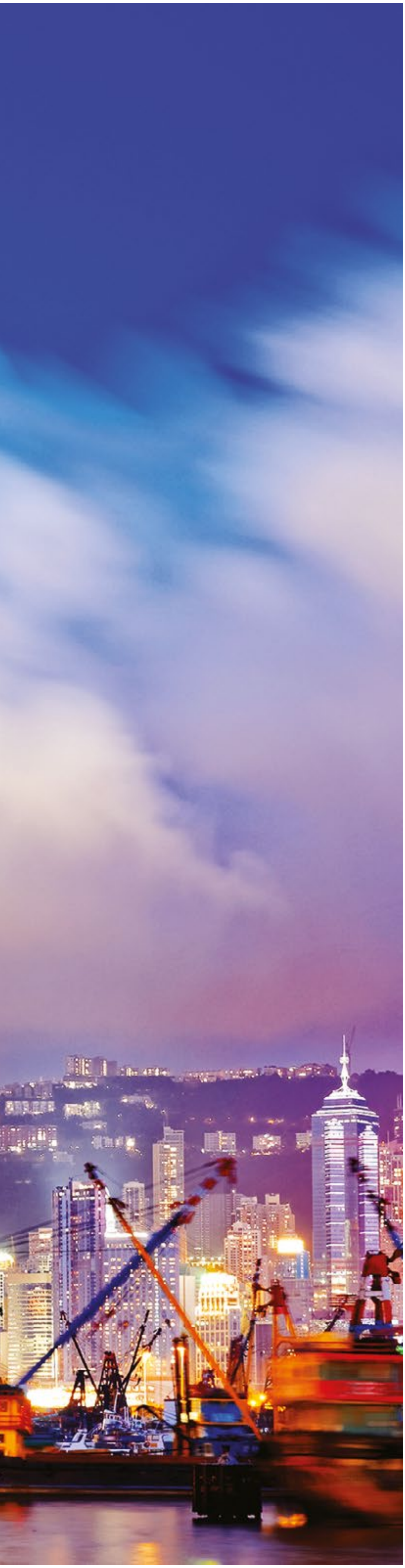
MAYER | BROWN

Guide to Shipping Finance in Hong Kong



Contents

Introduction

Preliminary

Ships are floating work-horses to some and objects of great beauty to others. They depend on their mobility for their income, but unlike other transportation assets they do not need to return to a home base, nor need they visit the same port twice. Ships can last for half a century or more without mishap, yet at the same time regularly disappear, collide and cause loss of life and widespread environmental damage. They are the cheapest means of transporting large volumes of goods, yet go up and down in value according to cycles which can be independent of other markets and difficult to predict. Different vessel types create different problems.

But one thing that is constant is that they are expensive to build and operate, which means that financial assistance is usually needed by their owners.

The business of financing ships generally involves a financial institution, be it a bank or a leasing company, lending money to a company or an individual to buy a secondhand ship or to build a new one. In a wider context, it includes the provision of short or long-term funds during the life of a ship, covering the cost of its repairs, improvements and replacements. In its broadest context, shipping finance even picks up the advance of money for non-shipping purposes, provided the common theme that binds all these types of finance together applies, namely the lender's security will be a mortgage or charge over the ship concerned and its income.

Sometimes, in order to take advantage of tax concessions or for other reasons, a bank may prefer leasing to straight financing. A typical structure would be the lender making a loan to a shipowning company (its own), which mortgages the vessel to the lender and leases it to the "real" owner. Because the lease is the source of debt service, the benefit of the lease is assigned to the lender.

What distinguishes ship financing from other types of lending is its international nature, the fact that it is, like ships themselves, not tied to geographical boundaries. A Hong Kong shipowner can easily borrow from a Chinese bank based in Tokyo to buy a second-hand ship, with the purchase money being paid in Germany. In fact, banks in London tend to see more shipping loans for Norwegian or Greek interests than local banks in those countries. Similarly, new ships are not normally built in the same country as that of the owner, and tend to involve foreign currency finance.

That foreign currency will usually be the US Dollar which has become accepted as the universal currency of shipping. A ship's income will be in US Dollars and ships tend to be bought and sold in US Dollars, so it makes commercial sense (to avoid currency fluctuations) for loans to be funded in US Dollars.

The US Dollars for ship finance primarily come from the Euro-dollar market, which is the largest international money market. London is its major financial centre in Europe, and Singapore and Hong Kong compete for the Far East. A Euro-dollar is a freely convertible currency that is held outside the control of the monetary authorities of the United States. It is a US Dollar that has been placed in banks in America at the disposal of banks outside America. In other words, the Euro-dollar market is a market in which European and other foreign banks borrow and lend, for varying periods of time, deposits in US bank branches or foreign banks located outside the U.S.A.

Ship Registration

Under English and Hong Kong law, property is classified into:

- Movables (covering goods such as furniture, cars, ships, aircraft etc., and intangible things such as debts, insurance policies, goodwill of a business, etc.); and
- Immovables (e.g., interests in land).

Usually it is only immovables that are registered. For example all land leases in Hong Kong of over three years term must be registered in the Land Office. Yet aircraft and ships also benefit from registration. The reasons for this are four-fold.

Firstly, ships are always on the move and for a large part of their life they are on the high seas outside the jurisdiction of any one country. Being very costly, their owners will want to ensure their ownership rights are well documented. Secondly, ship lenders will normally want to take security over them, and ship mortgages are difficult to enforce in many jurisdictions without physical possession unless they are registered; the registration of ships enables the registration of mortgages in most ship registers. Thirdly, ships are strategic assets of value in times of war and this is why countries wishing to exercise control over them require them to be registered. Fourthly, for economic and political reasons, countries may wish to restrict ownership of their flag ships or certain types of trade to their ships.

