Shipping Finance Exam, Thursday 27th May 2021: Examiner's Feedback.

Question 1.

This was a popular question about forms of security provided in respect of loans, with nearly all students attempting it. Marks were generally high, evidencing a good understanding of the issues. Some students omitted to deal with two significant words in the question: risks, and procedures. Students correctly noted that one form of security would be an assignment of earnings, but then did not mention how this is done, even if in brief terms. Receivables under a charterparty would be paid into an account controlled by the lender, interest and principal payments deducted, and the balance transferred over to an account controlled by the borrower at the same bank. This reduces the risk of the borrower withholding payments when these have been paid by the charterer. Accounts should be within the borrower's jurisdiction to avoid conflicts of choice of forum if there is a dispute. There is of course the risk that the charterer will default on payments to the borrower/owner, but this is beyond the lender's control.

There was also an assignment of insurances. The risk would be that the borrower would default on premium payments, leaving vessels uninsured. The borrower may also have made false or misleading statements to the insurer, or not made full disclosure. To overcome the risk, the lender will require notification from the insurer should there be a lapse in premium payments. This would be an event of default, enabling the loan to be called in early. Regarding procedure, the borrower will need to be involved in the assignment of the benefit of the cover to the lender, and documentation signed to this effect.

Regarding assignment of shares owned by the borrower, if this is a legal assignment then existing shares must be cancelled and new ones issued in the name of the lender, and the company's register of shareholders altered to reflect this. If it is an equitable assignment, then formal transfer does not take place- the shares are simply handed over to the lender to hold. The risk to the lender is that the value of the shares will fall, undermining the strength of this security.

The question also required discussion of a mortgage as security, as well as a guarantee. The procedure will not be discussed here, but the risk is that the asset may fall in value (hence the need for a loan to value covenant), or that the guarantor's ability or resources to meet its obligations may deteriorate, in which case the guarantee will have less value and the lender may not be aware of this until it is too late, subject to provisions in the guarantee documentation.

Question 2.

This question which was about types of shares appropriate at different stages of the cycle was popular and well-answered, mainly because it was very descriptive in nature with minimum application of principles to a critical appraisal of a scenario.

The first scenario required discussion of partly paid shares. Some students identified this but then did not take this further as was required by discussing the risk presented to investors. This is that,

should the company fail, they will still have to pay any balance outstanding on their holding. Dilution of earnings and voting control should also have been mentioned.

The second scenario required discussion of a rights issue. This will avoid dilution consequences.

The third scenario required discussion of cumulative preference shares. These reduce the risk to investors who will have prior entitlement on future dividend distributions.

The final scenario required discussion of participating preferred stock, or convertible preferred stock. There would be dilution implications should these be converted.

Question 3.

This was not a popular question, with less than half of students attempting it. This may be because it concerned a subject which was either known or not known: there could be no informed 'guessing'. Those who attempted the question did not gain high marks. Convertible bonds can be raised in several topics across the syllabus, and for this reason some knowledge of them, even if basic, is important. Students who attempted the question knew the general characteristics of plain vanilla convertibles, but were not able to give types, which would include mandatory convertibles, reverse convertibles, exchange bonds, contingent convertibles, foreign currency convertibles.

Benefits would include longer maturity, lower coupon for the issuer, and a speculative hybrid investment to bond holders. The list of advantages and disadvantages needs to be learnt if revising this topic: there is no alternative, and there is plenty of material and lists of bullet points on the internet. Risks include busted convertibles, dilution consequences, and bonds becoming illiquid and adversely affecting the balance sheet of holders who are not able to dispose of them at an acceptable price. Sometimes it may be possible to strip warrants from the host bond and trade these separately, but these are unusual.

There are several topics across the syllabus where learning the detail, or having practical working experience in the area, is essential. These would include, for example, standard terms or covenants in loan documentation, mortgage terms, covenants in guarantees, types of bonds and shares. In an exam it is perhaps wiser not to attempt highly descriptive questions in terms of requirements, rather than guess and achieve less than a half mark.

Question 4.

