the spot market, these are unstable and unpredictable, and accordingly do not satisfy the second criterion. However, some students correctly stated that these could be used to service a sinking fund, to be used to contribute to repaying principal on maturity of the floating rate note which will be issued. This in turn would reduce the basis point spread on the FRN. Regarding the earnings from the diverse sectors, it could be argued that these are not sufficiently homogenous to be securitised.

There should have been some discussion of the role of the SPV, this being to make the transaction bankruptcy remote regarding the issuer, and to protect the issuer against claims by aggrieved investors, whose right of recourse is against the s/PV which issues the SPV.

Diagrams were mainly correct, but some lost marks because they did not put in arrows to show the direction of payments and cashflows.

Securitisation is a popular topic for this paper. Students should focus on the criteria required of cashflows, being able to provide a detailed diagram, knowing how to reduce the basis point (interest) spread on the floating rate note issued, and the role of the SPV (as well as tax aspects, for example withholding tax deducted at source).

Question 2.

This question was less popular with candidates, with less than half attempting it. The question required an ability to understand the components in a shipowner's balance sheet which should be of concern to a potential lender, and how making such a loan will affect the lender's own balance sheet presentation from a risk weighting perspective. Students were required to discuss, amongst other matters:

Asset values and whether entered on market or historical value, the latter being less reliable

Levels of existing debt, and whether fixed or floating

Creditors, and when loans are due

Payments due from other parties (debtors) and whether or not these are at risk of default

Operating expenses and how these compare year on year for the past three years. Rising costs of insurance associated with increasing risks of accidents

Cost of repairs and maintenance, and whether these have been escalating in recent years (indicating a deteriorating fleet)

Remuneration paid to board members, and whether these have been diverging from the company's recent performance (the board plundering the company prior to its demise)

Cost reduction strategies:

Sale of underperforming assets

Sale and leaseback of assets to raise cash

Hedging of fuel costs

Reduction in number of employees

Use of a management company (outsourcing).

The second part of the question focused on regulatory issues, or the reporting by the lender of the riskiness added to its balance sheet from lending to a shipping company. The bank will focus on the capital adequacy rules as stipulated by the Basel Committee. This requires that a relationship be maintained between capital and risk. The greater the risk, the greater the capital which must be held against it- the seesaw effect. Shipping companies have volatility for banks in terms of asset values and earnings. Given how the cyclical nature of both will affect risk, the bank must keep the balance under constant revue, the purpose being to hold enough capital, whether in cash or equity, to withstand an insolvency of a borrower across the cycle. Students scored higher marks by briefly discussing case studies where banks have got this balance wrong, for example BCCI.

This question required a 'shallow' approach: it was enough to achieve a high mark if students identified balance sheet elements from both borrower's and lender's perspective, effectively listing these rather than going into too much detail on just a few issues. Some students listed two or three balance sheet considerations and discussed these in detail; this was good as far as it went, but omitted a wide range of other issues and accordingly could never achieve more than a pass mark or less.

It is recommended that students know their way around a shipowner's balance sheet, since this is as issue which can be addressed, even if tangentially, in the context of many other topics covered in the syllabus, gaining additional discretionary marks for raising pertinent issues.

Question 3.

This was a typical banker's security question and was answered by most candidates, with only a few achieving a fail but most a high grade, several nearly full marks. To list the forms of security which needed to be discussed:

Assignment of earnings

-Assignment of insurances

-Mortgages

-Legal assignment of shares (to be contrasted with equitable assignment)

-Guarantee from parent company.

Some students lost marks because they did not discuss the applicable procedure for taking each security. For example, an assignment of insurances requires the benefit of the policy to be transferred to the lender, and the insurer notified. If there is a lapse in payment of premiums, the lender will require the insurer to notify it of this fact, which in turn will be a breach of a loan covenant.

Several students failed to discuss the risks associated with each type. For example, a mortgage over a vessel may be weakened during a cyclical downturn when asset values decline. To protect against this risk, there would be inclusion of a loan to value clause. Similarly, regarding guarantees: if the parent company which provides this can provide further future guarantees to other lenders, or to dispose of assets such that resources to meet obligations are undermined, then the guarantee will be weakened. Guarantee covenants should be included to prevent this; ultimately there is no point in taking a guarantee from a 'straw man', or a parent company which does not have adequate levels of capital or liquidity to meet any future call on its commitment.

Question 4.

This question required discussion of principles underpinning Islamic finance, and reference to specific instruments which reflect these. The question was the least popular amongst candidates, with significantly less than half attempting it.

Regarding the main principles, these are as follows:

Prohibition against the payment or receipt of interest

Prohibited industries (gambling, alcohol, pork products)

Speculation not allowed

Title must be vested before an asset can be sold

Capital must be used for socially productive purposes

Instruments:

Ijara leasing

Musharaka

Mudharaba

Sukuk

For the advantages to borrowers from raising finance from an Islamic finance house, these would include the following:

The lender cannot take security over the borrower's assets;

The arrangement is more akin to a joint venture in which risk is shared, compared to a Western model in which risk rests with the borrower, and it has no vested interest in the borrower's success since it will not share in the profits.

