EXAMINER'S REPORT
NOVEMBER 2017

SHIPPING FINANCE

General Comments

As always, a common problem, or at least one which led to some candidates achieving less than they were capable of, was a failure in some answers to provide the level of detail required. Some candidates assumed that the Examiner would know all aspects of a particular topic, and for this reason it was not necessary to provide depth in an answer. For example, several candidates provided excellent answers in question 6 regarding types of shares (which will be addressed later in this report), but then failed to relate each type discussed to the state of the shipping cycle, as was specifically required in the question. The same happened in some answers to question 4; several candidates gave just one or two powers of mortgagees and discussed these in excellent detail, but because they didn't itemise and briefly discuss a raft of other powers, the maximum they could achieve, however good the points they raised, was at best just under a half of the marks available. This flawed approach flags up an important point for this exam and all others: read the wording of the question carefully, answer the specific requirements, and do not rephrase the question in a way in which you would have preferred it to have been presented!

Several students also showed evidence of having focused on some key topics from the course, and then reading around them, gathering additional information or case studies from the internet. This is an excellent approach; it means that your answers will be more detailed and, in many cases for this cohort of candidates, resulted in many achieving full marks for the questions which they answered. On the point of case studies, some candidates used their own experience with their own company or employment to illustrate points being discussed. As a general rule this should be avoided; it rarely adds any extra detail or information relevant to the question, and tends to be highly generalised and non-specific, using up valuable exam time and not getting any extra marks for the effort.

Q1. Explain how any FOUR of the following affect shipping finance i. Shipping as derived demand ii. The implications of the lag between the shipping cycle and the wider economic cycle iii. The implications of over- leveraging for a shipping company iv. Residual value insurance v. The consequences of negative equity in asset values for lenders to shipping companies vi. Loan to value maintenance clauses

This was a very popular question, asking candidates to explain four out of six possible topics, including lagged demand and loan to value maintenance clauses. The marks achieved were for the most part good. However, several students gained just below a pass mark for this question, not because they did not know a particular topic, but because they did not give the degree of detail required. For example, when asked about 'derived demand', several candidates did not realise that this was asking principally about the economics of shipping as they relate to finance. The answer should have linked the demand for shipping, and the impact on the value of tonnage (which itself is the foremost consideration, as available collateral, for lenders) to what is happening in the wider economic cycle. What is happening to freight rates as world economic activity is falling? The demand for shipping does not exist in isolation; as one candidate put it so succinctly, as a general rule if nobody wants to move goods from A to B, they will not require shipping to transport them from A to B. This in turn drives owners into more frenetic activity in the spot market, trying to get business which will at least cover OPEX.

With regard to the topic of over-leveraging, candidates answered this well but few went on to discuss, if this means a high level of debt in the capital structure, what is the nature of the interest being paid on that debt? If LIBOR-related, as it usually is, then rising interest rates will make it increasingly difficult to cover both OPEX and service the debt at the same time. In other words, the risk or likelihood of default will increase with the rising interest rate. However, if the rate on the debt is fixed, then the owner will know, subject to the rate being held at a certain rate for the tenor of the loan, that it should be possible to continue meeting interest payments, ceteris paribus, in the freight market. Floating rates, therefore, present owners with a degree of uncertainty which becomes more serious as interest rates rise and freight rates decline, as is characteristic of a wider economic recession.

With regard to residual value insurance, this was answered well in general terms by candidates. However, many failed to discuss the importance of the floor in terms of the collateral. Also, there should have been a brief discussion of the issue of the premium payable for this facility. In an uncertain market in which asset values are expected to decline in the short to medium term, the cost of the premium may become prohibitive since providers of the insurance are not willing to take on such risk. In a bad market in which values are plummeting, the insurance may be simply unavailable. This was a practicality which several candidates failed to discuss, and lost marginal marks as a result.

With regard to negative equity, some candidates discussed this in the context of equity, or types of shares. This was simply incorrect and gained no marks. Candidates were required to discuss the situation in which a ship's value is less than the amount outstanding on the loan, and how this affects lender behaviour. Some students took their answers forward by saying that in such a situation the lender would be unlikely to call in the loan since it would then have an asset of less value on its hands and banks are not, as has been proved many times over, shipowners with the required degree of knowledge to run the vessel themselves until the market recovers. Some students said that in such a situation it would be possible that the borrower would negotiate a moratorium loan; this was an excellent illustration of drawing upon other parts of the course to make an answer more complete, and in this way gained incremental, discretionary marks for bringing in extra detail which was relevant to the question.

