Regulation: Finding Clarity in Uncertain Times

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Disclaimer

- The opinions expressed in this presentation are intended for informational purposes, and are not formal opinions of, nor binding on, the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.
Overview

- Regulators are focused on the safety and soundness of financial institutions
- During the Shared National Credit Examination (SNC) in early 2015 examiners took issue with the risk rating approach taken for certain oil and gas loans
- Regulators held meetings with major O&G banks to discuss these differences
- Regulators updated guidance and provided supervisory expectations for O&G lending
- SNC recent exams have noted improved risk management practices
SNC Biannual Examinations

- SNC total portfolio is over $4 trillion in commitments, with $500 billion in the energy sector.

- Recent oil price increase and stability provide a lifeline to the industry, but price volatility and downside risks persist as high inventories remain.

- Results of Spring 2017 and Fall 2016 were recently released.
Bank Exposure to O&G Industry

- O&G lending constitutes a small portion (2–3 percent) of large bank portfolios.
- Size and exposure of large bank portfolios have decreased since early 2016.
- Banks continue to monitor and control their total capital exposure to the industry, as few bank holding companies have O&G loans that are concentrations.
- The majority of O&G loans on bank books are syndicated, hence diversified through Shared National Credits (SNC).
- Lending standards continue to be well managed with focus on borrower cash flow needs.
Industry Update

- The highest risk is in the Upstream (E&P) and Service companies.
- The risk continues with stronger E&P successfully weathering the price declines.
- Borrowers are continuing to service their debts, which is interest-only.
- Many highly levered borrowers have filed for bankruptcy, and others are restructuring and rapidly reducing debt levels.
- Capital is readily available for select borrowers who are well positioned for added production.
- Price increases throughout 2016 and stabilized in the $45–$55 range helping profitability. They recently dipped to $43.
- The shale oil industry (unconventional) is resilient.
- Technological enhancements have increased production and lowered break-even points for producers.
Supervisory Observations from First Quarter 2017
SNC Review

- Continued deterioration in credit quality as noted in Reserve-based loans (RBLs) to E&P companies and commercial and industrial (C&I) loans to oil field service companies.
- Some leveraged borrowers continue under financial stress with reduced earnings and weaker cash flows.
- Risk ratings have migrated downward year-over-year with many lower regulatory classifications.
- Agent banks generally have appropriate regulatory ratings and improved assessments from the last SNC review.
- Risk management practices at banks appear adequate and are heavily focused on the energy credits.
- Problems continue to appear manageable with banks increasing their loss reserves.
O&G Lending

- Bank loans are a significant component of capital structure for O&G E&P companies.
- Bank lending is primarily Reserve Based Lending (RBL) for larger credits.
- Collateral support through reserve analysis and risk adjustments remain current and transparent.
- Some companies are highly levered and have liquidity issues.
- Service companies use traditional C&I loans for their working capital and equipment purchases.
- Credit weaknesses were first observed in Services, then E&P, and now some Midstream borrowers.
Oil Sector Outlook Improving

NOTES: Percent reporting worsened is plotted as a negative value; percent reporting no change is plotted symmetrically around zero.

SOURCE: Federal Reserve Bank of Dallas
O&G Industry Overview

Upstream
- Exploration: Seismic Research and Leasing Activity
- Development and Production

Midstream
- Gathering and Transportation

Downstream
- Refining
- Commercial End Users/Retail Marketing

SOURCE: SNC Training
O&G Reserves Classification

- Oil & gas reserves
  - Proved
    - Developed
    - Undeveloped (PUD)
      - Producing (PDP)
      - Nonproducing
        - Shut-in
        - Behind the pipe
  - Unproved
    - Possible
    - Probable

Borrowing Base
RBL Repayment Analysis

- Primary source of repayment:
  - An evaluation of the Future Net Revenue (FNR) from *proven* O&G reserves as supported by a qualified and independent engineering reserve analysis
  - Base case repayment analysis should use the total borrowing base (BB) commitment and be based on repayment from undiscounted and unrisked total proved reserves.
  - A reasonable repayment period is typically within 60 percent of the economic life of the proved reserves.

- Secondary sources of repayment:
  - Sale of reserves or other collateral
  - Guarantor or sponsor/private equity support (if any)
  - Second lien notes, Mezzanine, high-yield bond, or equity issuance
Regulatory Expectations for Risk Management

- Loan administration: sound knowledge of current borrower operating performance
- Borrowing Base: sound bank policy and compliance
- Engineering reports: current and bank-analyzed
- Price decks: reset quarterly at a minimum with sound supporting rationale
- Rating accuracy: internal rating follows guidance
Prices Needed to Cover Costs for Existing Wells

Dollars per barrel

Number of responses

0 10 20 30 40 50 60 70
13 7 5 9 11 8 39

Permian (Midland)
Permian (Delaware)
Permian (Central Platform)
Other U.S. (shale)
Other U.S. (non-shale)

$24 $27 $29 $33 $33 $35 $38

NOTES: Line shows the mean, and bars show the range of responses; 60 Exploration & Production (E&P) firms answered this question from March 15–23, 2017. SOURCE: Federal Reserve Bank of Dallas

Restricted FR

Shared National Credit (SNC) Program
Federal Reserve System
Break-Even Prices for New Wells

Dollars per barrel

- Permian (Midland): $46
- SCOOP/STACK: $47
- Eagle Ford: $48
- Permian (Delaware): $48
- Permian (Central Platform): $50
- Other U.S. (shale): $53
- Other U.S. (non-shale): $55

Number of responses

NOTES: Line shows the mean, and bars show the range of responses; 62 E&P firms answered this question from March 15–23, 2017. SOURCE: Federal Reserve Bank of Dallas
Conclusion

- While the industry is in recovery since early 2016, there remain concerns.

- E&P companies continue to be cautious with their capital expenditure spending, focusing on high-value drilling prospects with short-term returns.

- Uncertainty over the price of O&G hangs over the markets as inventories remain elevated.

- The industry has shown resiliency.

- Regulators consistently apply guidance allowing financial institutions to meet the borrowing demands of their customers responsibly.