Types of Registry

OPEN REGISTERS

Loan officers will soon become used to the expressions "flag of convenience" or "open registers". Countries that depend heavily on revenue from shipping such as Panama, Liberia and the Marshall Islands open their registers to non-nationals. Anyone can register a ship on one of these open registers, and there does not need to be much of a link between the nationals of the flag state and the ship.

As well as being unrestricted as to ownership, open registers for the most part impose no restrictions on the nationality of the officers and crew, provided they hold the relevant seamen's certification for each flag. Crews from poorer countries are often prepared to work longer hours for less pay than a seaman from say Europe, and the cost savings can be substantial. At the same time however, owners flying a flag of convenience risk union action from the International Transport Workers' Federation (ITF), so the cost savings may come with a price attached.

NATIONAL REGISTERS

Traditionally a ship owned by a national of a particular country was registered in that country and crewed by nationals of that country. That ship was subject to the jurisdiction of the authorities of that country and was liable to requisition in time of war. In the UK for example it was not until 1988 that a British national had the option of registering his ship anywhere other than on the British register, a position which had stood since 1894. National pride has had to give way to economics in view of the uncompetitiveness that resulted from forcing the use of national registries. Nationalism brings with it protectionism of local crew's jobs and wages and high safety standards, both of which can bankrupt an owner unless his higher standards can command a better freight/charterhire rate in the market, or preferential cargo rights are made available or tax concessions are offered.

INTERNATIONAL AND OFF SHORE REGISTERS

A third type of register is a hybrid of the previous two. Typically this is either an "offshore" register in places like the Isle of Man or Cayman Islands (for UK), Netherlands Antilles (for Holland) and Kerguelen (for France) or an "international" register like the Norwegian International Ship Register (NIS) or Danish International Register of Shipping (DIRS) (for Norway and Denmark respectively). These registers either rely on their existence due to historical dependency or are set up in the home country to run parallel to the domestic register. In return for the right to requisition in time of war, less strict requirements for ownership and crewing are imposed. Both are devices to attract the registration of ships away from open registers and back to the home country.

OPERATOR AND DUAL FLAG REGISTERS

"Operator" registers for ships follow those set up for many aircraft registers. The regulations for operating, ownership and certification are designed for the operator or demise charterer and not for the beneficial owner. Hong Kong has such a category for its register and a Hong Kong operator, who may have no ownership rights to the vessel, can be registered in the register as the "owner" and fly Hong Kong flag. It is the operator that is accountable to the local maritime administration and not the owner, although to protect the owner's title his name is also entered on the register, as are any mortgages over the ship. The owner cannot register the ship elsewhere whilst the operator flies this "operator" flag.

Not to be confused, "dual flag" registers are registers allowing temporary registration of the operator at the same time as the owner's title is registered elsewhere. Panama and Liberia, amongst others, permit temporary registration elsewhere (with the Philippines being a popular choice) so as to enable the operator to obtain the benefits of cheap crew costs available there. The flag of the underlying registry is put in suspended animation for the period of the use of the temporary flag (usually two years, renewable), but the owner remains the registered owner in the underlying registry throughout. All mortgages created by the owner over the ship are registered in the register of the underlying registry, not the temporary register.

Significance of the Flag

An understanding of what each flag has to offer is essential for anyone engaged in shipping finance. Unfortunately there are over 160 shipping registers so it would be impossible to keep up to date on all of them. Each time a question as to any particular flag arises, a ship lender should check with his lawyer; hopefully the lawyer will have a network of correspondent law firms around the world and will find out the latest position. Why though should the flag be so significant to a lender?

The basic answer is that the law of the flag will determine the attributes of the ship mortgage which will be a fundamental part of the lender's security, so if the ship does not satisfy the ownership requirements at all times, its registration may be set aside and with it will go the bank's mortgage. Another factor will be the extent of regulatory interference. For example, a flag that requires its owners to withhold tax on interest payments abroad (such as the People's Republic of China and Singapore) or which imposes strict foreign exchange control (such as the People's Republic of China), may affect cash flow and make the loan uneconomic.

Some lenders have little concern about the flag chosen provided local lawyers have comforted them that their security is adequate. Others place great emphasis on the flags of their customers. The United States' ban on Panamanian flag vessels entering US ports may have lasted only a few months, and the Liberian civil war may not have affected its administration (largely contracted out to US entities operating in Virginia and New York) but political instability in both Panama and Liberia saw marked re-registrations elsewhere. A prudent ship lender should ask at least 10 questions as to the flag its customer has chosen. As a test case we have chosen Hong Kong as an example:

(i) Does the flag afford reliable and well-tested security?

The provisions of the Merchant Shipping (Registration) Ordinance govern the mortgaging of ships registered under the Hong Kong flag. The Ordinance prescribes just one form of mortgage. In effect, it secures all moneys owing (present or future) on a specified account and which are regulated by the documents mentioned in the mortgage. Bankers and shipowners are usually surprised when they see a Hong Kong form ship mortgage for the first time, for it is only one page long yet can be drafted to secure syndicated loans, guarantees, revolving credit facilities, multi-currency loans, interest rate swaps and virtually any other description of finance. The costs and expenses of the mortgagee in preparing, protecting and enforcing the security can also be covered. In order to ensure priority over subsequent mortgages, the mortgage must be registered against the register of the vessel kept at the Hong Kong Shipping Registry.

