



2014 ICS Examiner's Report

SHIPPING FINANCE (SF)

Question 1

This answer regarding securitisation was answered well by most candidates, with some very high marks awarded. Some answers were not able to give the fundamental three qualifying qualities which cashflows must possess before they can be securitised. They must be stable and predictable, homogenous and afford the originator the legal right to assign them to a third party, in this case, the special purpose vehicle. With regard to part b) of this question, most students correctly identified the specific functions of the SPV but lost a few marks because they did not explore the concept and implications of a separate legal personality.

Specifically, the interposition of the SPV protects the originator from legal actions brought by investors in bonds issued by the SPV. Their right only lies against the SPV and not against the originator which now acts, simply, as a conduit of cashflows. Of course if the originator has partially collateralised the SPV with a guarantee, then some legal redress may arise in respect of this. The SPV also protects the investors against bankruptcy of the originator ('bankruptcy remote'); the cashflows are assets legally owned by the SPV and as such do not fall into the pot which will be collected in by the liquidator of the originator for subsequent distribution to creditors according to raking as set out in statute.

Most candidates were able to provide a good, detailed diagram although some were untidy and too small, such as arrows to show directions of cashflows and payments. With regard to the latter, from investors in payment for the bonds issued by the SPV, and coupon payments paid to them by the SPV sourced from payments received by the originator. A few candidates rightly identified the possible presence of a third party providing a swap to the SPV, thereby converting cashflows from one currency to another prior to coupon payment, or changing fixed to floating payment streams or vice versa.

Altogether a popular and well-answered question, although some marks were lost for omissions of minor detail.

Question 2

This was not a popular question, although if a candidate had learnt the basic principles of the Modigliani Miller Hypothesis this was an easy one to answer. This observation is borne out by the fact that of those who answered this question, there were some very impressive high marks awarded. That said, candidates lost marks for failing to discuss the assumptions underlying the hypothesis. Marks were also lost by candidates who simply described the hypothesis without providing any critique of it. It has been subject to substantial academic debate and a small amount of background reading around the topic would have significantly bolstered marks awarded.

There is a vast amount of discussion on the internet. Crucially, several candidates failed to contextualise the hypothesis within the shipping sector, and its well-known cyclical characteristics. The debt-equity ratio is evidently not irrelevant at different stages of the cycle and accordingly must be subject to constant review and adjustment within this dynamic environment. For example, debt may be easier to raise during the upturn when a company is more likely to be able to service interest payments from rising freight rates and earnings than it will be during the downturn when earnings are tight and ability to service debt much weakened, and the prospect of enforced liquidation at its highest. Shipping finance must take account of this cycle, and investor appetite for debt or equity which is definitely not stable at all points along the cycle. Students who placed the MM hypothesis within this context scored maximum marks.

In conclusion, this was a less popular question but one which resulted in generally higher marks by those who attempted it and were willing to apply concepts within the practical environment of shipping. The question also reinforces advice that candidates should be prepared to read around topics which are technically challenging, thereby bolstering both their knowledge and their mark.

Question 3

This was a very popular question, and very straightforward in its requirements. Marks were generally high, with some excellent, detailed diagrams provided in illustration. Surprisingly, a number of candidates failed to identify all the participants in a syndicated loan issue, omitting the underwriters, and trustee- fiscal agent. These were omissions which probably occurred because of oversight rather than absence of knowledge. It is important when discussing a financing technique, particularly where a diagram is involved, to take a breath and read again what you have written. It is very easy to miss out a crucial participant and in so-doing, lose unnecessarily some otherwise well-deserved marks. Some candidates gave more detail regarding investors, identifying possible holders of bonds issued through this form of financing; for example institutional investors such as pension funds, sovereign wealth funds.

Part b) of this question was not so well answered. Candidates tended to identify one or two risks, such as jurisdiction and the difficulty of arresting other vessels within a group. There are several other types of risk which are identified in the suggested solutions to this paper on the ICS website which should have been discussed. It is an important exam technique that if a question asks for a number of factors to be discussed, a candidate who deals with only a few of these will get low marks even if he or she deals in excellent detail with those factors raised. Sometimes a question will require a broad but shallow answer in that many issues must be discussed. In contrast, sometimes a question may ask for a few issues to be described or critiqued, but in greater depth. The importance of reading a question carefully to understand which approach is required is something which candidates must keep at the front of their minds for this and indeed all exams taken for the ICS qualification.

