

Monitoring Energy Exposures



Bankers and bank supervisors are focused on what persistently low oil prices might mean for loans made to the sector. But, they're not sounding the alarm.



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Reports of a slowdown in shale activity started rolling in months ago, and now the banking industry has revealed that it expects to feel some impact of low oil prices, too.

In April, the Federal Reserve Board's Senior Loan Officer Opinion Survey revealed that bankers expect the quality of loans made to the oil and natural gas drilling or extraction sector to deteriorate somewhat this year.

In other words, bankers expect some loans they've made to the sector not to be paid as was set forth in their terms, and they expect to write off some loans as losses (charge-offs).

That said, bankers indicated that their exposures are small and that they are undertaking a number of actions to mitigate the risk of loan losses, including restructuring outstanding loans, reducing the size of existing credit lines, and requiring additional collateral, the survey reported.

Of the banks that made loans to oil and gas firms, more than 80 percent indicated that such lending accounted for less than 10 percent of their commercial and industrial (C&I) loans outstanding.

That's a relatively small portion of a bank's portfolio, explains Jenni Frazer, a Cleveland Fed assistant vice president and deputy regional officer of the Federal Reserve Bank of Cleveland's Cincinnati Branch.

Banks in the Fourth Federal Reserve District, which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky, are among those with increased exposures to the oil and gas industry, Frazer says. In the years following the recent economic downturn, such lending was one way banks could achieve growth.

Precise data on how much money bankers in this region have lent to the industry and information regarding how the volume of loans outstanding compares to that of other Federal Reserve regions are not publicly available.

But, Frazer notes, "You can't be in Ohio and western Pennsylvania and not do some energy-related lending." The Marcellus and Utica Shales activity spans land in both states.



“We do not have an outsized risk here in the Fourth District,” she notes. “It’s fair to say that the information that came out of the Senior Loan Officer Opinion Survey is a good representation of what the Fourth District companies are experiencing, as well.

“Some banks in the Fourth District have been growing those portfolios over the past 4 or 5 years,” Frazer says. “Over the past year, with oil prices being low for a longer period of time than people anticipated, that gave us [banking supervisors] cause for concern for the viability of borrowers in that group. Bankers share that concern and have been closely monitoring their borrowers’ vulnerabilities.”

Downside risk

So bankers have increased their oversight and monitoring of impacted borrowers, namely in terms of borrowers’ financial performance, Frazer says.

The Federal Reserve’s *Beige Book*, which reports economic business conditions throughout the country 8 times a year, began revealing signs in December of some contraction of oil and gas activity in the Cleveland Fed’s region.

“There is some financial belt-tightening by exploration and production companies,” the December 3 report noted.

In January 2015 came this reflection: “A sustained decline in oil and gas prices may pose some downside risk to drilling and production.”

In March, the *Beige Book* revealed that the number of drilling rigs in the region served by the Cleveland Fed shrank by 19 percent since mid-December.

And on April 15, the report noted, “Spending for new drilling in the Marcellus and Utica Shales has been significantly curtailed.”

In fact, April was the second month this year whose *Beige Book* report gave word of layoffs by oil and gas companies and their supplier industries.

Fourth District bankers are not overly concerned, though, they tell Cleveland Fed banking supervisors.

“There’s no sense of alarm with their oil and gas portfolios,” Frazer says. “Yes, they’re monitoring more carefully. They’re having more frequent discussions with their borrowers, but the oil and gas industry is somewhat prepared for these lower oil prices and has hedges in place to protect its financial performance. The risk that we are hearing from the bankers that is coming from the borrowers is that should oil prices stay low for a much longer period of time, then

there’s more reason to worry. In the short term, the oil and gas industry can withstand these lower prices.”

Recent public filings by a couple of institutions in the Cleveland Fed’s region reflect confidence in oil and gas assets.

One example: In its first-quarter filing this year, Cleveland-based KeyCorp noted, “Credit quality on our oil and gas loan portfolio, which represents 2 percent of total loans at March 31, 2015, remains solid, with net loan charge-offs lower than those on our overall portfolio.”

Not unusual matters

The sharpened focus on loans made to the oil and gas industry is not unlike what sometimes happens when any industry is experiencing hardship, Frazer explains, further citing as an example the way automotive industry borrowers came under stress—and scrutiny—during the financial crisis.

“This is part of the normal credit cycle,” she says. “At any given time, there are pockets of bankers’ portfolios that are under heightened risk. It’s not unusual for loan portfolios, as they become seasoned, to experience some kind of loss. What would be worrisome is if loans made 90 days ago were being charged off. But through the credit cycle, we expect bankers to incur some loan losses.”

Regulators have 2 roles when a particular risk escalates, Frazer explains.

“It’s our job to make sure that the bankers have the right risk management processes in place to know their exposures and where the risks lie,” she says. “If we don’t see that, we could exercise our authority and direct bankers to establish the right infrastructures and controls.

“We also have a responsibility to take broader information like what we’re getting from the Senior Loan Officer Opinion Survey to understand the risks nationally or even globally for the industry to make sure there isn’t a systemic risk that would impact financial stability,” Frazer adds.

The most recent Senior Loan Officer Opinion Survey revealed more than bankers’ reflections on oil and gas loans. The report also reveals that demand has strengthened and standards have eased for commercial real estate (CRE) loans. ■

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Find the Senior Loan Officer Opinion Survey at
www.federalreserve.gov/boarddocs/snloansurvey/201505/default.htm
