Why Banks Won't Cut Off Energy's 'Drunken Sailors'

January 22, 2016

The loans that banks have made to energy companies grabbed a lot of investors' attention this week as lenders said they have boosted cash reserves to deal with bad oil and gas debt. But those financial institutions may have trouble bringing the hammer down on drillers.

The continuing slide in energy prices poses a dilemma for banks: cut energy clients' borrowing ability and risk sending them over the edge, or continue to accommodate them in order to prevent defaults. While some worry banks are already in too deep, lenders are loathe to see drillers fall into bankruptcy, leaving them holding the drillers' assets.

"Once they pull the plug on them, it will be dead property," Oppenheimer analyst Fadel Gheit said. "They have to handle it very carefully, and so far they have basically extended the life of these companies."

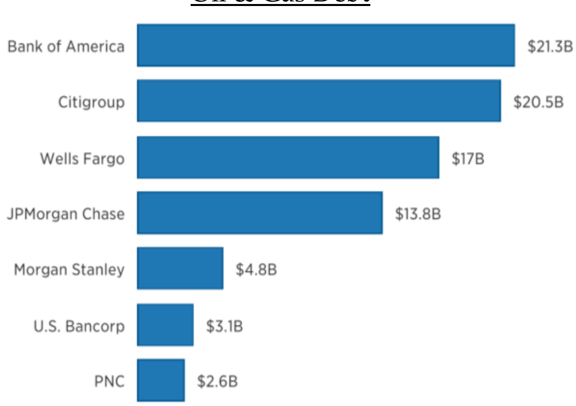
Indeed, banks reduced the drillers' borrowing bases less than many analysts expected during twice-a-year reviews in April and October of 2015. Those bases are determined by the value of drillers' assets, which in turn depends on the price of oil.

But analysts said banks were expecting significantly higher crude prices at this point when they last reviewed balance sheets in October. Instead, they have plummeted below $30 per barrel to more than 12-year lows, and contracts are not trading above $40 until early 2017.

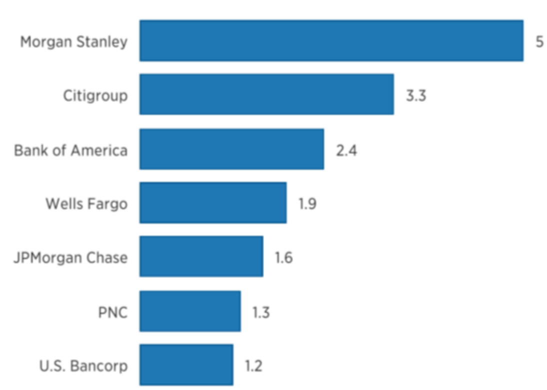
Now, the big banks are continuing to build up their reserves to deal with potential energy-sector losses. In the fourth quarter, Bank of America increased loan loss provisions by $264 million, largely due to energy-related charge offs and an effort to build out its reserves. Citigroup set aside another $250 million to brace for potential trouble with energy loans, while JPMorgan Chase added $124 million.

Oil & Gas Exposure
Outstanding loans to the energy sector as of Q4 2015

Oil & Gas Debt



% of Total Loan Volume



Source: Goldman Sachs

Smaller regional banks are feeling the pain, as well. On Thursday, San Antonio-headquartered Cullen/Frost warned investors ahead of its earnings next week that it expects its provision for covering loan losses to total $34 million for the fourth quarter, primarily due to energy-sector lending.

Meanwhile, Tulsa, Oklahoma-based BOK Financial increased its fourth-quarter loan loss provision to $22.5 million, due to an impairment on a single energy borrower's loan that came as a result of "steeper-than-expected production declines and higher lease operating expenses." The bank previously forecast loan loss reserves of $3.5 million to $8.5 million. It did not identify the borrower.

Analysts expect banks to continue to kick the can down the road by offering grace periods, exercising flexibility when loan covenants arise and postponing principal payments.

But Gheit said the industry is now venturing into uncharted territory, noting that many drillers took on more debt than they needed — in some cases, simply because banks offered bigger loans than they sought.

"I've been in the industry 30 years. I've never seen anything like it," he said. "Small producers went like drunken sailors. They just bought everything in sight. The banks were the enablers."