There is no need to endorse the mortgage on the ship's papers nor does the mortgage have to be carried on board the vessel. No official consents are required to mortgage a Hong Kong flag vessel to a foreign bank.

Unlike other registries, changes can be made to the terms of the loan package without the need for recording addenda, thereby saving lawyers' and registration fees, although (to be safe) we recommend that new loans be secured by a second mortgage. There is no need to even mention the sums secured. Registering a mortgage is free of charge. Hong Kong mortgages have been enforced by the Hong Kong courts and have proved to be a well-tested and reliable form of ship security. Other advantages are that, under Hong Kong law, a mortgagee is entitled to seize possession of the vessel as soon as a default arises, operate it whilst in possession and also sell the vessel privately or through the courts.

(ii) Is it complicated to register and de-register a ship mortgage?

The only document required for registration of a mortgage is the statutory form of mortgage mentioned in (i) above, duly executed. There are no lengthy application forms, no notarisations or legalisations, no translation, no bureaucratic delays and no stamp duties. Discharges of the mortgage are equally simple, involving the execution of a single page statutory form.

This is not to say that parties other than the mortgagee would find it easy to discharge a mortgage, because the original mortgage deed has to be attached to the discharge. The sale of the vessel to an unqualified person without the consent of the mortgagee, or the striking off of the owner's name from the Hong Kong Companies Registry (e.g., where a non-Hong Kong owning company registered under Part 16 of the Companies Ordinance ceases to have a place of business in Hong Kong) will not operate to discharge a mortgage from the Register. Similarly, deletion of a ship from the Register is not possible without the consent of all mortgagees or by a court order.

(iii) *Does the country of the flag have a reliable and respectable legal system?*

In 1997 China resumed sovereignty over Hong Kong and the Basic Law came into effect. The Basic Law specifically provides that Hong Kong's existing legal system shall survive the transfer of sovereignty from Britain to China.

The law and legal system of Hong Kong is based on that of England supplemented by local legislation and Chinese customs. Hong Kong's legal profession is divided between barristers and solicitors.

The language in the courts is English. Small claims and disputes are handled by tribunals, with larger claims being heard in the District Courts and the High Court, which is comprised of a Court of First Instance and a Court of Appeal. Admiralty actions can only be commenced in the High Court. The highest court in the judicial hierarchy for Hong Kong is the Court of Final Appeal. Hong Kong now has an internationally recognised arbitration centre.

Ship arrests are handled by a bailiff acting upon warrants of arrest issued out of an Admiralty Court. Hong Kong has proved to be a reliable and efficient port to recover debts by means of ship arrests. A mortgagee can arrest a defaulting owner's ship in Hong Kong very simply and enforce its security quickly and cheaply. An uncontested arrest and court sale of a mortgaged vessel can be completed in just eight weeks.

(iv) *Does the flag suffer from strikes, boycotts, or industrial action?*

Owners of Hong Kong flag vessels can expect few problems with the ITF and other seamens' unions, because traditionally Hong Kong ships are beneficially owned or managed by Hong Kong based operators. The ITF does not consider the Hong Kong Register to be a flag of convenience.

(v) *Are the vessel's trading limits affected by the flag?*

There are no restrictions regarding the employment or chartering of Hong Kong flag vessels nor are there any ports that currently restrict Hong Kong flag vessels, save for certain Arab ports that have blacklisted the entry of all vessels (regardless of flag) that have previously traded to Israeli ports.

As Hong Kong is bound by any United Nations sanctions, it is however necessary for shipowners to check the list of countries where Hong Kong companies are probited from trading.

(vi) *Does the country of the flag enjoy political stability?*

On 1 July 1997, Hong Kong became a special administrative region of China. The transfer of sovereignty has proceeded smoothly and Hong Kong enjoys great political and economic freedom and stability. This reflects the provisions of the Basic Law which is Hong Kong's constitution. The Basic Law provides that Hong Kong's capitalist system and way of life shall remain unchanged for 50 years (i.e., until 30 June 2047).

Given the importance of shipping to Hong Kong there are specific provisions in the Basic Law relating to shipping and to the register. The Hong Kong Special Administrative Region will continue to maintain its own shipping register and issue related certificates under its own legislation in the name of "Hong Kong, China".

The Joint Declaration signed by the UK and PRC Governments in 1984 (an international agreement legally binding in all its parts and constituting the highest form of commitment between two sovereign states) preserves the current social, economic and legal systems in Hong Kong for 50 years beyond 1997.

(vii) *Does the flag offer any preferential treatment to shipowners?*

As one of the world's best known free trade entrepots, it is currently not Hong Kong's policy to offer preferential treatment to Hong Kong flag vessels for the carriage of goods. Hong Kong is an "open" territory and imposes no restrictions or discriminatory practices against the entry of commercial vessels, whatever the flag, to the port of Hong Kong. There are no exchange controls, nor are there central bank or governmental restrictions. Money can be freely transferred in any currency without the need for permits.

Fiscally, Hong Kong is regarded as tax-benign. Shipowners operating ocean-going Hong Kong flag vessels are exempted from paying tax on their shipping income. Withholding tax has been abolished. There is no tax payable on dividend income nor are capital gains taxed. Stamp duty is restricted to land and stock transfers.

(viii) How good is the flag's safety record?

