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E&P Companies Continuing to Stumble Under the SNC Review

By Laura Martone and Jeff Nichols

The Office of the Comptroller of the Currency (OCC) is continuing to scrutinize loans to exploration and production (E&P) companies secured by oil and gas collateral (RBLs). Following the substantial drop in commodity prices over the past two years, the OCC has twice issued revised guidelines for evaluation of RBLs.[1] In its recently released SNC Program 1st Quarter 2016 Review,[2] the OCC noted that the overall level of special mention and classified assets in the SNC portfolio "continues to be higher than observed in previous periods of economic expansion" and, in particular, a high level of credit risk stems from riskier loans made to oil and gas (O&G) borrowers, who have a reduced ability to repay their debt in the current commodity price environment.[3] This paper examines the effect of the SNC classifications on a specific group of 58 E&P companies, focusing on the metric that creates the biggest hurdle for them – the leverage test recently introduced by the OCC.

The SNC classification system evaluates large loans shared among national banks. After a SNC regulatory review, loans and commitments in a bank's portfolio not considered as passing loans[4] are typically given one of the following ratings: doubtful,[5] loss,[6] special mention,[7] or substandard.[8] An asset that is rated substandard, doubtful or loss is also known as a classified commitment.[9] Given the recent decline in commodity prices, it is not surprising that the incidence of non-passing loans in the O&G sector has increased. The latest SNC review showed O&G borrowers with an aggregate $77 billion in classified commitments, representing 27% of the total classified commitments in the first quarter of 2016.[10] Both of these numbers were up from $38.2 billion and 16.7%, respectively, in 2015.[11] These statistics are

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[1] For a detailed discussion of these revisions, please see our Energy Alert dated March 28, 2016, which is available at http://www.haynesboone.com/news-and-events/news/alerts/2016/03/28/new-occ-oil-and-gas-loan-review-guidelines.

[2] http://www.occ.gov/news-issuances/news-releases/2016/nr-ia-2016-87.html (Shared National Credits Program 1st Quarter 2016 Review, July 2016).

[3] *Id.* at pg. 3.

[4] "Passing" means that the credit is in good standing and is not criticized in any way. *Id*. at p. 8.

[5] "Doubtful" means that the credit has all the weaknesses of commitments classified substandard and the weaknesses make collection or liquidation in full, on the basis of available current information, highly questionable or improbable. *Id*. at p. 8.

[6] "Loss" means that the credit is uncollectible and of so little value that its continuance as a bankable commitment is not warranted. These amounts should be promptly charged off. *Id*. at p. 8.

[7] "Special Mention" means that the credit has potential weaknesses that deserve management's close attention. *Id*. at p. 8.

[8] "Substandard" means that the credit is inadequately protected by the current sound worth and paying capacity of the obligor, or of the collateral pledged, if any. *Id*. at p. 8.

[9] *Id.* at p. 3.

[10] *Id.* at p. 7.

[11] *Id*.

interesting, but they do not provide clarity on exactly which companies are not passing the SNC review or why. Our study detailed below sheds some light on both questions.

The OCC recently gave new guidance for risk rating an E&P borrower's ability to repay its RBL by adding a total secured debt repayment test, which is to be evaluated along with various other metrics and borrower characteristics.[12] One of these additional metrics is the ratio of a borrower's total funded debt to EBITDAX (Leverage Test), as to which the OCC gave the following guidelines:[13]

Rating	Total Funded Debt to EBITDAX Ratio
Pass	≤ 3.50:1.00
Special Mention	> 3.50:1.00 ≤ 4.00:1.00
Classified	> 4.00:1.00

Although neither the Leverage Test nor any of the other metrics or characteristics set out by the OCC is meant to be a bright line test,[14] many E&P companies would have trouble achieving a pass rating under the OCC's Leverage Test in 2016 and beyond. Using publicly available data for 58 such companies,[15] we estimate that, in 2016, over 91% would be non-passing credits under the Leverage Test.[16] The leverage ratio of only 5 companies out of the 58 examined would justify a pass rating in 2016. This result is astounding. The 58 companies reviewed in our study represent the largest independent E&P companies according to market capitalization for which public information is available. There are hundreds of other non-publicly traded E&P companies and it would be reasonable to assume that, as a group, they are smaller, less capitalized and less able to pass the OCC's credit metrics than the basket of E&P companies we examined. As such, their non-pass rate would likely be in excess of the 91% shown

[12] OCC Bulletin 2016-9 at p. 32 - 39, http://www.occ.gov/news-issuances/bulletins/2016/bulletin-2016-9.html.
[13] *Id.* at p. 36 - 37.
[14] *Id.* at p. 36.
[15] The authors wish to thank Tony Montano of The Mitchell Group, who provided the data and calculations used for the analysis set forth in this article.
[16] For the numerator of total funded debt, we used total long term debt, including any availability under an RBL. For the denominator of EBITDAX, we used forecasted EBITDA numbers for the four quarters ending December 31, 2016, 2017 and 2018, respectively, furnished by The Mitchell Group. Because exploration costs were not added back to EBITDA in our analysis, the resulting leverage ratios discussed in this article are likely somewhat higher than if EBITDAX were used. However, many E&P companies have severely cut back their exploration programs, so any difference is likely not substantial and it is unlikely that adding back exploration expenses would change the non-pass rate appreciably.

