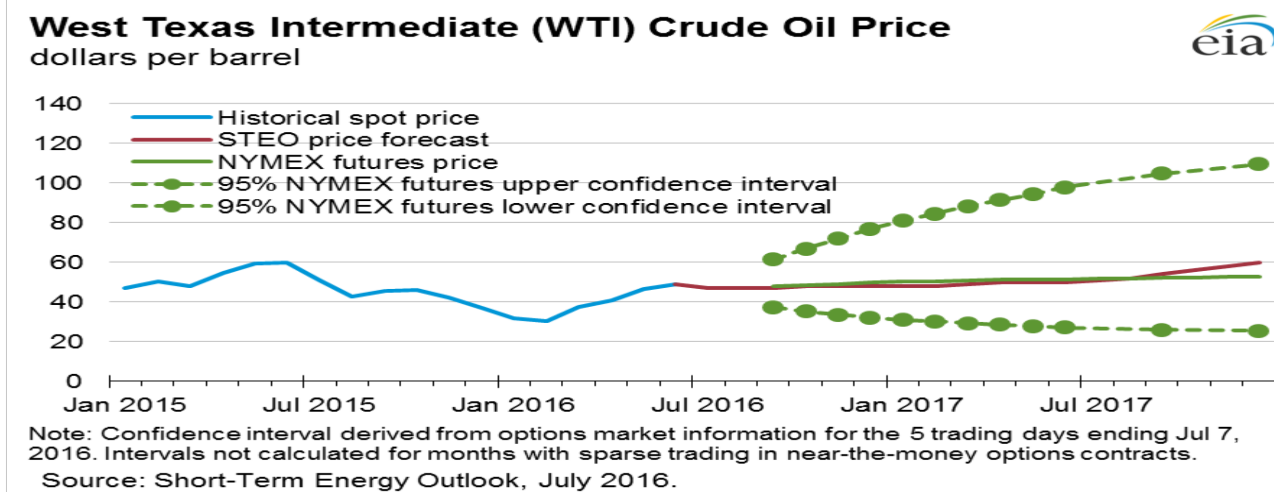
Prudent Risk Management of Oil and Gas Exposures

This Financial Institution Letter (FIL) reminds FDIC-supervised institutions with direct or indirect oil and gas (O&G) exposures to maintain sound underwriting standards, strong credit administration practices, and effective risk management strategies. When O&G related borrowers experience financial difficulties, the FDIC encourages financial institutions to work constructively with borrowers to strengthen the credits and to mitigate losses where possible.

Oil and Gas Industry

The volatile nature of the underlying commodities prices makes doing business in the O&G sector challenging. The continued slow and uncertain recovery in O&G prices projected by the U.S. Energy Information Administration[1] may continue to challenge institutions with direct and indirect exposure to this sector for the foreseeable future.



Direct and Indirect O&G Exposures

O&G lending is complex and highly specialized due to factors such as global supply and demand, geopolitical uncertainty, weather-related disruptions, fluctuations and volatility in currency markets, and changes in environmental and other governmental policies. As such, companies and borrowers that are directly or indirectly tied to or reliant on the O&G industry frequently experience volatility within key operational areas of their businesses that will directly impact their financial condition and repayment capacity.

Direct O&G exposure at FDIC-supervised banks is typically to borrowers for exploration and production (E&P) activities or support/services (e.g. equipment or support activities such as drilling, workover units, and water hauling services). Due to the size and complexity of E&P loans, larger institutions are more likely to be engaged in this type of lending. Most community banks that have credit risk in the O&G sector have direct exposure to support/service companies or indirect exposure through relationships with customers such as motels, restaurants, and other local businesses that provide services to O&G workers.

Guidance on Reserve Based Lending

Loans for E&P activities are typically secured by proved O&G reserves and governed by a borrowing base, an arrangement known as reserve based lending, or RBL. Effective credit risk management of this

[1] U.S. Energy Information Administration "Short-Term Energy Outlook" July 2016 http://www.eia.gov/forecasts/steo/report/

type of lending requires careful underwriting, appropriate structuring, experienced and knowledgeable lending staff, and sound loan monitoring and administration practices. The FDIC recently updated guidance to its examiners on RBL in the Loans section of its Risk Management Manual of Examination Policies (Manual), which is publicly available on the FDIC website.[2] This section covers important topics such as engineering reports, collateral discount rates, price decks, loan structure and covenants, borrowing base determinations, borrower and financial analysis, loan policies, and classification guidelines. Financial institution directors and officers responsible for this type of lending are encouraged to review this section of the Manual and discuss any questions with their Regional or Field Office contacts.