Ship financiers should consider the implications of one of their financed vessels being involved in a major environmental disaster such as an oil spill. The Hong Kong Marine Department exercises a tight control on manning requirements (following IMO guidelines), the training and certification of its seamen, and the surveying of the vessels which fly Hong Kong flag. Hong Kong's safety record is exemplary and flows in part from its adoption of the many safety conventions including the 1974 International Convention for the Safety of Life at Sea with 1978 SOLAS protocol, the 1995 Amendment to the Convention for the Standards of Training, Certification and Watchkeeping for Seafarers and the International Convention for the Prevention of Pollution from Ships (MARPOL 73/78/97).

(ix) How accessible is the country of the flag?

Readily accessible both by sea and air, Hong Kong also has extensive and modern communication links with the rest of the world. Once in possession of the appropriate visa, immigration formalities for an owner's crew are fast and efficient.

Hong Kong has one of the world's busiest container ports and air cargo terminals.

(x) Does the flag have high registration fees or tonnage taxes?

Initial registration fees are calculated on the gross tonnage size of the vessel. In addition an annual charge is imposed, determined according to net tonnage, although a discount system exists for the longer a vessel remains on the register without detentions from any port state control regime. They are competitive with other leading flags such as Liberia, Panama and the Marshall Islands.

Ownership Structures

GROUP OWNERSHIP

Major shipowners, particularly passenger, ferry and container line owners, regard the common ownership of their ships under a single entity as crucial to their corporate identity and status in national and international shipping circles. There are undoubted administrative advantages in running one company with just one set of accounts and having one set of directors; there is an increase in reliability and trust with suppliers and lenders.

THE ONE-SHIP COMPANY

In most instances the flag will dictate that the ownership of the vessel must vest in a company set up in the same jurisdiction. This applies with national and "open" registers alike. Thus a Liberian flag vessel must (unless specifically exempted) be owned by a Liberian company, and a Sri Lankan flag vessel by a Sri Lankan company. The main reason however for setting up a separate single-purpose company to own each ship concerns arrest.

Although rules differ between jurisdictions (particularly in South Africa and the United States), the separate legal personality of each company is respected enough to prevent a ship, beneficially owned by the same person, from being arrested to meet the debts incurred by another "sister" ship. The advantage for a ship lender in having to deal with a different borrower each time (in some cases a shelf company set up the day before) is that a ship can be made more or less immune from the debts of other ships in the customer's fleet, thereby minimising the risk of arrest by others and the seizing of earnings needed to service its loan debt.

Equally however, the bank must not lose sight of the fact that it is lending to a company with no assets other than the ship it is financing. Special attention must be paid to ensuring the company is correctly incorporated, and where the bank is not satisfied with the standard security of a mortgage and assignments of earnings and insurances (for more of which see the section A *Typical Ship Finance Package* later), then additional security may have to be obtained in the form of a parent guarantee, sister-ship mortgages and the like.

How to Test the Bank's Commitment

The Bank's View

A meeting between the shipowner and his banker may not get past the initial greetings stage unless the bank as an entity has already decided to commit itself to the industry. Shipping risk is generally considered to be at the high end of the commercial risk spectrum. The reasons for this include:

- The cyclical nature of the industry (three major recessions in 1974, 1985 and 2008)
- The potential for adverse publicity and uninsured losses arising from oil pollution and other environmental disasters (particularly for oil tankers)
- The complexity of documentation
- The need for trained staff specialised in ship finance (that is, capable of analysing the links between shipping and global economic fundamentals)
- The high level of loan funding flexibility (particularly during recessions) and
- The relatively large sums involved and the long-term nature of the risk.

Risk Analysis

Shipping is an industry that is competitive and capital-intensive. Rigorous analysis of the risks attached to shipping finance is necessary. Of the methods that are used many are outdated and most are misunderstood. It is an exact science for accountants, investment advisers and chartists and too complex for this brochure, mainly because of the variables (see later) that can apply.

By way of example, a common method to evaluate the size of the loan and optimum loan period is the "Payback Period Method". Here one simply adds up the ship's annual revenue, subtracts the average annual operating costs and divides the balance by 12, to come up with a monthly cash flow figure (after making adjustments based on intuition and variables). Debt service is added in as an expense and the project with the shortest payback period is deemed the one that should be accepted. The loan application is sent to the bank's credit committee, who make the final decision.

This method makes allowance for risk attitudes in the sense that a risk-averse shipowner will choose the project that returns his money as quickly as possible. But the payback method can also be misleading. Firstly, it ignores cash flow generated by the ship beyond the payback period. It over-emphasises liquidity and neglects the long-term earning ability of the asset; the ship does not stop earning on maturity and so the value of its future earnings should be added into the risk factor as a discount.

Each bank will have its own methodology so as to ensure that the shipowner can service its loan, meet the ship's operating expenses and leave a small surplus for growth and/or emergencies. Naturally the ship's operating expenses have to be paid first because a vessel that breaks down through lack of maintenance, or that is seized for non-payment of bills, is a non-income producing asset, leaving the debt unserviced. What makes the risk analysis a fascinating process is the degree of intuition or variables applied to the analysis.

Variables

(i) Growth or decline in world seaborne trade (will affect freight rates).

(ii) Size of world fleet (will determine overtonnaging and influence freight rates).

(iii Number of ships laid up, or being scrapped, or on order (same as (ii)).

(iv) Expectancy of harvest failures (will affect rice and grain shipments).

(v) Regional or global industrialisation (will affect iron ore and steel shipments).

(vi) Infusion of stock market profits or shipping funds (will affect values).

(vii) Level of governmental subsidies, tax incentives (e.g., Scandinavian K/S partnerships, same as (vi)).