Loan to value maintenance clauses. This was well answered in that students discussed the purpose of such a clause: to ensure that the collateral underpinning a loan should be kept at a certain level or proportion of the amount outstanding on the loan. However, some students lost marks because they did not briefly indicate what would happen if the clause was broken and the underlying loan security fell below the stipulated limit. Initially the borrower could provide additional security in the form of, for example, a mortgage over other vessels, assuming that they were not already acting as security for another loan in which case the mortgage on that other vessel would prohibit its offer as fresh security. As an alternative, the borrower may provide a charge over personal assets. If all fails and the borrower is not able to bring the security up to the required level, then the lender will have the option of calling in the loan early, to ensure that the situation does not further deteriorate. This may be unacceptable in practice if the lender will 'take a hit' on the loan, or may end up holding the vessel and having to trade it itself. The practical solution would probably be to allow the borrower to continue trading the vessel, but 'keeping an eye' on its value to ensure that it does not decline any further.

Q2. Banks should never make loans by reference only to the value of the ship purchase being

financed, the personal qualities of persons behind a corporate borrower are of equal importance. Giving your reasons, discuss whether you agree or disagree with this statement.

There should have been a brief discussion of the value of the ship because this is the main form of security. Age, condition, type, fuel consumption, would be issues which should have been briefly mentioned. But this said, the question was more about the importance of character, skills, and experience, of the owner and his or her team. This raised the issue of lending to the name rather than exclusively to the asset, and was certainly the basis of lending to many of the 'shipping magnates' of the 1960s and 1970s. The reality is that however strong the security, and however stable any charterparty offered in support of a loan, borrowers who are dishonest or who put their own interests before those of their lenders and shareholders, will invariably find a way around their contractual obligations. Hence the importance of looking at the borrower's track record and reputation in the industry. Importantly, character does not vary according to the phases of the cycle; a lender will expect a borrower to behave honesty and make ongoing disclosure of material facts, whether in a boom or recession. Some would say that character is tested in a very bad market when there is a temptation to wriggle out of obligations, possibly by putting a company into forced insolvency and hiding behind the corporate veil to make sure that one's own personal assets are not put at risk or seized by lenders. This behaviour may succeed in the very short run, but damage to reputation will probably ensure that the borrower will not be able to return to the banks who were deceived last time around. Fool me once, shame on you: fool me twice, shame on me.

Q3. Answer BOTH parts of the question. a) Discuss the reasons for using syndicated loans in shipping finance (in terms of advantages over a loan from a single financial institution). b) Identify the main parties to a syndicated ship finance loan, and the functions of each (Use a diagram to support your answer).

This was not a popular question with students, possibly because it was based on a topic you either knew or didn't know: there was no opportunity for generalised statements or raising points and hoping that they would be sufficiently tangentially relevant to gain some marks. For those who answered this question, the quality of the diagrams given in illustration of a syndicated loan was generally of a high standard. Students had to identify all parties, with underwriters and their role being the main omission from several diagrams. The role of the trustee was also not adequately discussed in several answers. Some students discussed syndication as a way of dispersing risk between a number of financial institutions, when a single bank would either be unable or unwilling to take such a risk entirely on its own shoulders in the form of a plain vanilla loan. This was briefly linked in to the Basel capital adequacy ratio, with students stating that one large loan to one volatile sector would have significant implications for this ratio. This analysis was excellent; it looked not only at the driver of syndication- to disperse risk- but also, even if briefly, at balance sheet considerations in the form of this ratio. This sort of 'thinking outside the box' gains considerable discretionary marks; shipping finance is about looking at an issue both on its own but also in relation to a range of other relevant facts upon which it may have an effect. Some students also correctly identified that syndication results in the creation of tradable instruments – bonds - which can be placed on a recognised exchange; this is in contrast to a plain vanilla loan which does not result in such a fungible asset.

Q4. Answer BOTH parts of the question. a) Identify and discuss the powers of a mortgagee in a typical ship mortgage. b) Discuss the main issues addressed in the Applicable Law and Jurisdiction clause of a typical ship mortgage.

Part (a) of this question was about mortgages, and was a subject which a student either knew or

didn't know: there was no room for guessing. It was apparent that several students were able to draw upon their practical knowledge of ship mortgages, possibly because they worked with them, and this was evident from the good scores achieved. This question required a large number of small points to be raised, almost in bullet form, rather than simply taking a few powers and discussing them in great depth. Students should ask themselves: is this a question which requires a wide but shallow set of points to be raised, or instead a few points to be discussed in great detail? Contents of documents such as mortgages, guarantees, loans, are clearly in the former category, hence the low marks scored by some students who just gave a few points, albeit well discussed ones. This difference is very important, and reinforces the importance of always reading a question carefully.
Part (b) required a discussion of the relevance of jurisdiction to enforcement of a mortgage. This in turn required consideration of actions against the vessel and briefly, a distinction between actions in rem and in personam. Some students gained an additional discretionary mark for discussing procedural issues, including service of process.

