Examiner’s Report, Shipping Finance.

Question 1.

This question was very popular, with most students attempting it and very few failing, with some excellent marks gained, including several which were full marks. It concerned types of loans that would be appropriate in specified scenarios. These are related to phases of the shipping cycle, with, for example, earnings and asset values being low during a recession, and high during a peak or boom. It is important to note that students could suggest different types for each situation, with a suggestion for a front-end loan being argued for in a recession scenario, but another student suggesting a back-end loan. The latter was, of course, the preferred suggestion, but that said, if a student suggested that, if a shipowner is able to manage to pare back debt at this time, even if it may be difficult given that earnings are low, it will be better positioned to buy distressed tonnage when the market starts to move into recovery. We have two opposite suggestions, but both are correct if they are supported with a rational explanation.

Risks to lenders were handled well in answers, these including that the borrower will be in no better position to meet payments at the end of the ‘breathing space’ than it was at the beginning, but in the meantime asset values or the collateral provided to the lender have fallen even further in value, giving even less to the lender on liquidation than it would otherwise have received if it had simply demanded repayment when the first sign of trouble, default in interest payments, appeared. Special arrangements, such as moratoriums or back-end loans, are also not a free lunch to borrowers, and the lender will expect a good spread over market rates when the obligation to start repayments arises at the end of the facility. This is another lender risk: that the borrower will not be able to meet these additional payments, which are intended to compensate the lender for accepting a temporary cessation of payments from the lender.

As a matter of practice, in any exam question involving types of loans, it is essential to discuss the risks associated with each, even if not specifically requested in the question.

This exam will always require some mention of covenants! Accordingly, it is vital to have these at hand. If necessary, search on Google for a list of typical covenants attached to traditional plain vanilla ship finance loans.

The question also differed from previous exam papers in that it asked for the Basel capital adequacy implications of each type of loan for the lender. This did not require a detailed discussion, but several students did not even have a go at this part of the question, ignored it in their answers, and lost marks as a consequence. All that was required was a statement that the bank must allocate capital, in the form of equity and/or debt, to reflect increased risk in its loan portfolio, meaning that it will be more likely to survive if the loan portfolio is subject to a crisis, such as the Credit Crunch of 2008. If a loan requires the bank to wait for interest payments, and the risk of default on principal and/or interest has increased, then this should result in a commensurate increase in the capital held against it. And of course, vice versa; if a loan is repaid early, then the risk reduces, and the bank is now overcapitalised relative to it. Look at it this way: capital adequacy of risk-weighted assets is like a see-saw: the greater the risk on one side of it, the greater the capital against it on the other side, to ensure some balance between them.

Question 2.

This question concerned the corporate structure often preferred by shipowners: the one-ship company. It was popular, but there was a disappointing number of fails. It specifically asked for balance sheet manipulation techniques; this did not mean fraudulent behaviour by shipowners, but the legal presentation of figures in the best light. Techniques which should have been discussed included:

Intra group loans at a market discount.

Intra group dividend payments.

Intra group sales of assets at an under- or overvaluation;

Misuse of management charges by the parent owner of shares in the subsidiaries;

Favourable use of depreciation methods to present better valuations of assets held by subsidiaries;

Revaluation of assets previously entered in the balance sheet at either market or historical value, the latter being less reliable;

Manipulation of operating expenses between subsidiaries.

Leasing needed to be mentioned, but not in any great detail, only to show how it could be used to remove an asset's value from the balance sheet through sale and leaseback.

There should have been a definition of what constitutes a one-ship company, a reference to the fundamental principle of separate legal personality, and the Solomon principle. Some students mentioned that the structure is used to avoid sister ship arrest, to isolate risk, and to avoid environmental regulations, and the risk of cost consequences should these be breached. These were fair comments and gained marks, but the main part of the answer should have been about the balance sheet, and how it can be presented (or manipulated) to potential investors to present the best picture.

Question 3.

This was a general question on the ethics and morality of shipowners. It was not popular, with less than half of the candidates answering it, even though it was the sort of question that could have been answered by intuition rather than revision alone. Fundamentally, it asked whether these values are compatible with the traditional model as advocated by Milton Friedman that the goals of a company are to maximise shareholder value and profits, within the framework of the law. Accordingly, ethics 'has nothing to do with it', for the reason that one person's ethical standards may be very different from someone else's, but both being equally valid. Bringing ethics into business decisions is, according to the market view, theft, since it is expropriating the ethical decision-making of investors, and taking business decisions according to the business's own ethical values. This is the dichotomy present in this question.

Students should have discussed how ethical obligations differ from one group of stakeholders to another. For example, it is a duty to make full disclosure to an insurance broker regarding material risk (although this is also embedded in statute). There is a duty to put a lender's interests before your own as a shipowner, within the confines and demands of the law. For example, it may be possible to liquidate a company at the expense of the lender, particularly where one ship companies are involved, and then simply resume business under a different corporate identity. Now, even if this is within the law, is it ethical behaviour? Also, to cheat a lender in this way, for it is cheating, will destroy the borrower's reputation and it will find it difficult to raise loans in the figure because it is simply not trusted. Equally, there is an ethical duty to the health, well-being, and safety of crew, which transcends statutory provisions. There is a duty to respect cultural diversity within a crew. This is where the ethical side of the question becomes highly relevant. For example, some shipowners have recently been known to liquidate their companies leaving crew stranded on board, with no way to get home and without having been paid for months. Now this may have been done within the technical letter of the law, but certainly constitutes unethical, immoral conduct.

