EXAMINER'S REPORT

MAY 2018

SHIPPING FINANCE

General Comments

The exam pass rate for May 2018 was an impressive 88.89%.

I. This exam is about detail. For example, procedural issues should be addressed as a matter of course in the context of subjects such as bankers' security particularly mortgages. For example, a sentence regarding registration steps, such as compliance with the written requirements of section 4 of the Statute of Frauds 1677 regarding guarantees, will gain marks. What are the re-registration and issuance of new share certificates when shares are given as a form of security? What is the legal status of the special purpose vehicle in the context of a securitisation? Why is it included- why doesn't the originator simply make a bond issue directly to investors? If you are the Chief Finance Officer preparing a briefing report for the board, these procedural issues are very important; they are also a sure fire way of gaining additional marks in the exam.

II. If the shipping cycle is being discussed, and it arises in the context of several topics in the syllabus, then students should consider the economics of the phases, and what drives the cycle. Here there should be mention, even if tangentially, of the principle of derived demand, and the lag between the cycle and the wider economic cycle. In this latter context, what are the implications of this misalignment? For example, just as the market is beginning to cool and move from peak into downturn or recession, we still have new tonnage being delivered, exacerbating pressure on freight rates.

III. When discussing issues as diverse as convertible bonds, types of loans, there are always marks available for identifying the risks to each party. For example, a moratorium loan puts the lender at risk that vessel values will decline during the period of suspension of interest and/or principal repayments, so that when postponed liquidation of the borrower arrives, the value recouped from the forced sale of assets will be even less than would have been the case if this step had not been taken at the 'first sign of trouble-'- when the borrower initially defaulted.

IV. When discussing bank behaviour, reference to Basel capital adequacy considerations, such as risk weighting, can gain further marks. Lenders do not have carte blanche to do whatever they like and to take on any types of risk; they are subject to tight weighting requirements which may tie up capital against excess risk that they would otherwise prefer not to do.

Now, for comments on individual questions.

Q1. It has been said that the best time to set up a shipping company is not when the market is doing well and rates are at a peak, but instead during a trough, when everything looks bleak and the world economy is 'in a dreadful mess'. To what extent do you agree or disagree with his opinion? In your answer you may wish to discuss, but without being restricted to, the behavior of asset values, levels of scrapping and lay-ups, freight rates and anticipated future trends, and the attitudes of lenders and investors (cautious or optimistic or over-optimistic, depending on the phase of the cycle).

This was a general question and there was no right or wrong answer. It all depended upon how a candidate decided to approach the issue. So, some candidates would suggest that in a depression (the characteristics of which should have been defined in the answer, in addition to how freight and asset values are performing), greater debt should be taken on if this is possible. The assumption underlying this is that as the market improves, asset values will increase, and it will be more possible to pay off principal early from the disposal of assets. During a recession, there are often under-priced assets available as banks seize vessels and put them to auction to recoup at least some of the amount still outstanding. This is the best time to buy, and accordingly additional debt, perhaps for example a hunter's loan or moratorium, gives the stronger companies the ability to purchase at undervalues. However, some candidates would argue the reverse; taking on additional debt, when earnings are perhaps just about strong enough to meet OPEX, is asking for trouble, particularly if the slump in the market lasts for longer than expected. The problem is exacerbated by the fact that medium term charterparties are not available during a slump, and the company is exposed to the uncertainties of the spot market. So, we have two candidates arguing for exactly the opposite: one says more debt, one says less, and they both get marks. In other words, it is all about how students argue their case, and how they contextualise the problem within economics and the freight and S&P cycles. Shipping Finance is about considering options and alternative strategies: the correctness or otherwise of a particular strategy will only be known some time, perhaps years, after the decision has been taken and implemented.