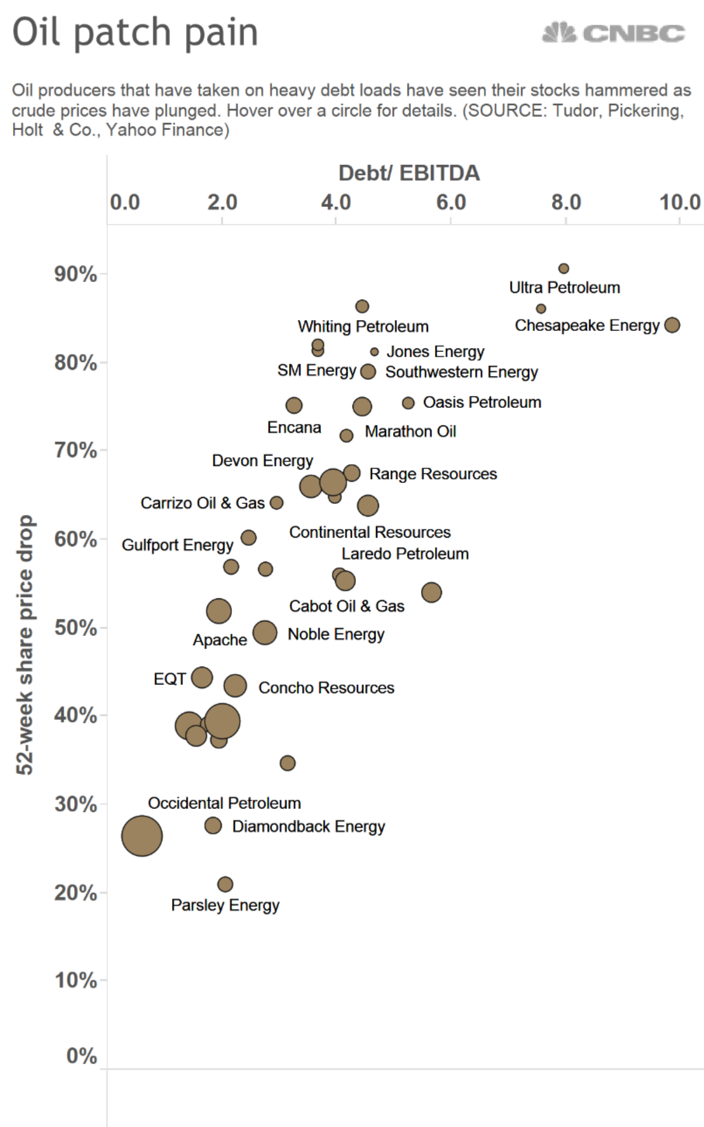
Kim Brady, a restructuring specialist and partner at financial advisory firm SOLIC Capital, said the banks don't have much choice but to try to clamp down.

"Definitely, they're going to be more aggressive than in October" when they last reviewed balance sheets, he said.

Some banks, however, may find matters out of their hands as some drillers choose to proactively file for bankruptcy, Brady said. Bankruptcies were mostly contained to private drillers last year, but he anticipates a significant uptick in the number of public company defaults as more firms see cash flow go negative.

To be sure, working with borrowers to remain solvent and continue operations is what a lender is supposed to do, said Brett Rabatin, an analyst at Piper Jaffray who covers regional banks. But in cases where banks and drillers don't see eye to eye on how to proceed, banks may consider selling off loans to private equity firms.

Banks that are party to large, syndicated loans — money extended to a borrower by multiple banks together — face their own challenges. This is the case for loans classified as Shared National Credits, a loan of at least $20 million shared by three or more unaffiliated institutions.



"If it's a SNC, you've got a few more inherent things that make it more scary," he said. "There's a roomful of people trying to figure out what to do, and regulators are going to be more involved in that, because they have a SNC review every year."

Regulators can take a "pretty draconian" view of how banks stress-test a company's cash flow to make sure banks have not gotten in over their heads, he said.

At any rate, market watchers may not see a resolution immediately, as Rabatin expects banks to reduce drillers' borrowing bases only gradually.

"Wall Street and investors would love to see things happen as fast as the tickers change on their Bloomberg machines," he said, "but it doesn't really work that way."

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