Q5. Discuss how the characteristics of a vessel, in terms of the seasonal, geographical, and commodity markets in which it trades, affects both the lender's decision as to whether or not to provide finance for its purchase, and the ability of the borrower to meet interest servicing and principal repayment obligations.

This was a 'think outside the box' question, where students could raise a large number of issues in the context of weather patterns, harvesting times, and charterers' behaviour at each stage of the cycle. Some students discussed the demand for oil transportation, looking at it as a demand derived from wider global economic activity. Some discussed how harvests can lead to spikes in the spot market, whereas crop failures can have the opposite effect. Students were free to focus on a commodity trade of their choosing. With regard to geography, students looked at how certain routes are closed by ice at different times of the year, and the implications of this in terms of fuel consumption of being forced to take alternative routes. Avoiding a particular route, for example because of Somali piracy or earlier, the Iran-Iraq war beginning in 1979, can significantly affect transit times and costs, and also feed through into insurance premiums if a route nearby to a regional conflagration is taken. This type of question is not unusual in the shipping finance exam paper; there is no right or wrong answer, and students who give well-informed, practical case studies, and are willing to link together or draw upon issues covered in the rest of the syllabus, will gain high scores, as was the case here where a number of students achieved a mark of over 80%. For students who have focused their revision on a few topics, and these have not come up, they should not be perturbed or put off from 'having a go' at such a question, rather than attempting another which may require a detailed knowledge of a very specific area of finance which they do not possess.

Q6. Describe the different types of equity (shares) a shipping company may offer to investors, and the suitability of each to the different phases of the shipping cycle.

Provided a student had learnt, verbatim, the types of shares and the times in the shipping cycle when they are suitable, they were able to simply write out everything they knew without having to apply it to a practical situation and gain high marks. As such, this was a straightforward question, hence its appeal. Some students missed the point that during a downturn, investors may be cautious; rather than asking them to put up the full value of the shares purchased, partly paid would be an alternative, although the risk would be that if the company subsequently failed, the shareholders would be required by the liquidator to meet the final instalments on their purchases, thereby contributing funds to a company which has failed. But the counterbalancing benefit is that shareholders are entitled to the full dividend, if one is declared, rather than one which is in proportion to the amount which they have paid. They also have full voting rights. Overall, a very well answered question.

Q7. Answer BOTH parts of the question. a) Describe the characteristics of convertible bonds, and the most appropriate time in the shipping cycle when they should be issued. b) Discuss the features of a sinking fund, and how, if at all, it provides reassurance to holders of bonds issued by a shipping company.

Part (a) of the question is an example of a very specific, narrow topic being examined, convertible bonds, and students either knew it very well or barely enough. It was not a topic which could be guessed at. Students were required to discuss how the equity element in a convertible varies with the position of the cycle. For example, if there is an anticipated upturn in freight rates and earnings, and with it share prices, then holding a convertible may be advisable because there is an opportunity to switch into equity and participate in the upswing. However, if the market stays depressed, then the holder will have the certainty of receiving the coupon or interest, regardless of how the issuer's business is performing. Some students correctly discussed the benefits of convertibles from the borrower's perspective, including the lower interest payable because of the embedded equity sweetener element. Also, convertibles can have longer lives than alternative plain vanilla bonds. For extra marks, students could have discussed 'busted convertibles' in which the conversion share price level is never reached, perhaps because the market stays in a protracted recession.
Part (b) regarding sinking funds was something a student either knew or did not know- there was no room for guessing. Students should have discussed how it is financed, that it is ring-fenced, and that it gives reassurance to lenders that there will be enough or nearly enough cash to meet repayment of principal on maturity; this will be particularly important if asset values have declined over this period

Q8. Answer BOTH parts of the question. a) Discuss the main components which make up the pricing of a ship loan. b) Describe the main practical options which may be available to a lender in the event of loan default by a shipping company borrower. How might these options be affected by the phase of the shipping cycle in which the default occurs?

Students were able to get full marks by giving loan components, including loan margin, legal fees, survey costs, and fees relating to mortgages. These should all have been briefly described; a list of bullets would still have passed but would not have gained the maximum mark because of a failure to discuss each item. With regard to part (b), it was surprising how many students did not mention that one of the options available to a lender when the borrower has defaulted is to do nothing at all! This may be appropriate for example if the market is depressed and a good price will not be attainable upon disposal of the vessel. Students should also have briefly discussed the lay-up versus trade decision, and the factors which are taken into account when making it. Some students correctly discussed the possibility of renegotiating the terms of the loan, or asking for a 'breather' or a moratorium loan. Banks do not like holding distressed assets from a borrower in default because of the Basel capital adequacy knock-on effects. Again, this minor detail, which does not need to be discussed in depth, shows a wider awareness on the part of students, and nearly always gains additional marks. It also illustrates how some topics need to be discussed 'in the round' or in the wider context as relevant to borrowers and lenders.