Examiner's Report
April 2016
Shipping Finance

General comment

Students need to read questions carefully: it is easy to miss the point entirely, or to bring in irrelevant points which have not been asked for.

Students must know procedural aspects of shipping finance, for example documentation, registration, formalities. Students must always specify types of risks faced by lenders when making particular types of loan available, and mention how these are eventually factored into the cost for a facility in terms of interest rate and facility fee.

Students must be aware of what is happening in the wider marketplace when discussing specific aspects of shipping finance. For example, if an owner takes additional equity in his or her company, this tends to communicate optimism to the wider marketplace. Remember, if the price of the share falls then there may be knock-on effects, for example in terms of breaches of existing loan covenants which will require the borrower to make fresh collateral available to existing lenders.

Students are encouraged to read around topics and keep up to date with developments in the market via trade and specialist media and resources.

Question 1

Gerda Shipping is a general shipping company which owns several bulk cargo carriers. The owner, Mr. Delius, intends expanding the business but since it is already highly indebted, wants to raise finance through equity instead. Within the next year he anticipates that he will be awarded a lucrative charter party by a commodities company in Brazil, and this will significantly increase the overall profitability of the business. The market also anticipates rising freight rates after a further period of retrenchment and market pessimism. Mr Delius has considerable private wealth which he is willing to invest in the business to help it expand, at least in the short term following which he will want repayment. He asks you, as Chief Finance Officer, to prepare a briefing report setting out the equity financing options which may be available to him personally, and also to the company. In your report you may wish to discuss, but without being restricted to, the issues of owner equity, private equity, rules governing public equity, and the types of shares which could be issued, bearing in mind the future prospects for both the company and the wider market in which it operates.

This was generally a very well answered question, with only a small minority of studens obtaining fail marks. The highest mark awarded was 19, with a number of students achieving 17. In a question of this nature it is important to state the principles which apply, but then discuss them in the context of the facts of the question. Some students made the error of identifying the relevant issues, for example the broad issue of potential dilution of shareholder control when outside investors are brought in, and providing a general discussion of types of equity, but did not then apply these to the specific facts of the question set. Students were also required to recognise that, when an owner increases his or her equity holding in the business, this usually provides a positive signal to the markets regarding the owner's confidence in anticipated future performance. It is for this reason that banks like to see owners taking greater stakes in their business: it extends the risk of loss of their own personal fortune, encouraging them to 'work harder' for the success of the business, but also gives an indication of optimism (although of course an owner may increase a shareholding precisely to convey an impression to external stakeholders which is opposite to known reality!).

Students were also required to discuss the possibility of raising public equity. A number of students correctly discussed, even if in brief, the listing rules of the major exchanges, the potential high costs of listing, and, very briefly, the Sarbanes-Oxley Act.

For a small discretionary mark, students could mention that, in the event of a falling share price (and declining value of the business as a consequence), loan covenants with existing lenders may be triggered, the usual one being that, following a fall in share price below a certain margin, the owners may be required to provide fresh security or collateral in respect of existing loans.

Overall, this question was answered well, with marks being lost at the margin because of a lack of smaller detail in places.

Question 2

Answer BOTH parts of the question.

a) Discuss the main differences between junior debt and mezzanine debt.

b) Explain the various types of loans available at the different phases of the shipping cycle.

This was a very popular question, with nearly all students attempting it passing with high marks. There was evidence in some answers that students had 'read around' the subject, obtaining additional detail and case studies from a basic internet search. This is an excellent way to prepare for this exam: a basic search for the major topics, such as syndicated loans, securitisation, and here mezzanine finance, will ensure that a student will have additional detail to achieve the higher discretionary marks.

On a specific point, students must know, in the context of types of debt, how these rank in the event of the borrowing company becoming bankrupt. Several answers failed to discuss this issue of ranking, or the position of unsubordinated debt holders in the event of insolvency.

With regard to the second part of the question concerning the cycle, nearly all students correctly discussed, in depth, the different phases and the broad characteristics or distinguishing factors of each. However, several students failed to relate loan structures to phases; for example, if profits are non-existent or low, then a moratorium loan, or back-ended loan, would be preferable. But in this context students should have discussed the fact that, if the lender agrees to this, they are taking a greater risk since the asset securing the loan may fall further in value in the S&P market, making loss even greater if liquidation eventually proves to be unavoidable. For this reason it would be expected that the cost of the facility, and the overall interest charge, would be higher than is the case with a plain vanilla. When discussing types of loan, reference should always be made to the risk presented to the lender, and the cost or premium which will be demanded of the borrower to reflect this additional risk.

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Question 3

Answer ALL parts of the question.

a) Discuss the characteristics of a legal mortgage and an equitable mortgage, and the relevance of Admiralty jurisdiction in each context;

b) List and describe the purposes of the main covenants in a typical ship mortgage;

c) Discuss the main differences between an action in personam and an action in rem in terms of right of arrest of a vessel in respect of a loan on which there has been a default.