This question was entirely about covenants in mortgages, and a mortgage form, and links back to the comment for question 3: either a student knew these or did not. This was the least answered question on the paper. However, it is possible to at least work out how the lender would seek to protect itself in the documentation. For example, it would require regular information, a limitation on the borrower disposing of assets covered by the mortgage, limitation on corporate reconstructions or moving registration to another jurisdiction. They would also need a power of arrest. It should be possible to draw up this list even if the specific topic has not been revised,

because the covenants should reflect common sense, and the objective of the lender to achieve maximum security whilst at the same time not unduly limiting the trading autonomy of the borrower. Students who were able to describe this dichotomy were able to score well despite not knowing the minutiae of the documentation.

Question 5.

This question about syndicated loans was very popular and well-answered. Marks were high, possibly because of the descriptive nature of the question. Several students were not able to answer the second part of the question, which required explanation of the terms force majeure, and joint and several liability. These are very important terms and are often found in other loan documentation, including standard loans, mortgages, underwriter commitments, and for this reason students should ensure that they are familiar with them if taking the exam in the future. (A simple internet search will suffice, and they will not be defined here). Students should be able to provide a diagram in which participants in a syndication are identified and their functions explained, as they should also be able to do in the context of securitisation (the two concepts are entirely different and should never be confused!).

Question 6.

This was a straightforward question in which students were asked to explain four terms of their choice. These will not be defined here. A small point but when defining terms, students should try and move beyond basic description by also considering risks to participants, whether these be lenders, investors, or borrowers or issuers, how these ca be mitigated, if at all, and whether suitable covenants should be included to protect the interests of parties. This was a popular question, but some students lost marks because they gave very basic, short answers: greater detail was required for higher marks.

Question 7.

This question was about the order of application of payments to stakeholders when a company enters insolvency. It was well-answered and popular, with nearly all students passing with good marks. Students were able to identify the easier stakeholders such as crew, suppliers, holders of liens, the liquidator, and tax authorities. Several did not make the distinction between senior and subordinate debt holders, the latter raking below the former. An easy mark was gained by students who noted that shareholders are the last to be paid. Weaknesses of positions would be as follows, as examples. Crew may find that the company is part of a one company corporate structure, and they are not permitted to proceed against other vessels in the group to gain payment of lost wages.

Regarding lenders, the weakness reveals a paradox. A bank may not want to force a defaulting company into liquidation because, if trading in a recession, there may be less raised on sale than the amount outstanding on the loan. Also, banks are not ship owners by training, experience, or inclination: for this reason, they would not want to seize vessels and then trade them, since they lack the knowledge. The vessels would also quickly become depreciating assets in the bank's balance sheet, negatively affecting its capital adequacy ratio. Instead, the bank may be more willing to negotiate or compromise with the owner and allow it to continue trading on condition that it first provides a viable business plan to get out of the present mess. Unsecured lenders who were receiving a high rate of interest because of the risk which this status presents will find that they are now far down the list in terms of payment entitlement.

The liquidator is perhaps the most secure of all claimants, hence the reality that after the costs of liquidation have been deducted from the amount raised from sales, there is often nothing eft for others on the list. Students should ensure that they are fully aware of this list, and the order of entitlement, not just for this exam but also for practical day-to-day purposes encountered in the business of running a shipping company or investing in it or lending to it.

Question 8.

This was a popular question about types of loans as applied to given scenarios, and was answered by most students, nearly all of whom achieved a pass mark for it. It is not necessary to describe the types of loan in this report: students will be fully familiar with these. However, the test in this question was the extent to which students could identify one or more types which may be relevant at different stages of the cycle, from peak to depression. There should also have been a detailed discussion of the risks associated with each. For example, a moratorium involves the lender agree to postpone interest for up to two years, to give the lender breathing space. But it may be the case that the borrower is in good condition despite the market, but simply wants to use retained finds to make assets purchases which are now available at a heavy discount. The risk is that at the end of the period the borrower is not able to resume payments and asset values have fallen even further, placing the lender in a worse position than it would have been had it forced the borrower into liquidation in the first place, after the initial default. It could also be argued, for example, that an upfront loan is to be preferred during a recession. This may appear counter-intuitive: surely borrowers do not want added payment stress when the market is difficult? But the other viewpoint is that if the borrower can reduce loan capital at this time, it will be in a much better position to borrow and make acquisitions when the market begins to turn in a favourable direction. Companies which emerge from a recession with a significant amount of debt may find that their freedom of manoeuvre to take advantage of new trading opportunities is severely restricted. This paradox makes the following point: there is no right or wrong answer to each of these scenarios- it all depends on how the student justifies the particular borrowing decision and relates it to the state of the cycle and future prospects.