
BUILDING A BOOK OF LOANS IN SHALE COUNTRY: FUTURE GAIN VERSUS PAST PAIN

Third in a series on renewed activity in energy credit

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Blogger Ed O'Leary learned many hard lessons about energy lending in his time in Oklahoma and Texas decades ago. The price of oil and gas may change, but the basics about loan concentrations and more carry on. His series began with "Banking The Oil Field: Looking Back and Looking Forward." A companion to this week's column is "O'Leary's Lab I: Financing Energy Execs' Personal Investments In Oil & Gas Production," an examination of some special credit issues in energy lending.

For the first time in almost a century the U.S. appears to be on the brink of energy self sufficiency. This is due to the oil and gas capable of being produced out of shale sands, subsurface rock that holds large volumes of both. The production of these resources requires a combination of relatively new technologies--horizontal drilling and hydraulic fracking.

With these techniques comes controversy. Oil and gas production has always attracted environmental opposition. It's unsightly: Who wants to live across the street from a "pump jack?" It's odiferous: Who wants to live downwind from a gas and liquids separation plant?

Community banks in some regions are at the juncture of such controversies. Public reactions and passions often ignite where economic stakes are high. Our customers will be on one side of these issues or the other. As community economic development participants, bankers naturally have opinions and even economic interests in the outcomes.

Said another way, reputation risk these days presents itself in an amazing array of guises and issues.

Yet reputation risk, a soft risk in some eyes, is hardly all that's at stake.

The size of this boom and its importance in so many ways suggests that we as an industry are likely making or going to make many of the same mistakes we did in the past. The faces are different but the issues and circumstances have an eerie familiarity.

Controversial technologies

Large areas of the country are at least generally familiar with the cost-benefits tradeoffs that have always surrounded the oil and gas industry since petroleum replaced whale oil as a source of lighting of American homes in the 19th century.

Fracking as a production-enhancing technique is relatively new and requires the injection of large amounts of water and

chemicals into subsurface rock formations to carry the oil and gas to the surface. The water and chemicals become by-products to be dealt with in appropriate ways. Environmentalists have been attacking the process of fracking--with varying success--as resulting in unnecessary and unacceptable risks to water supplies. Some have claimed that the fracking process contributes to increased seismic activity in areas sensitive to this sort of activity.

All of these concerns have a basic plausibility to them, though the harmful effects that have been conclusively proven are relatively rare. It is indicative of the enormity of the issues--financial, political, and national security considerations--that these discussions are both urgent and timely. It's also an expression of the strength of our democratic processes that these discussions can occur in the public forum and be resolved through political processes.

What's changed in energy country--and nationally

Shale oil and gas represent all the familiar issue--economic activity and wealth creation occasionally at odds with legitimate or occasionally exaggerated environmental concerns. What's truly different today is the context in which these issues are debated--national energy independence.

I wonder how the current shale oil and gas activity in some parts of the U.S. compares to my experiences in Midland nearly 30 years ago. The influx of workers to West Texas produced strains on community infrastructures and the need for housing and all the related venues of human activity. Roads, sewers, and schools strained municipal budgets then, as they no doubt do today in parts of the country that have little prior experience in the boom and bust cyclicity of the oil fields.

Banking can face similar risks, in their own way.

Gain, but at pain

My institution, the First National of Midland, hired experienced bankers from other parts of the country to staff up for the new workload. We manned lending desks and staffed loan review and credit administration positions that were familiar to us as bankers but what we didn't know when we arrived was a whole lot about a very specialized business.

This knowledge takes time to acquire. Expertise in oil and gas lending represents very specialized training acquired over years, not merely months. Much of this learning process has to be organically developed or at least force fed in a deliberate and programmed way.

Then too there are local cultures of the people populating these various regional areas that require understanding.

Flinty New Englanders are a different breed from the entrepreneurs and the risk takers of the oil fields in Texas and Oklahoma. These things are not assimilated overnight.

So my colleagues and I in Midland struggled as events, primarily the volatility of oil and gas prices, continued to produce unforeseen consequences.

We were ultimately overwhelmed.

Only a couple of years after the apex of the boom cycle, oil field equipment acquired (and financed) at cost in 1981 could be found idled and rusting in supply yards. Often, scrap dealers represented the sole buyers with interest. Equipment often sold to bottom fishers--if it could be sold at all--for five and ten cents on the dollar of historical cost.

Today's lenders: Are they up to this?

Hopefully, we've learned from the lessons of the relatively recent past.

Those who prosper during these next few years in the hyper-active oil and gas areas will be those who figure out what

they can do within their capacities as community bankers.

They will avoid the risks they don't understand in unfamiliar lending products and collateral while shunning the concentrations of credit that can stealthily accumulate within their loan portfolios.

They will recognize that speculative building activity is not an appropriate outlet for community bank deposits.

Bankers also need to know that sudden wealth may produce behaviors that are not always consistent with the best traits of human behavior. Character is paramount and it should never be simply assumed.

This is precisely the time in those communities impacted by unexpected wealth from oil and gas where community bankers need to exercise the five Cs of Credit with the discipline of seasoned athletes. In the companion article to this blog, "O'Leary's Lab I: Financing Energy Execs' Personal Investments In Oil & Gas Production," I review some relevant issues.

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. O'Leary's website can be found at www.etoleary.com.

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