THE NORTHERN SHIPPING ROUTES: A FINANCIER'S PERSPECTIVE

The seemingly irreversible increase in the world's temperature caused by climate change is opening up certain Northern shipping routes previously blocked by ice, raising new issues for financiers active in the asset backed finance sector. The potential savings in time and fuel (even with current low bunker fuel prices) appear compelling for owner/operators; however the inherent risks associated with these inhospitable areas causes additional concerns and considerations for an already fragile sector.

LOOKING FIRST AT THE OBVIOUS ISSUES AFFECTING ANY VESSEL TRADING THESE ROUTES:

Vessels trading to a region internationally designated as an ice prone area by insurers will expressly or implicitly include policy warranties stating that the vessel is constructed with sufficient strength to withstand the conditions at the time of the transit (known as "ice classed"). A consequential loss to financiers of a collateral asset caused by a declinature or a compromised (i.e. reduced) settlement due to non-compliance with this warranty would, in normal circumstances, be reimbursable to the financier by way of a claim under their mortgagees interest insurance policy.

Insurers underwriting the owners/operators policy may typically also exclude transits to excluded areas unless specific prior agreement is obtained in advance and additional conditions/premiums are mutually agreed and complied with. Failure to do so could result in the insurance on the collateral asset being terminated or suspended for the duration of the "breach voyage". Again a consequential loss to financiers of a collateral asset resulting from a declinature or a compromised (i.e. reduced) settlement by primary insurers due to non-compliance with such a warranty would, in normal circumstances, be reimbursable to the financier by way of a claim under their mortgagees interest insurance.

It should also be noted that insurers will, on occasions, require a condition survey to be carried out on the vessel both prior to the voyage and immediately after the voyage. This should be borne in mind as this will cause a period of downtime possibly not originally envisaged.

In both the above instances to recover from a mortgagees interest insurance policy, financiers will be required to demonstrate to their mortgagees interest insurers that they were unaware that a breach voyage had been undertaken without the necessary precautions and that they had taken reasonable steps to ensure the collateral asset was adequately insured for the duration of the loan period. Mortgagees interest insurers would typically respond to a proven loss based on the outstanding loan amount at the time of claim agreement plus a further proven amount pre specified by financiers to reflect the potential additional losses (costs/ interest etc.) that the financier would suffer in the event of a declined claim on the primary policy and a consequential claim on the mortgagees interest policy.

Other less obvious operational risks are associated with transits through remote areas subject to extreme weather conditions under the jurisdiction of politically less stable regimes, for example:

Weather conditions are extreme, in terms of ice, fog, and unforeseen storms. These all increase the likelihood of a claim and possible declinature by the primary insurers.

Ports of refuge and repair capabilities are far fewer than on established trading routes. Both these factors increase the potential increase in repair costs and downtime delaying the return to revenue generation by the collateral asset against which the financier has lent funds.

Modern navigational aids will not work in extreme northern latitudes leaving the master and crew reliant on previous generation navigational skills.

Charts for these newly accessible regions are non-existent or at least largely non-existent when compared to established trading routes.

Pollution response capabilities are vastly inferior to established trading routes. When coupled with the extreme weather conditions and the relatively small window when the area is accessible there is the potential the cost and effect of even a small spill will greatly increase.

The pollution issue is compounded further by the lesser effect of the detergents used to dispel oil spills in extreme weather. Even spotting and tracking spills will be much harder in areas prone to these extreme weather conditions. Furthermore due to the ever present threat of ice blockage at any time, a spill may be allowed to disperse under the ice pack greatly increasing the impact of the spill.

Consideration should also be given to the long term attritional damage caused to a vessel undertaking transits in these types of extreme conditions. This will inevitably affect the resale value of a vessel.

Lastly, we cannot disregard the increasing political instability of the Russian Federation, the controlling regime of this trading route. A reaction prompted by political motivation could adversely affect the impact on an owner/operator of a vessel held liable for a spill should the vessel be related in some way to a regime deemed unfriendly to the Russian Federation.

SO, WHAT CAN MORTGAGEES DO TO BEST PROTECT THE COLLATERAL ASSET AGAINST WHICH FUNDS ARE ADVANCED?

Firstly, we should consider the loan agreement: A typical loan agreement will require that the vessel is fully and adequately insured for the duration of the loan. In view of the extra perils associated with a transit such as this, mortgagees may choose to actively remind their borrowers that any voyages of this nature must be advised to the mortgagee in advance and that failure to do so will be considered non-disclosure of a material circumstance and as such a breach of the borrower's obligations under the loan agreement. This prior advice will enable the mortgagee to take separate advice and verify compliance with all additional insurance provisions imposed by primary insurers. The risk of this approach is that the mortgagee must then disclose this information to their own mortgagees interest insurance(MII) insurers and seek approval to maintain mortgagees interest insurance cover. Failure to seek approval in these circumstances will jeopardise their MII cover should a claim be declined by primary insurers. In such an eventuality, MII insurers may argue that their client was privy to information that increased the risk which should therefore have been disclosed to their insurers.

A less intrusive approach would be to merely contact all borrowers advising them of their duty to ensure the vessel is fully insured during any such breach trips to these areas. Whilst this may seem a sensible approach the mortgagee then runs the risk of being unaware that one or more voyages are taking place. In view of the implications of being intrusive as explained above a hands off approach may appear beneficial from the perspective of the mortgagees interest policy, it would however mean the mortgagee had no opportunity to monitor preparations for the voyage nor to arrange short term political risks cover, protecting themselves against a political action or inaction affecting the integrity of the collateral asset to the detriment of the mortgagee.

Lastly, the mortgagee could do nothing, merely relying on the existing wording of the loan agreement to require the borrower to ensure coverage is adequate.

One final complication is the matter of sanctions, both against Russian corporations and individuals by the international community and conversely by Russian authorities against certain non-Russian entities. Again, transits through these vulnerable areas may result in the non-payment of an otherwise valid claim due to alleged breaches of international trade sanctions or possible intervention by the Russian authorities if the transit involves in any way an entity sanctioned by Russia.

In conclusion there is no hard and fast solution or advice that suits all mortgagees. The decision on how to act or a decision not to act is very much based on risk appetite of the individual bank or banking syndicate and the asset content of each bank's loan portfolio.

Marsh Maritime Advisory are familiar with the risks and subject matter surrounding these trips and can be consulted on matters such as this which affect any marine or offshore collateral asset against which funds have been advanced.

For further information on this matter, please email Marsh Maritime Advisory on: mma@marsh.com

Alternatively please contact:

ALEC MORTEN
M: +44 (0)75 8415 0736
T: +44 (0)20 7357 2218
alec.morten@marsh.com

NICK RIDDLE
M: +44 (0)77 6749 5293
T: +44 (0)20 7178 4406
nick.riddle@marsh.com

MARIE RYDENFELT
M: +44 (0)74 6847 0912
T: +44 (0)20 7357 2198
marie.rydenfelt@marsh.com