Shipping Finance Examination, May 2022: Examiner's Report and Feedback.

Question 1.

This was a popular question, attempted by over half of candidates. It was the usual format for the topic covered; students were provided with scenarios and then asked to suggest which different forms of loan arrangements were appropriate, and then justify their answers. Most students were able to discuss moratorium, back-ended, bullet loans, but lost marks because they did not develop their answers to consider the risks to lenders regarding each type. Extra marks were also gained for mentioning, even if briefly, typical covenants which would be included in each type of loan; shipping finance is a highly detailed area, and granularity is the key to gaining high marks. Rational justification for a recommended course of financing, whether in debt or equity, gains marks because it shows critical thinking and not simply a 'learn and churn' approach to the subject. Students should be sure to revise, not just types of loans, but also risks, and typical covenants, as well as term.

Regarding point 1 (b), this required a brief exposition of relevant sections of the Sarbanes-Oxley Act 2001. Students should ensure that they are aware of this, not in detail, because it applies to IPOs and prospectus content for companies listing on the NYSE. There are of course other laws and regulations which are also applicable, but which will not be examined for the foreseeable future.

Question 2.

This was a straightforward question regarding the different types of shares, and the suitability of each across the stages of the shipping cycle. It was not scenario-based and was attempted by most candidates although the marks achieved were mixed, with a significant number of candidates not achieving a pass mark. This was mainly because of a failure to provide detail; some students simply described, for example, partly paid shares as shares where the investor does not have to pay all the amount due, and then left it there. As a result, some answers were just a few sentences, lacking in sufficient detail to pass.

Regarding iii., cumulative preference shares, there should have been discussion of suitability for the appropriate stage of the cycle. For example, it could be argued that the best time to issue these shares is during a recovery when the issuer may be tempted not to pay dividends because of a strategy to use cash to expand the fleet.

Regarding partly paid, it could be argued that these are best issued when investors are sceptical or wary, or do not have cash available to pay for an ordinary issue and need to be incentivised to invest. This may be during a recession or depression. Several students did not discuss the risk to investors, this being that if the issuer becomes insolvent, they will have to contribute the amount outstanding on their shares, and thereafter claim as unsecured creditors (the last to be paid).

Question 3.

This question was popular but just under half of students attempting it did not gain a pass mark. Securitisation is a technical topic, and it is not possible to guess or make an intuitive attempt at a question. That said, if the details can be mastered it is a topic which always gains a high score by those students who prepare for it. This was true in this examination round: there were some excellent marks and answers were full of relevant detail.

If revising securitisation, it is vitally important to know one's way around a standard diagram. This will give all the participants and their functions. It was surprising that some answers did not address the issue of the special purpose vehicle which intermediates between originator and inventors. There are also tax aspects concerning withholding tax which determine the location of legal registration of the SPV.

It is important to know the three qualifying criteria for cashflows before they can be securitised: homogenous, legal right to assign, and stable and predictable.

The SPV is a thinly capitalised entity the asset of which is only the cashflows assigned to it. It is essentially a shell company. To reduce the basis point spread, assets including shares may be assigned to the SPV, or insurances, or a partial guarantee from the originator. Spot market earnings can be accumulated in a sinking fund to be released to pay off in part principal on maturity of the floating rate notes which are invariably the financial product issued in a securitisation.

Previous exam papers have had a twist in the tale: part of the originator's cashflows have been previously charged in favour of a lender. As such these will not meet all three qualifying criteria and cannot be securitised.

Question 4.

This was a very descriptive question regarding the advantages and disadvantages of leasing for shipowners, and the different types of leases. Students were also required to list some standard covenants found in a lease. This question was not popular, and a significant number of students who attempted it did not pass it. There are topics in this course which are descriptive and there is no easy way around it: the detail must be learnt, perhaps as a series of bullet points which should make it easier. Students should be familiar with standard ship finance documentation: it is an examinable topic and only arises in the context of standard ship loans, leases, mortgages, and parent guarantees. It is important to know the rights and duties of lender and borrower in each case.

Question 5.

