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OIL PRICES

Oil Patch Banks Challenged by Falling Prices

In November 2014, many of us in the oil patch sat around our Thanksgiving tables and celebrated, among other things, the strong and sustained performance of our region's economy. Texas and surrounding states consistently led the nation in employment and economic growth. Our vibrant banking sector led the country in pricing and performance. There was much good to consider as we counted our blessings.

Some of us, however, were also digesting news out of the OPEC meeting the day before. The petroleum cartel shocked the energy world with a decision to maintain high crude production despite oil supply increases and sluggish demand. After that, West Texas Intermediate (WTI) crude prices fell by nearly 50 percent, remaining well below $50 per barrel for most of 2015.

A welcome benefit of all this is lower gasoline prices at the pump. The economic impact of lower prices on the oil patch, however, has been significant and ongoing. According to recent employment data, Texas saw significant declines over 2015 in oil and gas employment—with the industry shedding 11,300 jobs in November alone. These are sobering statistics for the Lone Star State—long accustomed to cornering the market on good economic news. There is a gathering sense that the oil price shock could set the stage for a longer term slowdown in the regional economy.

A hidden story in all this is the impact on banks and their small and middle-market customers. The quality of the oil patch loans currently on the books will be a continued focus of bank investors and regulators. And growth expectations will be tempered. Let's look at each in turn.

First, the regional bank energy loan exposure is mostly to small and middle-market companies. Consider that the critical commercial and industrial (C&I) loan portfolio segment in Texas banks, where most of the energy loans reside, has grown by nearly $8 billion since 2011. As default rates rise, regulators are pressuring banks to both aggressively address problem C&I loans and to slow lending. We hear anecdotally that the regulatory influence has significantly curtailed lending at many institutions—even in areas far removed from the oil and gas credits themselves. These restrictions will have a significant impact on community banks, energy companies, their employees and the surrounding communities.

Conservative risk management on the part of the banks has helped. Prudent hedging policies have created cash flows that will mitigate, for a while, the impact of low oil prices. We also hear anecdotally that credit standards among community banks to energy businesses remained fairly robust throughout the boom—with the bulk of funding coming from either money center banks or private equity. Banks in the oil patch remain exposed to the sector, both directly and indirectly, and the impact of a prolonged downturn could be significant.

Second, stock markets are factoring in a slowdown in growth at regional banks. Since November of 2014, Texas, Louisiana and Oklahoma bank stocks have traded essentially flat, despite continued strong financial performance. Both the price-to-tangible book value and price-to-earnings metrics are off significantly for the region's banks. Lower stock prices in this moment of uncertainty are already impacting bank consolidation as both buyers and sellers are hesitant to issue or accept regional bank stock in acquisitions. Bank merger activity in the Southwest is off for the year, with deal counts reverting to 2013 levels.

In the face of this uncertainty, bank boards in the oil patch should be proactive in shifting their companies to a crisis footing. Regulators and investors will be keenly attuned to adverse trends in credit quality and earnings, insufficient reserve methodologies and imprudent policy exceptions. By bolstering reserves, shifting to a workout footing to shore up every potential problem credit and slowing the rate of energy sector loan growth, boards and management can demonstrate to regulators and investors that their companies are positioned to handle the sector's slowdown and manage the issues that will emerge.

The oil patch economy is much more diversified than during prior oil shocks, and a big part of the region's growth story is the strength of a vibrant banking sector. How bank boards in the oil patch handle the challenge of falling petroleum prices will have important ramifications for the region's economy.

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As seen in the 1st Quarter 2016 issue of *Bank Director*