
BANKING THE OIL FIELD: LOOKING BACK AND LOOKING FORWARD

First of a series on the renewed interest in energy credit

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The oil business continues to be one of the most interesting industrial segments of our economy--and always a challenge for lenders.

Energy exploration and production are capital-intensive uses of funds that have to compete with all other uses on a worldwide basis. From the lender's perspective--and the regulators', for that matter--an intrinsic problem is the fact that these commodities--oil and natural gas--tend to cluster in geographically specific ways.

This creates inherent issues of concentrations of assets, as well as concentration in both sources and uses of funds.

Scale is another variant of concentration, so bankers serving communities dominated by oil and gas exploration activity start out by having to deal with known and predictable issues that have perennially been problematic for commercial banks.

Aiming towards the oil patch

Energy lending has significant personal history for me. For all but three years of my working career, I was a commercial lender/credit administrator/executive bank manager and cannot imagine a life's work more diverse or interesting. Even my three-year hiatus out of banking with the Florida Gas Co. provided an important foundation for what was to follow as a banker in the oil fields in West Texas and Oklahoma.

At Florida Gas I was the principal assistant to the CFO in several of the company's activities not relating to regulatory accounting matters. The company operated a natural gas pipeline that picked up gas along the Texas Gulf coast and delivered it to the rich consumer markets of Florida. The company was also the retail utility that distributed natural gas to several large cities in the state, including Jacksonville, Tampa, Orlando, Fort Lauderdale, and Miami.

Natural gas was a scarce commodity in those days due largely to the issue of a federally regulated gas price in interstate markets. Politically these issues were eventually overcome by allowing the price to float to market levels. But for probably 20 years before that, gas became scarce because the regulated price was too low. The producers couldn't find it and transport it at sales prices sufficient to cover exploration costs, while the intrastate gas markets were unregulated and developing into robust local markets for the product.

We had a pipeline to fill up and customers to serve in Florida. So one response on our part was to form a series of tax-sheltered exploration partnerships to try to find gas that we could dedicate to our pipeline and sell into our distribution markets. The company served as the general partner (and operator) of these vehicles and money was raised from limited partner investors.

We sponsored several of these investment partnerships and I found myself serving as a member of the "wholesaling" force promoting their sales through broker-dealers located primarily up and down the Eastern seaboard. I had to learn enough about the business of oil and gas exploration to talk intelligently about the risk/reward relationships and the tax implications of these tax sheltered vehicles. My education and lifelong interest in the industry dates from that experience.

A few years later, after I had returned to banking, I was recruited to Midland, Texas, a city of about 80,000 located midway between Dallas and El Paso. We were three hundred miles from either city, so it was not exactly an urban experience in those days, although Midland was very sophisticated in some important ways and had strong financial ties to major financial centers as well as to Dallas and Houston. I was the credit administrator of the bank, then approaching

\$2 billion in total assets.

When I arrived in Midland during the summer of 1980, the price of oil was \$29 a barrel. It was headed for a high of \$41 the following August. When I left in the first quarter of 1984 four months after the bank failed, the price of oil was back to \$29 a barrel-and headed for a bottom of \$8 by 1988.

In hindsight, what ruined our success was a combination of credit concentrations and the price volatility. It's not that we were incapable of knowing those risks but we were hard at work responding to customer demand for drilling and development money. And we were also protecting our market share from the "predators" in our business: oil field banks headquartered in Dallas and Houston. In turn, they actually served to some degree as surrogates of the very largest banks in the money centers of New York and Chicago.

Failing after the boom

We failed after almost 100 years of serving West Texas ranching and oil field families and businesses. It was a profoundly sad experience as First of Midland was one of the most unusual banks I'd ever worked for. We considered ourselves as family to each other and to our customers; this had both cultural positives and cultural risks but I'll save those insights and experiences for another time.

As much as I thought I was learning about the oil business as a credit administrator, my real education began when the bank's senior energy lender was sidelined for several months with a serious health issue. A recent OCC exam had identified about a dozen credit relationships that exhibited serious collateral shortfalls (and therefore considerably higher credit risk) and all of these were handled by the same lender. I quickly agreed to assume handling responsibilities for this segment of his customer base in his absence. As conditions were steadily deteriorating in the local market, I had no concern about being underemployed for the foreseeable future.

Within a few months, and at the prodding of the examiners, the bank formed an energy workout section and I was made the manager, as my existing cluster of credits was already in a workout mode. My group ultimately grew to over half a billion dollars in outstanding (and criticized) energy credit serviced and supervised by six credit professionals.

It was simultaneously the most interesting and most challenging work environment I'd ever encountered before or since.

The bank valiantly but vainly resisted its ultimate end. We experienced over a period of several months an increasing crisis of liquidity fortified by a continuing flood of bad news on collateral values and business activity. We were simply overwhelmed.

The end came during the second week of October 1983 when the bank experienced both a wholesale and a consumer customer run. The wholesale run came in the wire room as customers wired out funds to other banks. The retail run occurred on the teller line and was a two-day affair. I'll never forget that run--hundreds of customers queued in lines 10 and 12 deep withdrawing their money in cash.

The most vivid sensory recollection of those two days was the noise, a collective snarl of fear and frustration.

When the bank closed on Thursday night, FDIC's liquidating crew was there and began their grim work. The bank's deposit base and uncriticized assets were immediately purchased by Republic Bank in Dallas, while the criticized assets were retained by the FDIC for subsequent liquidation. My group's assets were all of the problem variety so while I wore the Republic Bank logo pin in my lapel, my bosses were all FDIC. I was part of the servicing crew of these assets for their

new owner.

I've heard this tune before...

In the recent months, oil and gas exploration have been at the heart of discussions in parts of the country that are experiencing boom-like conditions for oil and gas exploration in what are known as "shale sands."

Anecdotally, the stories sound awfully familiar to me.

That the oil and gas industry continues to be so central to our country's economic future is no surprise, though the issues at stake do come with an urgency that I'd not remembered in recent years.

Oil and gas exploration and development in 2012 also figure prominently in the political discourse, including tax reform, economic development opportunities at the local community level, ecological, and environmental concerns and risk management issues for commercial lenders.

As bankers can't seem to consistently absorb hard lessons of the past, this column over the next few weeks will discuss some of the lessons learned a generation ago. I do this in the hope that most bankers will not be forced to relive some of these painful experiences I lived.

It is also useful to be reminded about how energy integrates into the economic fabric of our economy and the strategic hazards of being excessively dependent on foreign sources of supply. This latter point is a principal component of the "Conditions" portion of the Five Cs of Credit and the implications for mischief by misreading these signs are enormous for our national economy.

As this series continues Ed welcomes comments and questions from banker in the energy sector or who are looking at it from afar.

Use the comment section below.

About Ed O'Leary

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can e-mail him at etoleary@att.net.

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