(viii) Interest rate fluctuations (increases will affect debt service).

(ix) Currency exchange rate fluctuations (same as (viii)).

(x) World new building and scrapping capacity (reductions will encourage speculative ordering).

(xi) Oil prices (will affect operating expenses).

(xii) War (will reduce seaborne trade and lower freight rates).

These are the most common variables for dry cargo vessels. Special variables will apply to other vessel types (e.g., tourist growth, currency strength and spending power will affect passenger vessels and ferries, while eco-related legislation will gradually affect the trading range of older vessels). Ship lenders are working more and more with professional ship valuers and ship brokers. Some have employed professional ship brokers as part of their ship finance team. A prudent ship lender will keep a close watch on all these factors both before a loan application and during the loan period, to ensure it does not lend too much at the wrong end of a cycle, and takes anticipatory action to reschedule if that happens.

Reward Analysis

Whether shipping finance takes the form of conventional loan finance, leasing or equity participation, the rates of return can be immensely profitable in the form of:

- Arrangement or "front-end" fees
- Prepayment or "tail-end" fees
- Margins on lending or "spreads"
- Commitment fees for making the funds available over a long period (e.g., for multiple advances) and
- Profit-sharing in sale or insurance proceeds.

Each bank will have its own charts showing the movement of spreads. In the 1970's shipping was considered an excellent credit risk (particularly in the Far East, where Hong Kong shipowners pioneered the use of the long-term charter called "Tie-in" or shikumisen deals, that saw surplus cash-flow virtually guaranteed for periods of 10 years or more) and so spreads were low over that period.

As a general rule however, spreads are inextricably linked to the availability of funds on domestic and interbank markets and to the capital adequacy rules imposed by the Basle Convergence Agreement (published by the Bank of International Settlement (BIS)). If liquidity is plentiful, spreads will decrease and vice versa. But if a bank is struggling to ensure that its own cash reserves are sufficient for the loans it has outstanding, then it does not matter if it has surplus funds; it will probably only lend funds for shipping if the returns help it maintain the required level of capital adequacy.

The BIS agreement requires banks with a European base to hold a certain percentage of their assets as capital, as does the Hong Kong Monetary Authority for Hong Kong banks and the People's Bank of China for PRC banks. The assets are weighted according to their perceived risk and borrowers are weighted according to whether they have a rating from the rating agencies.

Good customers with sound reputations deserve better terms than new, untried customers. Equally, heavily capitalised entrants who are prepared to inject a large percentage of their own funds on a recourse basis (with guarantees), deserve better terms than those who want to borrow on a non-recourse basis. It is a matter of policy for each bank to choose, whether lending to consistently blue-chip customers will give it the rates of return it desires, or whether a mix of customers in its portfolio is preferable.

The Borrower's View

Reduced world seaborne trade and tonnage oversupply are two events that periodically affect ship prices or their earning capacity, but in 2008 the shipping community had to contend with a collapse of the international banking system, exacerbated in 2014 by a collapse in oil prices which forced the de-commissioning of off-shore oil rigs and their support vessels.

For many borrowers this was a worrying time. Many had given security maintenance covenants in their loan documents that could not be met. Some vessels had to be taken back by their lenders and most loans had to be re-scheduled, but a low interest rate environment at the time meant that most loans could still be serviced.

Compare this to what happened in the previous recession in 1986 when the reaction of most banks to loan defaults was to arrest their mortgaged ships and sell them either privately or through the courts. These multiple ship arrests had the result of depressing values still further. The Scandinavian and Japanese banks that refinanced their customers and wrote down their losses on their books whilst maintaining their shipping loans, made windfall profits.

In 2008, this lesson had been learned so despite the financial market collapsing far fewer vessels were arrested to settle their debts. Increases in capital requirements for banks coupled with de-risking their portfolios, resulted in sources of long-term finance contracting, and an absence of buyers no doubt played a part, but the result was that valuation breaches were waived and even payment defaults were overlooked in favour of avoiding ship arrests and maintaining stability in book values. As a result, there was not a deluge of distressed assets being sold at deeply discounted prices.

Ship finance is no longer a one-sided relationship. A shipowner will want to know that his bank has the same commitment to shipping as himself. Ultimately, a shipowner with a choice will only borrow from a bank with a strong balance sheet and proven track record of supporting its borrowers.

How to Test the Shipowner's Commitment

Despite the Baltic Dry Index falling to its lowest level (hitting 291 points in 2016) leading to new building orders slumping to their lowest level in over twenty years, shipowners know that some things never change; approximately 90% of all goods traded continue to be transported by sea and ships need to be overhauled and replaced. Ship finance is constantly needed, so assuming the bank has decided to operate a ship lending department, what are the steps to take when a shipowner appears at the counter and requests a loan to finance the acquisition of a ship?

Known in the trade as the five "C's," the bank officer will have to build up a profile of the customer's commitment to the industry (character), his operating risks (cash flow), his financial standing (condition), the level of his own investment (capital) and the security he can offer the bank (collateral).

Character

Firstly, does the shipowner have a reputation? The shipping community is small in the sense that people employed in it – be they owners, managers, underwriters, brokers, repairers, bankers, lawyers – all know or know of each other. An owner's reputation can often be gleaned from discreet enquiry in the market place (does he maintain his ships properly, is he financially shrewd, does he pay his bills, is he respected in the trade?). A bank would be foolish not to carry out some "due diligence" investigation of the shipowner before committing itself to any loan.

