Shipping Finance, November 2020: Examiner's Report.

There was a lower number of entries for the November 2020 examination, possibly because of the ongoing pandemic. The standard of answers was variable, with a higher number of failures than usual. Reasons for this were threefold. First, answers lacked detail: there was a tendency to give a small amount of descriptive detail, but not to look at wider issues within each question. Second, the requirements for some questions were not addressed in a focus way. Third, some answers did not address all constituent parts in scenario-based questions: instead, only a few issues were addressed. There were also many excellent, highly detailed answers in all scripts, with a good degree of reasoning and justification given for approaches taken. There follows a detailed discussion of each question, and points which should be taken onboard by students taking the next paper.

Question 1.

This question was popular, and all answers attained a good pass. It required consideration of several scenarios in which owners wanted to raise debt finance through loans. Such questions can sometimes result in answers which are too basic or simplistic. For example, if an owner is presently experiencing difficulties in meeting interest and principal repayments on a plain vanilla loan, and a question asks for an alternative type of loan into which existing borrowing can be replaced or consolidated, then it is easy to suggest a moratorium loan and then simply define this. However, a student who takes this one-dimensional approach will gain a borderline pass because he or she is not looking at the wider context. For example, a moratorium is not a 'free lunch': the lender is taking a risk that, when payments are restored in anything up to two years' time, the borrower will still be unable to meet these. This represents a significant risk to the lender; if it holds back from pushing the borrower into liquidation for default on a loan, then it may be the case that a moratorium is postponing the inevitable, by which time the situation may have deteriorated further. For example, asset values may have declined, resulting in the lender receiving even less on insolvency than would have been received if the 'nettle had been grasped' earlier.

Regarding a types of loan question like this, always identify the risks to the parties. Also, is there a facility fee which will be lost in the overall cost of funding of the moratorium, but which will of course raise the amount of debt over the term of the loan? The borrower needs to be aware of this.

Remember, a particular loan may be defeated by a change in the cycle. For example, a balloon payment or a back-ended loan may be undermined if the cycle moves into recession, asset values fall, and the borrower is not able to meet principal repayment upon maturity.

Always consider possible loan covenants. For example, the lender may want to stipulate that the borrower cannot dispose of assets during the term of the loan, may be barred from making dividend payments to shareholders, may not take on fresh debt, will have to keep up insurance payments, must notify if there is any pending litigation or if a vessel has been arrested.

These are the finer details connected to a types of loan question: they result in a more reasoned, deeper answer than is otherwise the case with a student who simply identifies the type of loan but then leaves it there.

Another point! Remember that it is rarely the case that one form of loan is suitable and there are no others. For example, it may be that instead of a moratorium, a back ended loan may be appropriate. Or perhaps the borrower, even if facing severe stress on meeting OPEX, decides to go for a front-ended loan. The reasoning for this is that, as the market recovers, there will be less debt in the capital structure because it will have been cleared, even if with difficulty, meaning that the borrower has more liquidity or cash to buy assets very cheaply or even to raise another loan on good terms such as a lower rate of interest because the company is not already carrying significant levels of debt. It is only with the benefit of hindsight that we know whether a particular type of loan was correct in the circumstances.

Turning to the individual parts of question 1.

a. This could be a moratorium or back ended loan, given that the borrower is already struggling with existing levels of debt and meeting OPEX. The fact that the owner's vessels have been breaking down means that it does not have regular cashflow, justifying further these types of loan. As an alternative, a bullet in which there is less stress in meeting regular principal payments over the life of the loan. But this will come at a cost in the form of a facility fee.

b. Here the borrower will face a balloon payment at the end of the loan which will have to be made from declining revenues as the cycle falls into recession. Here it may be an idea to go for a front-ended loan: clear as much of the debt now as is possible, when earnings are high, meaning that there is less stress when it comes to repaying principal on maturity in a collapsed market. Alternatively, a moratorium to enable the borrower to build up cash reserves to cope when the market moves away from the peak and into recession. To meet principal repayment obligation on maturity, the borrower may set up a sinking fund, which will also give reassurance to a potential lender. This will be ring-fenced to ensure that the fund is protected from the borrower. Payments into the fund will be regular and should not present a difficulty during the present good times. Balloon payments can be a real problem if they mature when asset values are falling and cannot be sold to meet perhaps 130% on maturity. Sinking funds are a way to build up cash without undue stress, but the fund must be under the control of a reliable third party, and the borrower must not be allowed to 'dip in' to the fund to meet immediate expenses, including OPEX, or this will defeat the purpose of setting up the fund in the first place.

c. Here the borrower does not want the cost of taking out a loan the full amount of which is not presently needed. Instead, the borrower should negotiate a revolving credit facility. This gives access to cash as and when needed, which means that interest is not payable on a loan which is not needed. The risk to the provider is that the borrower will not be able to repay the amount drawn down. Remember, the borrower can draw down and repay several times without needing to renegotiate a new loan- and a facility fee- each time this is done. The amount available under the facility usually diminishes towards the end of the loan, to reduce the provider's risk exposure. As an alternative, a note issuance facility could be taken out by the borrower.