Q2. In the context of <u>ALL</u> the following scenarios, discuss the type or types of loan which you would consider appropriate for a shipping company borrower. With regard to each loan, discuss the risks

to both borrower and lender may be subject and, where appropriate, any covenants which may be included to protect the lender against such risks.

i. **A chemical carrying shipping company has a lucrative charter party with a global chemicals manufacturer. However, the charter party will end within the next year and, with a looming world recession, it is anticipated that the demand for chemicals will fall in the following few years. The company already has in place a plain vanilla loan, interest payable on which is LIBOR-referenced. The owner is concerned about the risk of rising interest rates and falling revenues.**

ii. **A shipowner trading in a difficult freight market anticipates that after the next two years there should be an improvement in conditions and a return to strong profits. The company is currently covering operational expenses but will not be in a position to service additional debt for a while, at least not until the market recovers. However, the owner would like to purchase additional distressed sale vessels while prices are low.**

iii. **A shipowner is expecting an upturn in the freight market soon and with it a significant improvement in the prices achievable for vessels which it holds. For now, it is possible for the company to continue covering operational expenses and paying a rate of interest, but lower than that which it is already paying on its outstanding debt and which is currently causing financial stress.**

This question required consideration of types of loan, and as mentioned in the comments for question 1, some of the scenarios could be answered with different and contrasting types of loan but still receive marks. It was all about how a candidate placed a loan in the context of the facts of the question.

For part i) if a borrower is exposed to floating rate interest rate on its debt, and rates are expected to rise, then it should as a matter of urgency try to renegotiate to a fixed rate so that this part of outgoings will be certain, when perhaps other aspects of OPEX are rising. Students who considered interest rate swaps, or a swaption, received marks, but always remembering that there is a cost for such a facility and the further out interest rates are fixed, the higher the premium payable for the facility. A front-ended loan could also have been discussed here.

For part ii), candidates discussed back-ended loans, or a bullet. Given the intention to buy distressed assets, a hunter’s loan could be negotiated (with full discussion of the characteristics of this). To ensure that the borrower does not become over-leveraged, increasing bankruptcy risk, a loan to value covenant will be included.

Part iii) required discussion of a moratorium, or a balloon. With regard to the latter, the risk to the lender is that asset prices will have fallen by the time of repayment of principal and the balloon, and accordingly possible residual value insurance could be taken out. However, in practice the price of this will probably be prohibitive, and there are currently very few providers of it in the marketplace.

In the context of all three scenarios candidates were required to identify risks to both parties, and suggest possible loan covenants which will be included to address some of these concerns.

Q3. Answer BOTH parts:

a) **Identify and discuss the purposes of the main terms in a parent corporate guarantee in respect of a loan made to a subsidiary.**

b) **Discuss the procedure that must be followed for the taking of a corporate guarantee, and the practical steps that a lender should take before accepting such an arrangement.**

This was a question for a candidate who was fully familiar with loan documentation in general and guarantees in particular. Documentation is very important in Shipping Finance since the loan covenants required by lenders are often highly restrictive of what a borrower can do in the future. For example in terms of prohibiting asset disposals, taking on of fresh debt ranking at the same level (a negative pledge clause), giving of accounts on a frequent basis. Contents of loan documentation, guarantees, covenants, are all very legitimate areas for examination for this subject, and will continue to be so. The procedural dimension of the question was a discussion of section 4 of the Statute of Frauds 1677.

Q4. Answer ALL parts:

a) **Discuss the advantages of a convertible bond from the perspectives of both an investor and an issuer, over a simple plain vanilla bond.**

b) **Discuss the consequences, in terms of the signals given to the investment market, of a convertible bond which has either not been capable of conversion, or which was convertible but the option has not been exercised by investors (a so-called busted convertible).**

This question did not require in-depth application to a scenario, just a listing of the advantages and disadvantages from the perspectives of investors and issuers. A Google search will fully equip someone to deal with such a question, a good starting point search term being ‘convertible bonds, characteristics, advantages, disadvantages’. The ICS coursebook also sets these out in excellent detail. Some issues which were missed included dilution implications, stripping the host bond, bearer status of Euro-convertibles. Students had to provide a discussion of the basic characteristics of convertibles (there are in fact several forms). Candidates should assume that the examiner knows nothing about a topic and in this way will not lose easy definition marks. The negative signal of a ‘busted convertible’ to the market is that investors are expressing doubt about future dividend performance of the company. They would rather have the certainty of regular coupon payments on an unconverted bond than risk exposure to the possibility of future falling share price, or dividends falling in time below the level of coupons.