Secondly, does the shipowner have a management team? Managerial capacity is the most important factor in shipping credit analysis. Without continued management commitment, even the most well-conceived projects fail to reach completion. It is not easy for a loan officer to quantify management but these are the types of questions that will help assess their character.

(i) *Does that team have a track record?*

What is the combined years of experience of the team? Has the company been a profitable ship operator? Has it ever run into trouble? If so why, and was the trouble avoidable? Did it survive and has it learned lessons? Does it have a long-term strategy? Is the strategy achievable in a realistic manner? Do control systems exist and are they effective?

(ii) *Is the management team honest and hard-working?*

Is integrity taken seriously? Is a formalised management system with regular meetings, written reports, targets, etc. in place? Has succession been provided for? Do they communicate openly? Are they likely to liaise in a timely manner with their banks?

(iii) *What is the corporate structure of the shipowner?*

Is it a state-owned company, privately limited, publicly-listed, family-run, or perhaps a combination? Can the shipowner still operate if a key member is absent?

(iv) *What trade does the shipowner operate in?*

Oil, liner (i.e., containers), bulk, inter-island, tramping, passenger, offshore drilling? How well does it know and market its specialty? Does it do its own operating, crewing and charter broking or does it contract out to third parties?

(v) *What is the management's appetite for risk?*

Is it about to embark on a major expansion plan? Does it regard shipping as cargo transportation or an investment opportunity? Does it have ambitions and are they realistic?

Each bank will have other criteria to help it develop a "feel" for its customer. *Guiding Principle No.1* is that if the bank does business with a company which lacks integrity, commitment and professionalism, sooner or later those missing ingredients will cause an increase in account management time for its loan officers and expose the bank to the likelihood of financial loss.

Cash Flow

The success of Hong Kong owners, at one stage the world's third largest shipowning and ship-operating group, arose out of the security of cash flow. This cash flow supported 80% vessel finance for periods of 8-10 years and was in the form of long-term charters to substantial charterers. Whilst profit during the operation of the vessel under the charter was relatively small, cash flow was continuous, was sufficient to service bank debts and maintenance costs, and left the residual value of the vessel after expiry of the charter as a pure capital gain.

The weakness of the long-term charter was that because of its fixed income nature, inflation of operating expenses and interest rate fluctuations in bank financing could wipe out the expected small cash flow surplus. Charters that were once paying charterhire at market rates, became much cheaper as against what other vessels in the market were achieving because they failed to contain escalation clauses. The banker of the future will have to analyse the overall economic environment within the projected period of the financing.

(i) *What is the present and future trade pattern for that type of ship?*

What is the regional pattern? What is the global pattern? Will its trade be taken over by larger, more fuel-efficient vessels, or will the capital cost be so high that smaller vessels will dominate? Are there changes in consumer demand for the specific commodities carried by that type of vessel? Will air freight, road or rail be a competitor? Will transhipment centres move their base? Are ports likely to become congested? Can it be assumed that grain and rice harvests will improve? Are countries within the ship's trading range becoming more industrialised, corrupt, politically unstable? Are sizes of traditional cargoes increasing or decreasing? Are the ports in its trading pattern subject to union action, government corruption, theft?

(ii) *What is the supply and demand situation for that type of vessel?*

Is there an excess of tonnage, regionally/globally? Is the vessel easily employable (e.g., does it have special characteristics, such as a shallow draft or cargo-handling gear (allowing it access to more ports), or fuel efficient engines that will command a premium from end-users)?

(iii) *What is the vessel's earning capacity?*

Does it work in a competitive trade (e.g., container liner or offshore sector)? What are the daily running costs? What is the average freight rate for that vessel at the time and how do they compare with running costs? What do the vessel's trading records reveal (if second-hand)? Is she often under repair? Is the vessel black-listed from any ports (thus affecting its trading range)? Does it have speed or excessive fuel-burning deficiencies? Does the flag (e.g., flags of convenience) suffer from strikes, boycotts or industrial action? Does the flag offer any tax "holidays" or other preferential treatment to shipowners? Does the flag have high registration fees or tonnage taxes?

(iv) *Does the vessel have a charterparty or contract of affreightment in place?*

What is the creditworthiness of the charterer or shipper (see the subsection Character above)? Does the charterparty have provisions allowing for escalation of the charterhire rate (so as to cover increases in operating expenses) or by a link to the Baltic Dry Index (to average out increases in global rates as well as drops)? Can it be cancelled early? Does it have payment of hidden commissions? Are the off-hire provisions unduly burdensome for the owner?

One of the more valuable lessons learned from the last recession is that lending based upon pure asset values, without caring about earning potential, is unsound banking practice. Although it was a widely held belief that inflation and past scrap steel price levels would ensure a minimum or "floor" price for vessels, experience has shown that floor prices can easily be breached.

A prospective customer must now come prepared to discuss in detail his analysis of the particular vessel's future earning capacity, and that of his fleet if he has more than one. *Guiding Principle No.2* is that cash flow repays loans; accounting profits are not the same as cash.

Condition

The financial condition of a shipping company is not always easy to assess from its accounts. But what if there are no accounts, or the company is controlled by a government or is family-run, where detailed financial information or detailed explanations of items on balance sheets are not given? A thorough understanding of the borrowing company's condition is indispensable to the bank's credit decision. To facilitate this analysis, a bank will normally require financial statements for the previous three years to ascertain its debt to worth ratio, profitability, cash flow and debt service capacity.

(i) How does the shipowner present its request for funds?

Does it produce financial statements, balance sheets, cost estimates and cashflow charts? Are the accounts audited by professionals or are they only in-house management records? Are the financial records presented in a structured fashion or are they only a few numbers written in haste on scrap paper? Does the company provide full disclosure of its financial condition?