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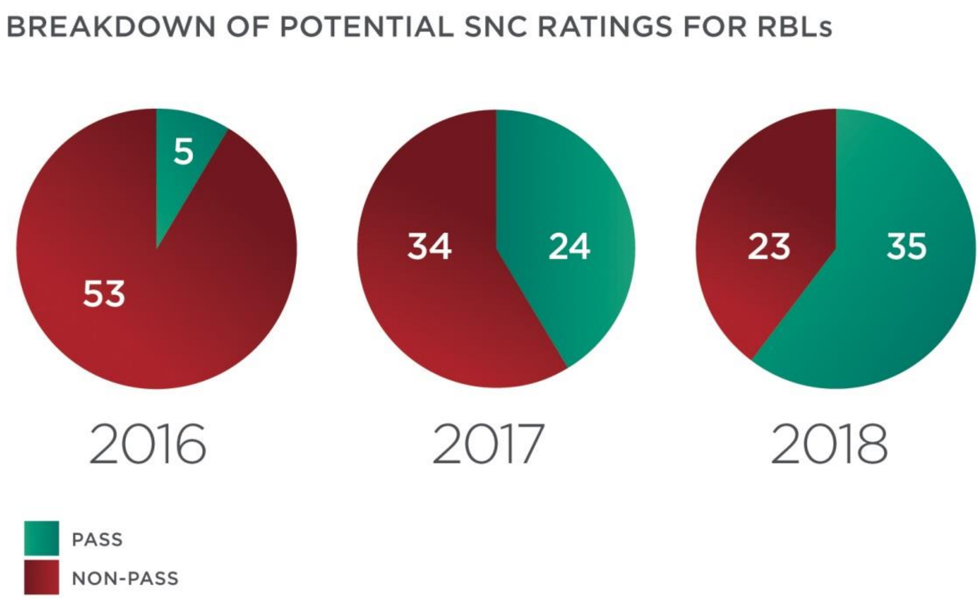
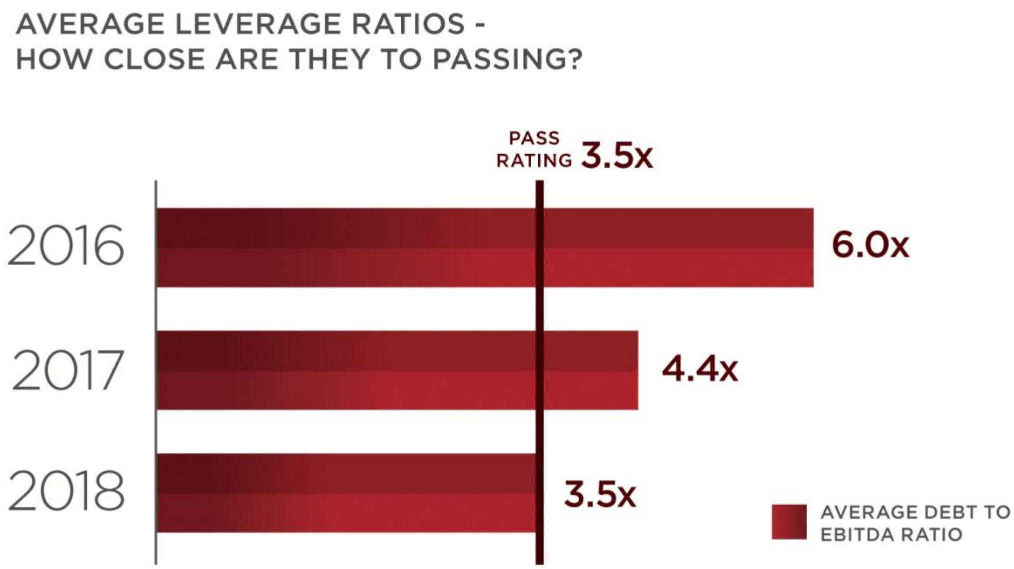
by our study.[17] This data suggests, therefore, that the OCC has deemed the vast majority of the oil and gas industry as non-bankable.