Question 2.

This was a popular question about securitisation, with several high marks awarded and no failures.

a). This was simply the three requirements for securitisation: cashflows must be stable, homogenous, with a legal right to assign to a third party (in this case, a special purpose vehicle, or SPV). Look at the earnings profile of the company in the question; some of the cashflows are stable and from a reliable charterer, but others are derived from the spot market. The former meets the criteria, but the latter do not. But remember, even the volatile and unpredictable earnings can be used to narrow the basis point spread on the floating rate notes issued by the SPV, for example by paying a portion of them into a sinking fund to meet principal repayment on maturity. After all, it is only the cashflow which collateralises the SPV and for this reason, if other assets can be transferred, this should give reassurance to investors, reduce the risk of principal default, and lower the interest rate as a result.

b). This part required a discussion of the sovereign ceiling, which is always relevant to borrowers located in developing economies. This in a nutshell means that the borrower cannot raise debt at a rate of interest lower than the government of the country in which it is located. If the sovereign has a low rating, then this means that the borrower will also pay a higher rate of interest. To overcome this, all payments received under the charterparty should be made into an account outside the borrower's jurisdiction, set up in the name of the SPV. Payments to investors will be taken first, and any balance remitted to the borrower. In this way the entire chartering and payment transaction is kept outside the borrower's jurisdiction, overseen by a third party acceptable to investors such as an international bank, and interest rates will be lower than would otherwise have been the case. This means that the sovereign ceiling will have been pierced, and the borrower will raise debt at a lower cost than the government of the country in which it is based.

c). The SPV acts as an intermediary between originator and investors. They only have a claim against the SPV which has issued the FRN. Similarly, If the originator falls into bankruptcy, the cashflows have been sold to the SPV and cannot be taken by the liquidator. In other words, both sides of the SPV are protected by its intermediation.

d). It is possible to find a securitisation diagram on the internet, and it is also included in the ICS textbook.

Question 3.

All students who attempted this question achieved a pass mark, with some being high. It was a descriptive question with students required to define any three out of five terms. **However, to gain high marks there had to be detail**. For example, what are the risks to participants? What are the legal requirements, for example regarding a guarantee which must be in writing? What is meant by leverage, and how does this relate to the debt-equity ratio? Regarding this final point, discission of Modigliani-Miller theory would have increased a mark because it provides a theoretical context. Regarding e), students should have discussed how the register of members (shareholders) is changed when there is a legal assignment of shares and a new certificate issued in the name of the lender, but that this is not the case with an equitable assignment. Students should also have discussed the risks to the lender in each scenario. For example, an equitable assignment means that a dishonest borrower can pledge the same share over and over again, because it has the certificates. With descriptive questions it is vital to provide this extra detail, and not simply a definition and nothing more.

Question 4.

The marks for this question were lower than for the earlier ones because students did not provide the degree of detail needed., They also demonstrated a lack of understanding of the role of the Basel Committee, or the principle of capital adequacy. Students should have opened their answers with a brief discussion of the Basel Committee. Its main functions are to ensure that risk is transparent, and that they are accurately measured. Financial institutions must hold capital against such risks, otherwise known as the capital adequacy ratio, to ensure that they are able to withstand short term shocks such as recessions, collapse of a counterparty, rising defaults in a particular sector.

It would be wise for anyone taking the Shipping Finance exam in the future to make sure that they have at least some understanding of the Basel Recommendations, how they work, weighted capital, and capital adequacy. This detail or even brief mention of it can be brought into many other parts of the course, for example regarding types of loan, securitisation, syndication, but as said, only briefly and for incremental discretionary marks. Basel III was introduced in part as a response to the credit crunch of 2007-2008; students should have some familiarity with its recommendations regarding liquidity ratios and counter-cyclical buffers, which of course is relevant to the shipping sector as a source of borrowers. After doing this, the question required students to discuss the range of risks to which lenders to the shipping sector are subject, of which the following are examples. Foreign exchange risk; interest rate risk; market risk; reputational risk; management risk; counterparty risk; specific cyclical risk, including asset value deterioration.

The question also refers to a politically unstable country; this raises the issue of **political and jurisdictional risks**. Regarding owner risk in the question, this would raise the issue of corporate governance risk, lack of transparency of ownership, jurisdiction. Regarding trade, this would raise issues of seasonality, spot versus chartering strategy, geopolitical issues, unstable or dangerous (piracy-affected) trade routes. Students could also have discussed relevant risks such as meteorology on trade routes, for example ice at certain times of the year and insurance implications. The recent blocking of the Suez Canal could have been used, if it had happened before the exam! Regarding asset values, this part of an answer should have dealt with volatility and the susceptibility of prices to fluctuate in line with the phases of the cycle. Principles of derived demand and the lag could have been briefly alluded to.

Question 5.