Regarding an ethical duty to the natural environment, owners should adhere not only to the letter of legal regulations, but to go beyond these minimal requirements and to abide by the provisions of the Poseidon Principles, which have no force of law. Those students who mentioned these Principles gained high marks for this part of their answer.

Question 4.

This was a descriptive question that required a simple listing of points. For example, a student who was able to list the costs associated with syndication would have gained full marks for this part of the question. These would include, principally:

Margin fee
Facility fee
Arrangement fee
Legal fee
Commitment fee.

These did not require explanation.

Regarding covenants, there was a huge choice available to candidates, and the question only required four. These could have included:

To ensure the vessel and keep it seaworthy
To conduct all necessary repairs
To provide regular information and management accounts to the lender
Not to use the vessel as security for future loans
Not to change the flag
To make regular payments on the loan
Not to do anything that undermines the lender's security
To give the lender notice of actual or pending legal proceedings that affect the security.

A diagram was required. Some students lost marks here because they did not put arrows on the link lines between participants; marks were similarly lost for not putting arrows on lines in the securitisation answer. These are essential: the diagram must show where payments come from and where they go to, at the very least! The question was very popular with nearly all candidates attempting it, many scoring full marks, and almost no candidate failing.

It is important to recognise that syndication results in the creation of a fungible or tradable financial product, a bond, which gives a coupon to investors. In this way, it is very different from a bilateral arrangement between a borrower and a lender in the form of a loan.

Regarding factors to be considered when appointing the lead manager (whose role should have been explained in the answer), the following were pertinent:

Placement power.
Financial resources.
Complexity of the issue.
Investor base.
Have the parties dealt with each other previously?
Ability to put a management group together.
Reputation in the market.

Question 5.

This question concerned types of equity and the relative advantages and disadvantages of private placements. It was not popular, with less than half of the candidates attempting it and a significant number obtaining failing marks. Students were required to discuss the possibility of the owner putting in equity, given that he had personal resources to do this. This would have the benefit of flexibility, control, and avoidance of listing requirements of the various exchanges. It would also overcome the problem of investor reluctance to invest when the market is underperforming other investment opportunities. The disadvantage is that if the company becomes insolvent, they will be treated as any other shareholder and will be last to be paid. In other words, they are putting their own personal net worth at risk. However, this investment might also encourage other outside investors since it will signal confidence in the company's future prospects. It will also give reassurance to those banks with which the company has existing loans, and future banks from which new finance may be sought.

Publicly listed equity should have been discussed. Students should have discussed the implications of this in terms of shareholders rights, particularly regarding disclosure of the company's future business plans. This may be at odds with the owner's secretive nature. Students should discuss, briefly, listing rules of the main exchanges, as well as the implications for the company in terms of trying to make dividend payments to shareholders to maintain the share price. The Sarbanes-Oxley Act should have been briefly discussed here as an example of legislative provision regarding market rules and corporate disclosure. A small point but mention could have been made of the fact that a falling share price can trigger loan covenants and require the borrower to provide additional collateral, since the value of the company has declined. This could unsettle existing lenders.

Regarding types of shares to be issued, ordinary shares could be considered but the reality is that the company will not be able to pay a good dividend until the charterparty comes on line; preference shares, preferred stock, partly paid should be discussed against this background. Marks were variable, with a significant number of candidates obtaining fail marks. Some students overlooked the fact that the company was listed on the NYSE, and accordingly, there should have been some mention of specific sections of the Sarbanes-Oxley Act; marks were lost for not at least referencing this fact. The CEO wants to keep the company's business aims secret and not to allow shareholders to question him about future plans. He cannot do this: as a public company, shareholders are entitled to have this information and to ask questions. This is not a family-owned private company. Regarding types of shares, and/or for that matter for future exam papers, it is important to know that different types can be used to entice investors when they are perhaps cautious because of the state of the market. For example, there should have been a discussion of partly paid shares and the risk to investors of holding these, preference shares, and cumulative preference shares.

Regarding a private placement, this has the advantages of saving costs associated with a prospectus and capitalising on the expertise of niche investors. But these will also be more intrusive and may demand representation at board level.

Question 6.

The topic of securitisation is predictable in this exam paper given that it draws together many themes in shipping finance including risks, structures, types of investors, and products issued (invariably, a floating rate note). There were many good diagrams, but marks were lost for not providing arrows to show directions of payments. The question was very popular, with most candidates attempting it but some gaining fail marks because of a lack of detail and in some cases omitting a diagram even though it was specifically required. An answer for such a question should begin by providing a definition of securitisation: assume the examiner knows nothing about the subject and you will not miss the easy low-lying fruit! Also, there should have been a discussion of the SPV and its purposes, and why it is included. This is, after all, intermediated finance in the sense that the SPV is positioned in between the originator and investors. If not, then it would be a straightforward bond issue by the former to the latter. The SPV should have been briefly explained in terms of the legal principle of separate legal personality, and how this makes the arrangement bankruptcy remote: if the originator fails and goes into liquidation, the cashflows do not pass to the liquidator because they have been 'sold' to the SPV.