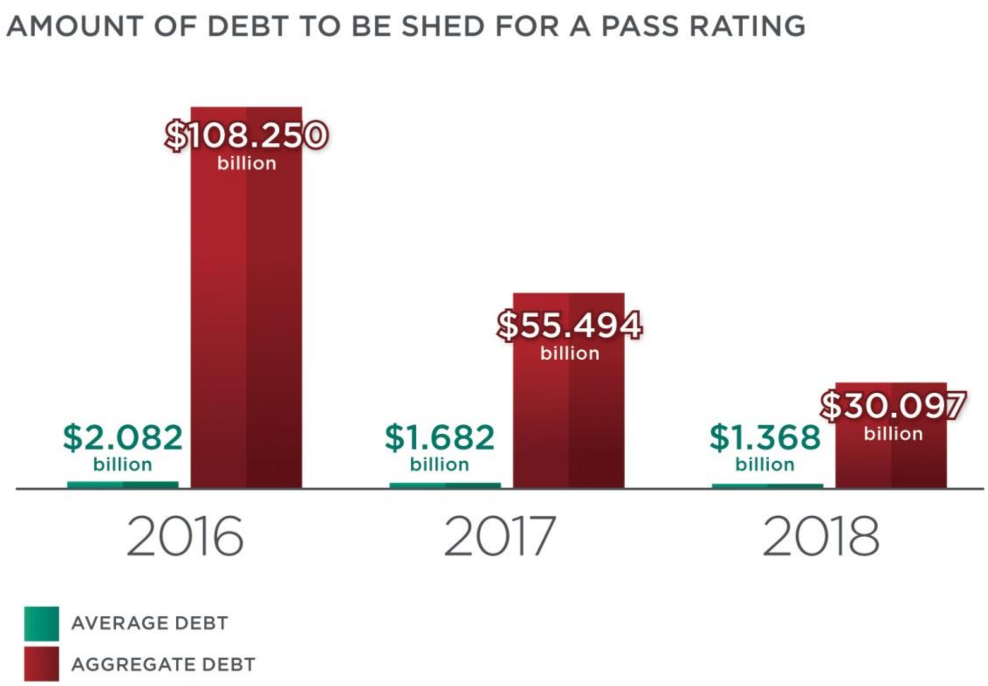
As detailed in the pie charts above, although the number of passing loans to E&P companies increases over time and actually surpasses non-passing loans by the end of 2018, almost 40% of such loans at that point in time would still fail to achieve a pass rating under the OCC's Leverage Test.[18] Not only do these results show a high percentage of E&P companies failing the test, but they also show that in 2016, the average leverage ratio of the 58 E&P companies reviewed was 6.0x, well in excess of the OCC's specified guideline of 3.5x. As reflected in the bar chart below, the average leverage ratio remains elevated in 2017 before reaching the target in 2018.

[17] It must be noted that the OCC's guidelines apply only to reserve based loans. Some of the most creditworthy companies in our study that are not required to collateralize their loans may not be subject to these regulations if their loans are not considered "reserve based". Removing these companies would be an uncertain process and would only increase the failure rate because we would be removing the most creditworthy companies from the pool.

[18] We assumed current debt levels remained steady until the end of 2018.



In addition, the companies surveyed that would not achieve a pass rating missed the targeted 3.5x leverage ratio by a fairly large margin – an average of 2.8x, 2.3x, and 2.1x in the years 2016, 2017 and 2018, respectively. In order to bring their ratios down to meet the target, over $108 billion in debt would need to come off the books of these E&P companies in 2016. Although this number declines through 2018, at that point in time, there remains over $30 billion of excess debt on these companies.



Although the Leverage Test is just one factor the OCC has suggested be considered in the risk-rating of O&G loans, the illustrations above show that many E&P companies do not, and will not for the foreseeable future, have a leverage ratio that helps to tip the scales in their favor under the SNC review. As described in our prior alerts,[19] the OCC's revised guidelines reflect a divergence between oil and gas bankers and banking regulators. Before these recent revisions, oil and gas lending emphasized reserve value, which is a forward looking determination of the value of oil and gas to be produced by the borrower. The leverage ratio, by contrast, is backward looking because it utilizes a four quarter EBITDAX number. While oil and gas lenders have always utilized leverage ratios, they did not necessarily take into account subordinated debt and they were not necessarily set at 3.5x. Now that they have become a predominate variable under the SNC review, this shift has implications beyond the high non-pass rate. It means that US banks will be slower to allocate capital to energy companies when commodity prices rise because even though reserve value may support the extension of additional credit, an E&P company's

[19] See footnote 1 above.

four quarter EBITDAX will not improve until it can drill more wells and produce better earnings for a period of four consecutive quarters. Of course, E&P companies would be quick to point out that it requires capital to drill these wells and therefore produce earnings – capital that banks will now be constrained to provide. On the other side of the cycle, the reverse would be true. When commodity prices drop, the company's four quarter EBITDAX will remain high for a period of time until four quarters of low earnings are included in its leverage ratio. If the company is hedged for several quarters, then it could take even longer for the ratio to catch up. In his recently published book, *Oil Capital*, Haynes and Boone partner Buddy Clark details the history and rationale of reserve based lending and its veracity through booms and busts. If the recent regulatory guidance causes banks to move away from reserve based lending, it will represent a new chapter in the history of oil and gas financing.