This question was not answered well, with most students who attempted it not achieving a pass mark. The main reason for this was as follows. Students were well able to identify sources of security in respect of a bank loan to a shipowner; for example, the vessel itself, assignment of insurances, parent guarantee, assignment of shares, assignment of earnings. But students then failed in the second and third parts of the question regarding risks presented by each form of security and the covenants needed in the loan documentation to overcome these. For example, the risk regarding the vessel as security is that it will decline in value. This may result in less being realised on forced sale than is presently outstanding on the loan. To overcome this problem, covenants should be included that the owner will keep it in a good state of repair and maintenance, that it will be kept insured. There would also be a loan to value covenant to ensure that, if the vessel value falls below a certain percentage of the outstanding loan, the borrower will be required to provide fresh security to maintain the ratio. Failure to do this will be a default entitling the lender to call in the loan. Also, the borrower could be forced to take out residual value insurance to ensure a floor value below which the asset as security will not be allowed to fall or at least, if it does fall the insurance provider will make up the difference between sale price and the floor.

Regarding assignment of insurances, a covenant that the borrower will keep up premium payments. Also, the insurer will be asked to notify the lender if there is a default in these.

Regarding assignment of earnings, these should be into an account controlled by the lender. After interest and principal payments have been taken, the balance will be remitted to the borrower's account.

Regarding guarantees, ensure that the guarantor does not do anything to undermine the guarantee. Also, check that it has the financial strength to be able to meet the guarantee if called up to do this.

When answering any question on types of security, **these issues must be addressed in the round**, either directly as was specifically required in this question, or part of the background context. Shipping finance is about detail, and not focusing on one issue to the exclusion of other equally important ones.

Question 6.

Regarding this question, most students who attempted it did not achieve a pass mark. One student confused securitisation with syndication: the question was about the latter and is completely different as a topic. Diagrams also omitted key participants including fiscal agent or trustee, and underwriter. Lists of factors taken into consideration when awarding the mandate could have been presented in list format with just a sentence for each, but instead some students chose perhaps one or two factors such as cost, previous collaboration between issuer and lead manager. Other factors include: ability to place the paper; ability to put a team together, including management and selling groups; reputation; complexity of the issue; geographical placement issues. Regarding costs associated with the issue, these would include: margin, for example spread over LIBOR; commitment fee; utilisation fee; arrangement fee; legal fee. These costs should be included in an answer on syndication even if not specifically asked for, since they are deciding factors as to whether a syndicated deal goes ahead in the first place.

Question 7.

Stakeholders to be discussed in this question included: crew; shareholders; bondholders; lenders; bunker suppliers; repair yards (in other words, a list of general creditors). Students needed to address the issue of priority to repayment as asked for in the question. For example, lenders are usually secured against the assets of the business, the ships. Creditors are usually unsecured. Bondholders will be senior and subordinate, with the latter being paid only after higher or senior creditors have been satisfied. Crew will also have priority over other unsecured creditors to the extent of three months unpaid wages. Shareholders are of course the last to be repaid, but if there is a surplus they will share in this pro rata.

Regarding cyclical issues as raised in the question; secured creditors may oppose sale of assets during a recession for the simple reason that they will recover less on the outstanding part of loans because values have fallen. Unsecured creditors may want to force liquidation now if they think they will receive more if the market is in reasonable condition, for example approaching a boom. Shareholders will be reluctant to see their investee company forced into liquidation during a depression because share prices are probably going to be undervalued. Stakeholders with senior or secured status may be more likely to force a company into liquidation because they will be repaid above and before lower ranking creditors. The latter would prefer to wait for a market recovery in the hope that asset values will improve to such an extent that, even after meeting higher ranking stakeholders, there will still be enough left over to satisfy their claims. It was these latter two points which let down several of the answers, resulting in lower marks than should have been the case if this extra detail had been provided by students.

Question 8.

This question was not attempted by any students, and yet it was relatively straightforward. It related to corporate structure. Reasons why owners use one ship companies registered in different jurisdictions include: to avoid arrest of assets held in one company should for example a vessel cause environmental damage and a state agency decides to seize whatever is available to meet future potential fines; to limit the powers of arrest of lenders following default on a loan; to hide the identity of owners of several vessels by using nominee directors and shareholders; to take advantage of tax rules in different jurisdictions; to raise debt at lower cost, because a loan is raised regarding one vessel and the pricing is not affected by a high level of indebtedness within a group; to avoid sanctions.

Regarding structural changes, a lender will require all assets to be held in one company, registered in a jurisdiction which recognises the rights of mortgagees and these are easily and quickly enforced.

Regarding possible covenants, it is strongly advised that future students taking this exam should pay attention to the clauses, particularly the powers of the lender, in a typical mortgage deed. This issue of covenants can be raised tangentially in other answers, for example regarding types of loans, to gain additional incremental marks because it is a highly relevant consideration. In respect of a guarantee provided by a parent for a loan to a subsidiary, these would include; not disposing of assets to weaken the loan guarantee; keeping the lender informed of any issues, for example legal proceedings, which could weaken the guarantee; not giving similar guarantees to other loan providers.