The second part of the question placed the previous discussion in a practical context by looking at impediments to the development of Islamic finance in a shipping context. The issues to be discussed included the following. Arbitration will probably not be available in the event of a

dispute between borrower and lender. Which law applies? Shariah or for example the law of New York relating ton contracts and their enforcement?

Arrest of a defaulting borrower's vessel may not be available or may be disputed between an Islamic and non-Islamic financial institution because this would represent taking and enforcing security, which is prohibited under the former.

How will the loan contract be drawn up? What will be the standard terms? For example, interest is prohibited under Shariah. Security is not allowed. Issues of default and the consequences for the borrower will be very different.

Islamic financing arrangements are gaining significant appeal in the shipping sector, particularly for companies located or registered in predominantly Muslim countries. For this reason, it is suggested that those involved in shipping finance should obtain some knowledge, even if rudimentary, of the principles and instruments, not just for the purpose of this exam but also for future career development.

Question 5.

This question was attempted by every candidate, such was its popularity. It was highly descriptive in its requirements, with limited application of the discussion to a scenario, as has previously been the case in this paper. For this reason, there were a significant number of candidates who gained full marks, with only one candidate failing.

Regarding vessel analysis, the following factors could have been considered:

Type of vessels to be bought, and existing and anticipated market conditions

History of the vessels

Age

Valuation

Insurance

Employment

Condition: new or old, and the risk of being off hire for maintenance

Speed consumption and emissions, including ability to comply with environmental regulations

Class and registry: enforcement of loans, and jurisdiction issues

Regarding part c), evaluating a prospective borrower, the following factors could have been listed:

Type of borrower (for example, partnership or company, corporate structure, for example one-ship companies,

Track record

Experience, including years of trading

Opaqueness of ownership

Existing level of indebtedness, and record regarding its servicing

Jurisdiction in which it is located, raising for example enforcement of mortgagees' rights.

This form of question in which students are required to identify or list factors has become popular with the examiner in recent years. The risk for candidates is that they are only able to list a few considerations, and not a 'broad sweep', and accordingly cannot gain a high score, however pertinent the factors which they identify. If a question asks candidates to identify or list factors, it is not necessary to give a detailed explanation since this is not required and will not gain marks. However, if the question does not appear in this format, then the default position must always be to provide plenty of detail and explanation and to assume that the marker does not know the topic and in this way not lose the easy marks.

Question 6.

This question was quite popular, with about half of candidates attempting it. Of thee, three achieved a fail mark. Several students failed to notice that, as the company was listing on the NYSE, they should at least briefly mention the Sarbanes Oxley Act, and some of the main sections as applicable to senior officers in a company. Some of the risks to be discussed included the following:

Weak corporate governance: the shares are owned by a family, and the board does not have non-executive directors.

War risk, given the present conflict in the region.

High cost of insurance given the present situation, and dangers in the waters in which the company trades its vessels.

Instability of earnings on the spot market

High levels of existing debt.

A bond issue about to mature: where will the funding come from to meet principal repayment obligation?

Fleet is old: risk of breakdowns and increasing costs of repairs.

Risk of vessels falling out of class.

Opportunities would include the potentially high profits to be gained by trading vessels in troubled regions. There have been recent acquisitions of newbuilds, presenting a possibility of asset plays if prices increase in the near future.

Question 7.

This was a popular question with nearly all candidates attempting it. Marks were good, with several over 90%. One ship company structures are typical in shipping ownership and accordingly students should ensure that they understand the drivers, and risks to lenders when making loans to any of the constituent companies or the parent owner. The main reason for owners is that one ship companies shield assets held throughout the fleet from the risk of arrest should one of them, for example, be arrested for nonpayment or for a pollution incident. The structure also hides true beneficial ownership, which is relevant when rogue or sanctioned states are the true owners. Lenders are reluctant to lend to such structures because they are usually

based in different jurisdictions, again to hide beneficial ownership, and lenders' rights may not be as protected in these diverse places. Lenders will usually require all vessels to be re-registered in one jurisdiction which is acceptable to them in terms of ease of enforcement of rights. Shareholders are reluctant to invest in such structures because they are opaque and can also manipulate reported earnings across companies through creative accounting techniques, which students should be able to explain albeit briefly.

Question 8.

This question was not popular, with less than half of candidates answering it. But of those who did attempt it and who knew their way around a syndicated loan structure and diagram, the general results were excellent. Some students were unable to answer the part of threw question relating to ratings agencies; these are vitally important to lenders in terms of the information they provide, and it is recommended that future students ensure they know how they work, particularly regarding the risks and rewards, and level of indebtedness and leverage, of shipowners.