

CHALLENGING FUTURE OF ENERGY LENDING

Fourth in a series about energy lending

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This week's column both continues Ed O'Leary's series about energy lending and addresses issues raised in last week's "O'Leary's Lab" special installment.

There's another piece to prudent oil and gas lending that's not always present in other types of transactions and it's an old and durable one for bankers.

Bankers are often notoriously wrong in their efforts to price for risk.

Many speak rather glibly about the idea. But simply adding a half point or more to a borrower's rate is hardly a rigorous assessment and reaction to what pricing for risk really means.

Truly pricing for risk is a process requiring intellectual rigor and a constant monitoring process of borrower activity and collateral values. So, I'm confident in saying that some banks, if not many of them, are building into their portfolios some unseen and underestimated interest rate risk in the form of insufficiently discounting oil and gas production cash flows for collateral valuation purposes (discussed below).

The risk of overleveraging in the oilfield

Overleveraging is something that most all borrowers --in energy country or otherwise--do, either deliberately or unconsciously.

They are typically optimistic about their businesses and their assets. All too often, bankers are willing accomplices in this biased evaluation process. We need to learn from the past. Let's look at the case in energy lending.

The anticipated cash flows for a specific period are margined by an aggregate discount of 30% or 40% (perhaps more for wells with short half-lives) to arrive at the loan value of the production. This makes the discount rate an important component of the valuation process. The lower the rate, the larger the net present value of the cash flow is; this is reflected in a larger loan value.

In this very competitive environment for loans, bankers may be tempted to shave a rate to get a deal. But note that it's

not just the borrowing rate that could get shaved.

When I was an oil and gas workout person, the discount rate of the cash flow was typically two or three points above the prime (or a bank's reference rate). But in today's terms, I don't think that a rate of 7% or 8%, extending out on a time horizon of four or five years, captures the rate risk, in terms of an appropriate discount rate of the cash flow.

Any lending bank, in the current environment particularly, must be very careful that the bank's interest rate outlook is reflected in the engineering appraisals. The uncertainty of rates looking out 18 months or so for signs that the economy is improving or as a consequence of market concerns on the financing of our national debt is a potential consequence of the so-called "fiscal cliff" that's impending.

Lessons from hindsight

Hindsight's perspective on the lending errors my banking colleagues and I made in Oklahoma and Texas during the 1970s and 1980s tells me that the most significant were our overleveraging of the equity in the producing properties--the oil and gas interests that were producing regular cash flow.

We allowed equity in these properties to suffice in place of hard-dollar equity in oil field equipment. Compounding that error, we commingled the cash flows with values supporting as many as three different types of loan purposes.

I'm not sure that avoiding these errors would have completely averted disaster for many banks serving the oil field. However, it probably would have limited our losses somewhat.

Rollercoaster ride on energy commodity prices

The real problem was the price volatility of the commodities, oil and gas. That's still an issue today, as anyone knows who has experienced the hardship of escalating gasoline and heating oil and gas costs on the family budget. Natural gas producers have experienced enormous volatility in gas prices over the last few years due in part to the suddenly increased availability of natural gas from shale formations. The dynamics of a truly national market seldom rely on a single factor, but supply is a significant component of the equation.

Supplies are now plentiful (though not optimally distributed) and offer the prospects of being continuously available in significant quantities compared to historical norms. The implications for consumption of coal, oil, and gas are shifting--and probably permanently--at least in terms of very long-term trends that are now evident. And there's an intense political debate about energy alternatives, shale oil and gas and the future of coal as a source of electricity generating fuel that have yet to be worked out in a definitive way.

From a lender's viewpoint, the market will continue to play out primarily in price volatility. I expect that this volatility, especially for natural gas, will moderate and that the differences going forward will relate more to seasonal differences in demand and the relative proximity of large users (or markets) to pipelines for constant and economical supplies.

Lenders' main task going forward

So what remains is figuring out how to accommodate oil and gas producers and operators of oil-field equipment, such as drillers, in a safe and sound way from the lender's viewpoint.

Bankers must be realistic about the risks to the cash flows of changes in interest rates as well as to changes in market values of the commodities themselves.

These are multi-dimensional risks. They result in energy lending being one of the most sensitive environments for the proper evaluation of Conditions, that C of Credit that is second in importance only to Character.

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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