Every exam paper in recent years has had a question like this: write notes on four topics out of a list of usually six. The difficulty for some students is that sometimes they can manage two or three well, but then have not revised others appearing on the list. In this case, and if a student is struggling to find a final question to answer, it makes sense to attempt this type of question, even if one of the explanations falls short in terms of detail. Nearly all students attempted this question, with only a few not achieving pass marks and the majority gaining high marks.

Question 6.

This question was popular, with most students passing with high marks. One ship companies predominate in the shipping sector, but not to the extent as they did several decades ago. The reason for their falling out of favour is that, although owners like to use them as a way of avoiding arrest of sister ships in a fleet and to obscure true beneficial ownership, lenders do not like these structures for these very reasons. Shareholders also do not like them because of the ability of owners to divert earnings across the group. This may be achieved by creative accounting techniques, including intra group dividend payments, intra group loans, intra group sales of assets at an under or over value, and inflated management charges levied by a parent company.

Lenders may require prior to making a loan that all vessels are re-registered in one company in an acceptable jurisdiction. This will facilitate future arrest of vessels within the fleet following loan default, as well as easy enforcement of mortgages and rights arising thereunder. Insurances across the fleet should also be assigned to the lender.

Typical covenants would include:

Not to dispose of assets

To keep all vessels in a good state of repair, and insured

Not to re-register vessels in a different jurisdiction

No corporate reorganisations

Not to pay dividends

Not to take out fresh loans.

Extra marks were gained by those students who briefly mentioned the concept of separate legal personality of companies within a group, and the circumstances in which the corporate veil may be pierced (although this is rarely done by the courts).

Students should familiarise themselves with the concept of one ship companies: it is used in many contexts, including securitisation. It also has balance sheet implications for borrowers.

Question 7.

This question was attempted by most students but with a significant number not achieving passes. This was a good critical thinking question with no specific right or wrong answer: it was all about how students came to a logical position and justified it. It was an open question requiring students to discuss how debt and equity are affected across each stage of the shipping cycle. For example, it could be argued that at the peak shipowners find it easier to issue equity than during a recession because investors have got caught up in market exuberance. This is the nature of an asset bubble. In a recession, however, shareholders are reluctant to invest and must be incentivised, for example through cumulative preference shares of partly paid shares. Lenders are also reluctant at this stage because assets may still be falling in value and are as such weak forms of loan security. However, shrewd lenders will know that the best time to buy is in a recession and not at the peak when asset values are dangerously inflated. Niche lenders may be willing to finance an owner if it has secure cashflows, for example the tail-end of a charterparty, and is looking to acquire cheap tonnage sold by distressed owners or lenders which can be utilised during the recovery stage of the cycle. The last person standing after a recession is the one who will dominate the market during a recovery.

Students should also have referenced Modigliani Miller capital structure irrelevance theory in the context of this question, to deepen its analysis. MM is abstract and does not work in the 'real world' but is a useful tool.

This question is important for future candidates for this exam: it raises issues which are invariably addressed in the context of other parts of the course, for example dealing with types of loans, types of shares, and lender's security.

Question 8.

This was a standard 'list, describe, explain' question which did not require critical thinking. It was very popular, with most students achieving strong pass marks. It is essential that students should know their way around a standard ship mortgage in terms of covenants, duties, rights. This is important not just for this exam, but for working in practice, whether on the owner or lender side. It is suggested that in the future students studying for this exam should obtain a standard mortgage agreement and list these terms in bullet form for revision purposes. It is a popular exam topic, but this does not guarantee that it will come up in any future papers!

To recap.

1. Shipping finance is a details-based subject: always follow through with a full discussion and do not assume that the examiner knows anything about a topic. In this way you will not miss the easy marks- the low-hanging fruit. For example, types of shares, loans, should always look at risks to investors and lenders, and in the case of the latter, a few standard covenants.

2. Know your way around standard documentation for certain frequently used items in shipping finance, including leases, mortgages, loans, and guarantees.

3. Draw across the syllabus if you think that topics are related. For example, debt-equity balance across stages of the cycle, MM theory, separate legal personality (securitisation, and one ship companies). Financiers cannot take a blinkered approach: they must see financing arrangements in the round in terms of risks, balance sheet issues (Basel capital adequacy rules), and standard covenants to protect their position.