Q5. Answer BOTH parts.

a) **A diversified ship owning company wants to borrow a large amount of money in order to finance an expansion of its fleet. The Chief Executive Officer (CEO) is considering either applying to one of the company's existing lenders for a new loan, or alternatively raising a syndicated loan. As Chief Finance Officer (CFO) to the company, prepare a briefing note for the CEO, addressing all relevant issues including, but not restricted to, the following: the advantages of a syndicated loan over a plain vanilla loan and the concerns which may be expressed by the company's bank when approached for the full funding (you may wish to briefly discuss the Basel capital adequacy ratios in this context)**

b) **The criteria for appointing the lead manager to a syndicated loan issue.**

Lenders syndicate loans rather than taking a single loan for several reasons. First, the amount to be raised may be too great a risk for one bank to take on alone. Second, a group of banks may be better able to place bonds through an extensive investor network than one bank acting alone. Third, the overall cost of the loan in terms of interest rate may be lower than if one bank alone had provided the funds (because of the greater risk attached to one bank providing the loan). In this context some reference to Basel capital adequacy considerations could have been made. Some candidates were able to provide recent case examples of syndicated loans to shipowners which gained additional marks for showing context.

Q6. Discuss the various forms of security that can be offered by a shipping company to potential lenders. In the context of each type you should describe the risks associated with it and how, if at all, these can be avoided or reduced.

This question focused upon forms of security, and discussion of the risks associated with each would have raised marks. For example, risks arising in the context of assignment of insurances is that first, the borrower failed to disclose all material facts when taking out the insurance (this is an unavoidable risk the lender takes, and renders the policy voidable), and second, that the borrower discontinues premium payments after the loan has been made. This second risk can be mitigated by including a loan covenant that premiums will continue to be paid, and the lender will be given ongoing proof of this. Mortgages are another form of security required in this question; risk can be reduced by value maintenance clauses (worthless if the borrower has no other assets or security to pledge if asset values fall), or residual value insurance. Assignment of earnings risk can be reduced by insisting that charterer payments are made into an account controlled by the lender.

Q7. Discuss the factors, including environmental, which should be taken into account by a lender when evaluating an application to finance the purchase of a vessel or vessels. To what extent do these factors differ in terms of objectives and methodology from those of a classification society?

This question required discussion of the characteristics of the vessel to be purchased. Issues such as age, speed, fuel efficiency, class, repairs and maintenance record, general condition, relevance of trading routes, should have been discussed. Classification societies (some candidates gave examples, and received marks for doing so), focus upon maintenance and condition, safety, technical condition. In contrast, although these factors are taken into account, the foremost consideration for lenders is the ability of a vessel to generate earnings, not to be off hire, and to cover principal repayment if sale is necessary on conclusion of the loan (or a balloon is payable). Lenders are concerned with the business side of the vessel, although of course safety is a vital consideration (an unsafe vessel is likely to become subject to PSC, or union action).

Q8. Answer ALL parts:

a) **Explain the required characteristics of cash flows for them to be suitable for securitisation. In addition to the cash flows transferred to the special purpose vehicle (SPV), what other assets may be used to collateralise the issue?**

b) **With the use of a diagram, illustrate the direction of the cash flows in a typical securitisation, and its participants.**

This was a descriptive question regarding securitisation requirements. This is becoming a highly relevant form of ship financing; this makes sense given that earnings under a long term charterparty are stable, predictable, and there is a legal right to assign to a third party- the special purpose vehicle, these being the basic requirements for a securitisation. This topic certainly lends itself to scenario-type questions. A good diagram, showing cashflows from the originator through to the SPV and then to investors, with arrows showing directions of flows, gained high marks. Some candidates missed the obligor- the payer of cashflows (the charterer) to the originator (the owner). There should have been discussion of the role of the SPV: to protect the investors should the originator fall upon hard times (the cashflows belong to the SPV and cannot be taken over by a liquidator- the SPV is ‘bankruptcy remote’), whilst also protecting the originator against actions by investors, whose claim lie against the SPV for issues such as default. This principle of separate legal personality should have been discussed in the context of the SPV, and the implications of this. It can be eroded if the originator gives a partial guarantee to the SPV (to narrow the basis point spread on the securitised bonds).