Question 4

This was one of the least popular questions which was a pity bearing in mind that Islamic finance is one of the fastest growing areas of finance in the world today. It is growing at approximately 15% per annum. It is already having a major impact within the shipping sector, particularly in the Middle East. This, combined with the United Kingdom's very proactive efforts to make the City of London one of the international centres for Islamic finance, for example for sukuk issues, make this a highly relevant topic for ship financiers. Results awarded to students who attempted this question were varied, with most scoring high marks but others being awarded marginal or firm fails. The main reasons for low marks were twofold. First, candidates gave only one or two principles underpinning Islamic finance, although nobody missed the prohibition against riba, but many missed the bar on speculation, or selling something which you don't yet own. Second, candidates did not explore some of the main Islamic instruments, for example, ijara or leasing, mudharabah, musharakah. Marks were also lost for not attempting to contextualise these instruments within the shipping sector, with the result that instruments were described, usually in insufficient detail, and then not followed through with practical application.

With regard to the reference to the application of Islamic finance principles within the oil sector, some candidates rightly identified the price volatility associated with this commodity, and how some forms of conventional finance link interest payments to fluctuations in an oil futures contract benchmark on one of the leading exchanges such as NYMEX. This linkage, involving a speculative element, would be prohibited within an Islamic finance framework.

Question 5

This question was unpopular, with few candidates attempting it. The results were very varied with those candidates who knew the usual covenants in a ship mortgage gaining high marks, and others completely misunderstanding the question's requirements and gaining a zero mark as a consequence. The question did not ask for the purpose of a ship mortgage to be discussed, or for consideration of its legal status. It did not require discussion of registration of mortgages, or of enforcement of this form of security. Candidates providing answers based on these issues gained very low marks. Instead it asked for standard covenants and terms to be itemised and then discussed in terms of purpose. There is a standard mortgage provided in the ICS textbook but a very basic internet search would also have found examples of standard mortgages together with principal terms. Shipping finance is a practical subject and accordingly knowledge of standard terms in a mortgage is expected of candidates. The zero marks awarded to some candidates evidences the crucial importance of reading an exam question thoroughly and meeting its specific requirements. In this way candidates avoid a usual cause of failure, this being an implicit re-writing of a question to read how it would have been preferred to have been set rather than how it was actually set.

Question 6

This was a very popular, descriptive question which gained high marks for most candidates who attempted it. Some diagrams were too general or imprecise. Diagrams should be neat, with clear identification of principal participants or components. In the context of the typical KG, candidates could have briefly discussed the issue of separate legal personality with regard to the corporate and partnership dimensions of the structure. Some candidates had evidently revised the German KG in depth, as evidenced by detailed answers in this regard, but had failed to revise at all the Norwegian equivalent and accordingly lost marks for this omission. These two structures should always be revised alongside each other. Marks were also lost for superficial discussion of the tonnage tax and its method of calculation.

Question 7

Marks were 'patchy' for this general question, although it was popular. Most candidates scored well. But a significant number ended up at the borderline pass-fail mark. It required a wide range of issues to be identified but some candidates focused on just a few, such as the implications of corruption, illiquid currencies, and unpredictable court processes for example regarding rights of arrest of vessels. Even if a few issues were discussed in excellent depth, the mark awarded could only be average if this was at the expense of a more wide-ranging discussion. Other issues which could have been considered included risk of state seizure of assets, difficulty in paying dividends between a subsidiary and its parent located in another jurisdiction, exchange controls, thin domestic equity markets, leading to a risk of insider dealing or share price manipulation and volatile domestic interest rates as a consequence of persistently high levels of inflation. When reading a question such as this, it is important to understand whether it is asking for a few issues to be discussed in depth, or many issues to be itemised and then discussed briefly. The Shipping Finance exam paper is always clear in its requirements in this regard. With regard to risk minimisation techniques, hedging methods would have included interest rate and currency swaps as well as hiving out of assets to offshore-incorporated special purpose vehicles with cashflows also accumulated offshore in a stable jurisdiction, in other words, a brief discussion of the process of securitisation.

Question 8

This was a very popular question which combined descriptive and contextualised discussion by candidates. With regard to the former, several candidates failed to discuss the embedding of put and call options within a convertible bond, and the implications of this for both issuer and investor. Conversion trigger points were also omitted in some answers.

Part b), dealing with the application of convertibles in terms of their suitability or otherwise at different points in the cycle resulted in patchy answers. Candidates should have identified, briefly, the different phases of the shipping cycle, and then discussed issues such as the attractiveness or otherwise of equity, such as high during a boom, very low during a depression when asset values are declining, and debt which is cheap during a boom, costly during a depression, during each phase. But these are generalisations which a well-informed candidate would have been able to challenge in their answer. Hot and cold months for the suitability of issuing convertibles should have been discussed, as well as the signalling implications of a busted convertible. But despite these smaller points, the marks were generally high for answers to this question.