Oil and Gas Lending Concentrations

For institutions doing business in O&G dependent areas that would be affected by volatility in commodity prices, prudent management of geographic, industry, and borrower concentrations is needed for sound risk management of such exposures. Policies and risk limits should address portfolio mix within the loan and other asset categories. The institution's business strategy, management expertise and trade area should be considered when establishing and reviewing these policies and limits. When reasonable diversification realistically cannot be achieved due to geographic or other factors, resultant concentrations may indicate the need for capital levels higher than the regulatory minimums.

Management should closely monitor all credit concentrations. To establish a meaningful tracking system for concentrations of credit, financial institutions should consider the use of industry codes to track individual borrowers and related groups of borrowers. Financial institutions are also encouraged to use the standard industrial classification (SIC) or similar code to monitor industry concentrations.

In addition to monitoring direct lending concentrations, institutions should attempt to quantify and monitor the following, as applicable, when analyzing the impact of expanding or contracting economic cycles on borrowers who are heavily reliant on a single industry, such as O&G:

- **Loans to businesses that would be immediately impacted by a growing or contracting local economy**. For example, hotels and motels, rental housing, restaurants and bars, recreational vehicle parks, and auto dealers near the production field areas would be impacted either positively or negatively, depending on the direction of the economic cycle for commodities. Independent O&G service companies will be impacted almost immediately by an extended expansion or contraction production period. Trucking (delivering pipe and well infrastructure, water and chemicals) and equipment rental companies would also be impacted positively or negatively, depending on the economic cycle.

- **Other borrowers who may also be impacted by a growing or contracting local economy, but not necessarily immediately**. For example, an associated increase or decrease in vehicle sales at local auto dealerships, home sales, building permits for new homes and apartments in surrounding towns and cities, and commercial office space leasing by production companies would affect borrowers engaged in these businesses.

- **Potential compounding effects of other concentrations in the bank's loan portfolio**. For example, institutions doing business in O&G markets may also have concentrations in commercial real estate or agriculture lending that could be adversely affected by declining commodity prices or economic conditions.

[2] https://fdic.gov/regulations/safety/manual/index.html

Where exposures represent a significant proportion of capital, institutions should consider performing periodic sensitivity analysis or simple stress testing to assess how significant downturns may affect the performance of the portfolio and its potential impact on the condition of the institution.[3]

Management should report the results of concentration monitoring programs regularly to the board of directors. Failure to effectively monitor concentrations can result in management and the board being unaware how significant economic events might impact the overall portfolio, and management may be unprepared to take mitigating actions such as strengthening underwriting and credit administration practices, reducing concentrations, or increasing capital, as necessary.

Working with Troubled Borrowers

FDIC-supervised banks are encouraged to work with borrowers who are affected by adverse economic conditions in accordance with a well-conceived workout plan and effective internal controls to manage these loans. Financial institution management should refer to previously issued FILs on this topic for further information.[4]

[3] The Summer 2012 FDIC *Supervisory Insights* includes an article, "Stress Testing Credit Risk at Community Banks," that provides information on how stress testing can help financial institutions evaluate lending risks and capital adequacy under stressed, but plausible, scenarios and develop appropriate strategies to mitigate the risk. The article describes the credit-related stress-testing process, discusses its usefulness in managing risk, and provides simple examples of how community banks can conduct stress testing. *Supervisory Insights* articles are provided for informational purposes and are not regulatory or supervisory guidance. https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum12/SIsmr2012.pdf

[4] Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers, February 12, 2010 (FIL-5-2010), Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts, October 30, 2009 (FIL-61-2009), and Interagency Statement on Meeting the Needs of Creditworthy Borrowers, November 12, 2008 (FIL-128-2008)