(ii) Could the shipowner conceivably go public one day?

Does financial planning rank high in the priorities of management? Do management take all the decisions or do they use accountants, lawyers and tax advisers?

(iii) What do the accounts reveal?

Is the debt to worth ratio high for that type of business (e.g., as a guide 1:1 for a spot operator and 3:1 for an owner with ships on long-term charter)? Is the company too diversified or not diversified enough? Is the company profitable? Are operating expenses in line with inflation? Have problem areas been disguised?

(iv) How does the shipowner compare with similar companies in the industry?

Is the company's performance better or worse than its competitors? What are the company's commitments in shipping and/or other businesses (e.g., is the shipowner committed to large-scale borrowing due to a new-building programme)? What are the company's charter commitments? Is too high a proportion of tonnage chartered-in or chartered-out? Is the company over dependant on one of its charterers?

The amount and terms of a bank's loan should be reasonable for the purpose of the project and the size and financial strength of the shipowner. *Guiding Principle No.3* is that the quality of the financial disclosure will greatly enhance the company's ability to obtain long-term finance, and may also affect a bank's pricing.

Capital

Because of economic uncertainties, shipowners desire as long a loan period as possible with the minimum amount of equity or capital investment. This puts the shipowner and the bank on opposite sides of the fence, particularly since the days of 10 year loan periods for 90% finance have long since passed. Banks are looking for ways to reduce this exposure, as are their regulatory authorities.

(i) How much equity will shareholders invest in the project?

Assuming 70% finance to be a comfortable level, can the shareholders raise the remaining 30% in cash? Do the shareholders have other cash or convertible securities that can be placed with the bank? Do members of their family have deposit accounts that can be moved to the bank?

(ii) *Can equity be raised from other sources?*

If the shipowner is publicly-listed, can it add equity from other sources? Does the company have access to income or credit from sources that will not require security? If the bank is willing to lend more than 70% (say to increase its yield) will the shipowner offer a share of the vessel's residual value upon maturity of the loan?

Guiding Principle No. 4 is that a prudent bank should only make loans for projects in which the borrower has made a significant capital investment (which it has already advanced or has available before the bank loan) and which the borrower is prepared to lose if the loan is not repaid.

Collateral

Last, but by no means least, in the loan officer's analysis is the value of the collateral offered to support the loan request. The bank should assess the asset risk, as a separate exercise from the vessel's trading prospects or "operating" risk (already looked at under the subsection *Cash flow* above, although some overlapping does tend to occur, because in the event of a default the bank may wish to operate or sell the vessel in order to recover its money).

(i) *What is the market value of the vessel being constructed/purchased?*

Can the shipowner supply written details of the ship's present condition, scrap value, current market value? What is the expected future market value for vessels of this type? Does it depreciate in value quickly or is its residual value likely to be low due to hard wear and tear (e.g., log carriers)? Will environmental legislation make the vessel obsolete or severely limit its trading opportunities by loan maturity? Are there too many ships of the same type?

(ii) *What is the reliability and quality of the bank's ship mortgage?*

Does the flag afford reliable and well-tested security? Is it complicated to register and de-register the ship mortgage? Does the country of the flag have a reliable legal system and does it enjoy political stability? (see the subsection *Significance of the Flag* earlier).

(iii) *Will the loan be non-recourse or with guarantees?*

What is the creditworthiness of the guarantor? Will it support its guarantee with sister ship mortgages or other security? Will the shipowner agree to a "top-up" security clause agreeing to keep the ratio of loan to vessel value constant?

(iv) *What other security can be provided?*

Can the shipowner supply assignments of charterhire and insurances, charges of shares or cash collateral or mortgages of other assets such as real property or sister vessels?

Guiding Principle No. 5 is that ship values do tend to fluctuate so, although important, collateral should not be the sole reason for lending. It must be looked at as just one part (along with the other four "C's") of the customer's profile.

A Typical Ship Finance Package

Second-Hand Vessels

(i) Loan agreement

Once the loan application is approved it is normal for the terms of the offer letter to be set out in a loan agreement, specially designed by the bank's lawyers for the purpose, although some banks use their own printed forms. The major features of a loan agreement will describe the borrower (usually a company incorporated in the state of the vessel's flag), the amount of the loan, the terms and conditions of its advance, the repayment terms, the level of interest and choice of interest periods, and events of default. There are many other miscellaneous clauses, collectively known as "boiler-plate" clauses, which are usually inserted, obliging the borrower to supply copies of financial records, stating the governing law, and so on.

(ii) Ship mortgage

This will vary from flag to flag because each flag has its own recommended form. In some cases, such as for Hong Kong flag, a single page statutory form can only be used. The mortgage will have to be registered in the registry of the flag state, and the bank's lawyers or their overseas correspondents will attend to this. Put simply, a ship mortgage is a charge over the ship which enables the bank on default by the shipowner to take possession (and either operate the ship using its income to service the debt or sell the ship by private sale) or arrest the ship and sell it through the courts.

Although the priority of a mortgagee varies between jurisdictions, under Hong Kong law a mortgagee will receive its share of the sale proceeds before suppliers of bunkers and provisions, repairers and cargo owners (who may have claims for damaged or lost cargo), but will rank after claims for wages by crew, port dues, salvage and collision damage.

It is possible, with careful planning, to ensure that the bank's mortgage is registered at the same time as the loan monies are advanced, so that at no time is the bank unsecured.

