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Energy lending once again attractive, but this time it's different

BY ANDY PETERS

As the energy sector recovers, and geopolitical developments point to even higher oil prices, energy loans are starting to look more appealing.

What's different this time is that banks are pressuring more borrowers to adopt hedging practices that are supposed to soften the impact on lenders of the wild price swings typical in oil and gas.

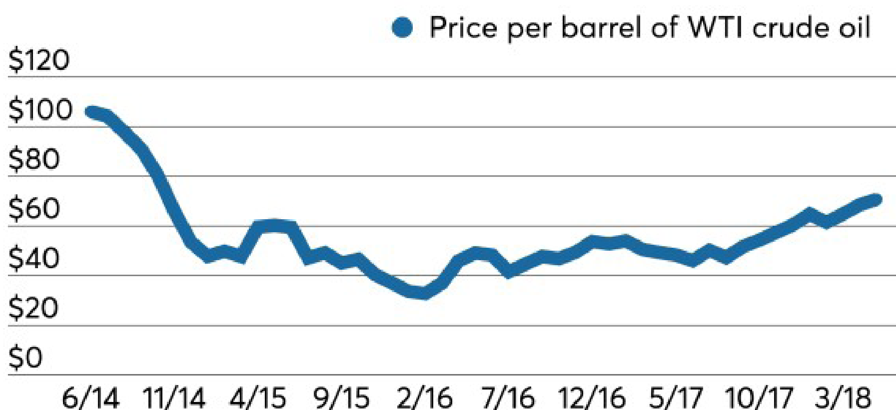
During the energy downturn of 2014 to 2016, many banks were walloped by problem credits. They padded reserves, shrunk dividends and restructured loans, credit relationships and their own business operations. In some cases they had to take tens of millions of dollars in chargeoffs.

As a result, some banks decided that they had had enough of the booms and busts of making loans to oil drillers. The $4.2 billion-asset Green Bancorp in Houston decided to exit the sector entirely. Other banks significantly cut their exposure, including BBVA Compass, Cullen/Frost Bankers and Comerica.

But a few hardy banks kept making a steady stream of loans for oil exploration, including BOK Financial in Tulsa, Okla., Texas Capital Bancshares in Dallas and LegacyTexas Financial Group in Plano, Texas.

These banks have taken several steps to lower their risk, such as avoiding large syndicated loans and focusing on smaller borrowers. Perhaps most important, bankers have gotten more drillers to enter strict contracts with oil buyers in order to receive the loans they seek, said Lester Keliher, head of energy lending at the $24 billion-asset Texas Capital.

In such contracts, suppliers agree to pay for the oil at a set price. That makes the drillers' income easier to predict for lenders that have extended them credit, but the agreements also mean that the drillers could lose money if the market price rises above the contractual price.



Wildcatters were long resistant to those kinds of limits, but bankers have made it clear that such agreements are prudent – if not mandatory.

"Hedging is a very meaningful tool that's more acceptable now than it used to be in 2014 and 2015," Keliher said. "We at Texas Capital have always tried to be aggressive about hedging, but it's a joint decision with your partners" whether to use it.

Hedging is a necessity in today's market for energy loans, said Kevin Hanigan, CEO of the $8.9 billion-asset LegacyTexas, which has about 8% of its loan book in energy credits.

"All the banks that know what they're doing in energy lending" are using hedges, Hanigan said. "We're all really good at engineering and geology and determining how much oil is in the ground. But it's the price risk that's harder to deal with."

"In the past, you didn't require hedging from your borrowers," Hanigan said. "Now, it's pretty standard for all of us to require a minimum of two years of rolling hedges and sometimes three years."

Banks historically avoided hedges because Saudi Arabia and other members of the Organization of the Petroleum Exporting Countries (OPEC) had always cut production after downturns to boost prices, Hanigan said. That did not happen in the last downturn.

Additionally, oil prices dropped to such low levels that it wasn't possible to use other traditional techniques to manage the volatility. Banks historically valued oil in loan terms at significantly lower levels than its existing market price to build a cushion in the event of a downturn. But when oil dropped below $60 per barrel, as it did for virtually the entire period from 2015 to 2017, the cushion technique no longer worked because spreads were too narrow, Hanigan said. At its lowest, West Texas Intermediate crude oil dropped to $26 per barrel in February 2016, according to the St. Louis Fed.

Oil has been on the rise but still has not returned to pre-2015 levels.

"We don't have the margin we used to have on the spot price of oil," Hanigan said.

Prices have strengthened in recent weeks. West Texas Intermediate crude oil rose 8% to $71.56 in the one-month period that ended May 11. It was trading Monday afternoon at $71.12.

The price could soon climb higher. The Trump administration has said it wants to expand drilling in U.S. continental-shelf waters and cut back on regulations for exploration companies. And Trump's decision to withdraw from the Iran nuclear agreement could boost oil prices further. Bank of America analysts this week said that oil could reach $100 per barrel next year.

Other banks, such as Independent Bank Group in McKinney, Texas, and Zions Bancorp. in Salt Lake City have taken notice and plan to make more loans to drillers.

"We are seeing some new requests in energy, and we are intentionally focused on growing that portfolio," David Brooks, chairman and CEO of the $8.8 billion-asset Independent Bank Group, said during an April 24 conference call. "It's taken a little longer to see the bottom and to begin to trend up than we had expected, but we expect we are going to see some positive tailwind for energy this year."

Zions officials said on their first-quarter conference call last month that classified loans fell substantially in part because of improvements in the energy sector and that energy could provide a needed boost to commercial lending in the near future.

"I mean, we've got $68 oil and we've been through the portfolio pretty carefully and we think that that [negative] story is pretty much over," Zions Chairman and CEO Harris Simmons said at the time.

Hedging is not the only way to manage energy risk. LegacyTexas, for example, is participating in fewer shared national credits on energy loans, and originating more of its own loans. That gives the bank more control over the borrower relationship, Hanigan said.

"When you've got 15 banks participating in a single credit facility, 15 different opinions are hard to deal with," Hanigan said.

And Texas Capital has moved to the smaller end of the market. Previously, Texas Capital used to make loans to the largest, or at least midsize, energy projects. Now the bank has shifted to smaller deals, which typically means a commitment of between $10 million and $45 million by Texas Capital, Keliher said.

"I've been trying to focus on more on the lower end of the middle market, on transactions in which we have more control" and don't have to compromise as much to satisfy the needs of several other banks involved in the loan, Keliher said.

Regardless of how lending terms may change, banks like the $33 billion-asset BOK Financial are going to stick with energy lending and won't reduce their exposure, no matter how bad things get.

"Our philosophy is unchanged and we've been in this business for 100 years," said Stacy Kymes, executive vice president of corporate banking. "We're not close to approaching our internal limits [on energy loans]. Prices don't change how we look at this space."

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