Some students missed the point that one of the cashflows had already been charged in respect of a previous loan and accordingly could not be assigned to the SPV, not meeting all three of the cashflow criteria, which are that they must be: stable and predictable; homogenous; with the legal right to assign to a third party, this being the SPV.

Some students lost considerable marks because they did not explain how the basis point spread on the FRN can be narrowed. However, this is a vital consideration of any such issue in practical contexts. These would include:

Using the company's volatile and short-term earnings to build up a sinking fund to repay principal on maturity:

A guarantee in respect of the SPV may be given by the parent company, by cross-collateralisation over assets held elsewhere in the corporate structure.

Transfer to the SPV of shares held in the subsidiary**.**

Registering assets and vessels with the SPV.

Remember, the SPV is a shell without any assets apart from the cash flows held by it; if this is the case, what else can be added to bolster its value?

Question 7.

This question was about forms of Islamic finance and was very popular with most candidates attempting it. However, it is not a subject which can be guessed at: either a candidate knows the principal vehicles such as ijara, mudharaba, musharaka, or does not. Those who had specifically revised the principles underlying Islamic finance, and instruments, gained very high scores, with some gaining full marks. Those who attempted it without any knowledge gained very low fails, which took down their overall result.

Regarding principles, the following are relevant:

Prohibition on speculation.

Prohibition on the payment or receipt of interest.

Capital must be used for socially productive purposes.

Risk rests with the lender and not with the borrower.

Certain activities are haram or prohibited, including alcohol, pork products, and gambling.

The asset financed cannot be insured (with many exceptions).

Mudarabah. The term refers to a form of business contract in which one party brings capital and the other personal effort. The proportionate share in profit is determined by mutual agreement. But the loss, if any, is borne only by the owner of the capital, in which case the entrepreneur gets nothing for his labour. The financier is known as 'rabal-maal' and the entrepreneur as 'mudarib'. As a financing technique adopted by Islamic banks, it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, unless caused by negligence or violation of terms of the contract by the 'mudarib' is borne by the Islamic bank. The bank passes on this loss to the depositors.

Musharaka. Musharakah is a joint enterprise or partnership structure in Islamic finance in which partners share in the profits and losses of an enterprise. Since Islamic law does not permit profiting from interest in lending, musharakah allows for the financier of a project or company to achieve a return in the form of a portion of the actual profits according to a predetermined ratio. However, unlike a traditional creditor, the financier also will share in any losses should they occur, also on a pro rata basis. Musharakah is a type of shirkah al-amwal (or partnership), which in Arabic means "sharing."

Ijara Leasing. Rental payments are not permitted—instead, the lessee shares in the profitability of the asset leased. There can be no residual value insurance. The lessor cannot be compelled to buy the asset at the end of the lease.

Several students did not address the final part of the question regarding advantages and disadvantages of Islamic finance. These would include the following.

Advantages. Genuine risk sharing between lender and borrower. No security can be taken over the borrower's assets. Lender is more engaged with and supportive of the success of the venture because it has something to lose if it fails.

Disadvantages. It tends to be short-term because of the absence of security. Lender may be intrusive because they have much to lose.

Question 8.

This was a very popular question with nearly all candidates attempting it. There were a good number of candidates who achieved full marks due to the richness of the detail that they provided in their answers. There were a few fails, but this was because of a complete lack of knowledge of the lender's security.

Each form of security had to be discussed according to three criteria:

Procedure:

Risks:

Form.

Students lost marks because of a lack of awareness of procedures, for example that guarantees must be in writing and comply with section 4 Statute of Frauds 1677, and are secondary liability as opposed to indemnities which are primary and do not need to be in writing. The same goes for equitable and legal assignment of shares. There should have been a discussion of the change to the register of members if there is a legal assignment, and new certificates issued in the name of the lender. Risks would include, for example in the case of a mortgage on a vessel, that the asset or collateral will deteriorate in value; even if there is a loan to value clause in the loan, this may not be enforceable in practice if, for example, the borrower has no other assets, personal or corporate, which can be added.

Forms of security that should have been discussed included the following:

Parent guarantee. Must be in writing to comply with section 4, Statute of Frauds 1677. Only as good as the financial resources of the guarantor. There should have been a brief mention of some of the covenants in a typical guarantee.

Assignment of charterparty earnings. How do these pass through the account of the lender into that of the borrower, after interest and principal payments have been deducted?

Mortgage over vessels. What form does this take? How is it registered?

Legal or equitable assignment of shares from the borrower to the lender. Need to adjust the register of shareholders, and new certificate issued in the name of the lender.

Assignment of insurance, but this may be avoided by the insurer because there has been non-disclosure of a material fact, that the vessel has previously broken down.

Overall, an excellent set of results, giving the richness of detail required for a shipping finance exam.