(iii) Assignment of earnings and requisition compensation

The principal source of earnings for a vessel will be the sums payable to the owner for the use of the vessel by charterers. It is these earnings that a bank will look to as the source of repayment of its loan and interest. This security document assigns to the bank all the owner's right to receive the vessel's earnings.

The assignment will specify an account at the bank opened in the shipowner's or the bank's name into which the earnings are to be paid. The charterer is served a written notice as to the details of the account, which he then acknowledges.

The bank then monitors the income flow through the account. If the loan is not in default it releases the earnings into an operating account, also opened at the bank, out of which the vessel's operating expenses are settled. It is usual nowadays for the bank to keep back a portion of the earnings in an interest-bearing retention account until the next principal or interest payment falls due.

A well-drafted assignment will include in its definition of earnings, one-off payments received by the owner such as damages payable by the charterer for breach, or salvage monies, and even swap gains. In addition it will include requisition compensation, which is the compensation paid by the government of the flag state for buying or hiring the vessel in times of war.

(iv) Assignment of insurances

An insurance contract is a contract of indemnity for loss. This can arise from the accidental happening of any of the perils named in the policy. Ships regularly sink, have accidents and require major overhauls, all of which result in them ceasing to earn income to service the bank's debt. Ship lenders take an assignment of the insurances to ensure that they receive the insurance proceeds upon a loss. This form of security is, like the mortgage, vitally important and should always be taken.

It is also the norm in current ship security packages to obtain a letter of undertaking from the brokers, underwriters and P & I Clubs addressed to the bank, promising to notify the bank if the insurance premium is not paid or if the insurance policy is not renewed.

A bank should be certain that the insurance brokers, underwriters and P & I Clubs used are first class and highly reputable and it is common practice to use an independent insurance adviser to issue a report that the insurance cover is satisfactory.

(v) Guarantee

Largely due to the widespread use of the one-ship company, which has no assets other than the ship it is buying, banks will normally ask for a guarantee from the parent company or the individuals who hold the shares in the borrowing company.

The expression "non recourse" is taken to mean a loan which is not guaranteed.

Guarantees are complex documents and the reason for their length is to minimise the defences available to guarantors (evolving out of the large number of cases that have gone to court arguing over their terms). One guiding principle for every bank officer to remember is that they are construed strictly, with nothing implied in the beneficiary's favour; notwithstanding the ease with which guarantees are signed, it is by far the most litigious document in the ship security package. If a court can take the side of the guarantor it will do so, therefore its content must be exact, and the power of the guarantor carefully checked before signing, to avoid it being set aside.

Guarantees from individuals require a warning notice to be given, advising as to the risks and recommending the guarantor takes separate legal advice.

(vi) Mortgage or Charge of Shares

This document mortgages or, more commonly, charges in favour of the bank the customer's shares in his shipowning company. It will enable the bank to transfer the shares in the shipowner to the bank (or its nominee) in the event of default. To "step into the shoes" of the owner can be of benefit in order to keep a lucrative charterparty in existence, which might otherwise be terminated due to the bank's intervention. It also gives the bank the flexibility, if it wishes, of selling the shares in the company, rather than the ship itself, to third parties. Whilst this can save re-registration fees for the purchaser, he usually takes on the unknown factor of that company's world-wide debts and this will deflate the price the bank can achieve.

New Vessels

(i) Loan agreement

A loan agreement for a vessel under construction will contain the same features as for a second-hand vessel, although the security documents will be different and the terms and conditions of the loan's advance will be closely related to the pre-delivery stage payments payable to the builder under the shipbuilding contract.

(ii) Maritime mortgage

The availability of a mortgage over an unfinished ship depends in most cases upon whether title or property in the ship passes to the shipowner with each pre-delivery stage payment. In those countries that permit such mortgages (e.g., Italy, Greece, Belgium, Norway and Denmark), they must be registered. In England, property does pass to the ship owner as the building progresses, but the UK Merchant Shipping Act does not regard an uncompleted vessel as a "ship", so a maritime mortgage in Britain is not possible. It is necessary to use some other form of floating charge or hypothecation. As Far Eastern shipyards tend not to pass title until delivery, mortgages over newbuildings are uncommon, although the People's Republic of China allows mortgages to be registered over vessels under construction.

(iii) Assignment of shipbuilding contract

More usually it is not possible to obtain a mortgage because property and title in the unfinished ship remains with the builder. Instead the security will comprise of an assignment of the benefit of the building contract (principally the right to call on the builder to finish construction).

(iv) Assignment of refund guarantee

Often a shipyard will provide a bank guarantee to its buyer, the shipowner, as security for its obligation contained in the shipbuilding contract to refund the pre-delivery instalments, should the vessel never be finished. It is common security for construction finance that this type of guarantee, called a "refund guarantee", is assigned to the bank thereby entitling it to call on the refund guarantor following a default of the builder. Care should be taken to ensure the refund guarantee also covers the shipyard going bankrupt.

(v) Guarantee

Construction finance is often risky because the security is unlikely to be worth much in the builder's yard unless the bank is willing to finance the completion of the construction. New building loans are therefore supported by other security until completion of the vessel, and where a guarantee is required the same points raised in item (v) of the subsection *Second-hand vessels* above apply equally here. Other security may include property mortgages, sister-ship mortgages or cash collateral.

(vi) Mortgage or Charge of Shares

The same reasoning as given in item (vi) of the previous subsection *Second-hand vessels* applies equally with construction finance. A right to step into the shoes of the buying company will in some cases ease enforcement rights against the shipbuilder.