This was an unpopular question, with very few students attempting it. It was very precise in its requirements; with regard to structure of a mortgage and typical covenants. Students who already work in ship finance and have had experience with mortgage documentation would have found this a straightforward question but in any event, students should be familiar with the standard terms and conditions of documentation in ship finance even if they do not work in the area. This practical knowledge was reflected in the high scores of those students who did attempt the question, including a maximum score. The importance of jurisdiction in terms of court applications, and enforcement of orders, should have been discussed in detail.

Question 4

Answer BOTH parts of the question. You are a loan officer with a London-based bank. You have recently received a loan application from a Russia-registered company which owns several ageing oil carriers which were built in the mid 1990's. The shareholders are based in several European countries. The company has the prospect of buying further similar vessels which it hopes to trade in European Union waters. It wants to secure the loan through a series of mortgages on its existing vessels.

a) Discuss the issues which you will consider when making a formal customer analysis.

b) Discuss the company's intention to trade its vessels in EU waters, and the possible obstacle to this plan.

The first part of the answer should have discussed the significance of the type of borrower and its risk characteristics, its track record, and experience. The issue of opacity of ownership was highly relevant: lenders are cautious when lending to companies comprising many one ship company subsidiaries which are located in jurisdictions where enforcement of loan covenants, or vessel arrest, may be difficult. A very important exam technique point arose in this question: when asked to make a customer analysis, the question is not asking for a discussion about the type of vessel to be purchased. Several students discussed issues relating to vessels, and gained no marks since this was outside the specific terms of the question set. This reinforces the age-old requirement to read the wording of the question set: beware of rewriting a question so that it meets the issues you have revised, because this will gain very few marks.

With regard to the second part of the question, students needed to take note of one of the fundamental facts, that the shipowner had ageing oil carriers but intended trading these in European Union waters. This would not be possible if they failed to meet the onerous anti-pollution regulations which apply in this geographical context, and which some students set out in detail (and were awarded maximum marks for providing this sort of depth of analysis).

Question 5

Describe the main forms of security, other than a mortgage, which may be taken by a bank from both a company and its owners in their personal capacities, in respect of a ship loan. In the case of each, discuss the risks to lenders, and the continuing obligations, if any, on the borrower.

This was a straightforward descriptive question which simply required candidates to list the alternative forms of security, such as pledges of shares, assignment of earnings and insurances, guarantees provided by a parent in respect of a subsidiary. Marks were lost by some candidates because of a lack of discussion of procedural issues. For example, with regard to guarantees the Statute of Frauds 1677, section 4, should have been mentioned, even if simply in brief. With regard to assignment of earnings, a basic mention of the structuring of accounts through which earnings will be received and paid out should have been described. With regard to assignment of insurances, some mention of notification to the insurance provider should have been made, as well as, briefly, the risks to the taker of this form of security (that premiums may be discontinued, or that the policy was taken without disclosure of all material facts). With regard to share pledges, then the obvious risk is that this form of security may fall in value, but a covenant obligating the further provision of fresh collateral in such circumstance should protect the lender, assuming of course that the borrower is able to provide this. Loan security and discussion of basic risks and procedural aspects all go hand in hand, and should be integrated within a detailed, comprehensive answer. Omission of one of these elements will result in a lower mark being awarded.

Question 6

Explain ALL of the following forms of leasing.

a) Tax leasing

b) Shipping funds/leasing companies

c) Islamic leasing

This question was answered either very well, with some students gaining maximum marks, or very badly, with fail marks, including a few at zero. It required very detailed answers, and not generalised statements. For example, tax leasing required not just a general discussion of taxation as a driver of behaviour, but greater detail regarding qualifying criteria and how tax advantages were actually made available. To answer Islamic leasing required discussion of the Islamic principles which drive this form of financing (for example, the prohibition against riba, speculation, and sale of assets which are not first owned before the transfer).

Question 7

Discuss the factors which you will take into account when making a loan analysis for a vessel.

In order to gain marks, students needed to focus on the question which specifically asked for factors to be taken into account when making a loan analysis for a vessel- it did not ask for any discussion about the qualities or characteristics of the borrower. Answers should have been tightly restricted to discussion of the vessel. Issues such as age, valuation, employment, compliance with environmental regulations, speed consumption, any history of collisions, should have been discussed, amongst other issues.

Question 8

Discuss the purpose and main provisions of ALL of the following clauses in a typical ship loan agreement.

a) ship covenants

b) events of default

c) security cover

d) illegality

This question required students to set out the general provisions of each clause, although it did not require detailed drafting of such clauses. In other words, it was looking for an understanding of purpose, rather than simple descriptions. The typical events of default should have been listed, and a couple of sentences given in respect of each.

students who ran out of time and simply provided a list of bullet points gained marks, but lost marks because of a lack of explanation, however cursory. If a students finds that he or she is running out of time in this exam, it is fair to provide lists of bullet points rather than answering one part of the question in great detail but not providing anything in respect of the remaining parts of the question. For example, if there are four parts and a candidate only answers one part but in great detail, the maximum mark which can be awarded for the answer is 25% since the remainder of the question has not been addressed. But unless the question specifically asks for bullet points, this really has to be the last resort and only done when time is near running out.