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New OCC Oil and Gas Loan Review Guidelines

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The Office of Comptroller of the Currency ("**OCC**") issued a revised Handbook for examination of Oil and Gas Exploration and Production Lending on March 16, 2016[1] (the "**March 2016 Handbook**"). This March 2016 Handbook replaces and significantly revises the OCC's prior version issued April 9, 2014, which is no longer available on the OCC website[2] (the "**April 2014 Handbook**").

Since April 2014, there has been significant activity and dialogue between energy lending banks and their regulators regarding the appropriate metrics for evaluating risk of repayment for oil and gas secured loans ("**RBLs**"). Under the Shared National Credit Program ("**SNC**"), established in 1977 by the Federal Reserve System ("**Fed**"), the Federal Deposit Insurance Corporation ("**FDIC**"), and the OCC (collectively with Fed and FDIC, the "**Agencies**"), the Agencies agreed to collectively review and assess risk in agented credits of more than $20 million that are shared by three or more financial institutions. Under the SNC review, using the Agencies' guidelines, examiners review banks' assessments for risk of repayment by their borrower under their RBLs. If the examiner determines a bank has improperly risked a credit, then there can be adverse consequences, including the requirement that the bank set aside greater reserves.

Last November, following their 2015 annual review of the SNC portfolio, the Agencies reported a high level of credit risk and increased weakness in oil and gas loans following the decline in energy prices since mid-2014. According to the report, "Aggressive acquisition and exploration strategies from 2010 through 2014 led to increases in leverage, making many borrowers more susceptible to a protracted decline in commodity prices. … Classified commitments—a credit rated as substandard, doubtful, or loss—among oil and gas borrowers totaled $34.2 billion, or 15 percent, of total classified commitments, compared with $6.9 billion, or 3.6 percent, in 2014." The Agencies further warned: "Because of the growing volume of special mention and classified commitments, as well as the significant growth in the leveraged lending portfolio, the agencies will continue to monitor, in particular, the associated underwriting and risk-management processes in the leveraged lending and oil and gas sectors."[3] In connection with the 2015 annual review of the SNC portfolio, examiners reported that a high number of SNC loans were incorrectly rated by the energy banks. Banks appealed certain of these determinations to the Agencies for loans that the Banks believed they had correctly evaluated; without much success.

The disconnect between the banks' internal rating of their SNC loans and the examiners' critique led to several meetings and telephonic conferences beginning last summer and continuing into March of this year between representatives of the large energy banks and the Agencies. In particular, much discussion, and consternation for the bankers, was caused over the Agencies' position that in risk-rating a borrower's ability to repay its RBL, energy lenders should review not just the likelihood of repayment of the RBL but the likelihood of repayment of the borrower's total funded debt.

[1] (OCC Bulletin 2016-9, http://www.occ.gov/news-issuances/bulletins/2016/bulletin-2016-9.html)
[2] (http://www.occ.treas.gov/news-issuances/bulletins/2014/bulletin-2014-15.html)
[3] (https://www.federalreserve.gov/newsevents/press/bcreg/20151105a.htm).

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Banks expressed concern that measuring an oil and gas company's total debt versus repayment of just the RBL was a significant departure from the banks' and Agencies' prior practice. Historically, while banks reviewed the general creditworthiness of a borrower and its junior debt, they principally measured their ability to recover on their RBL by comparing the value of their borrower's oil and gas assets against amounts outstanding under their loan. Banks would also measure the borrower's ability to keep its junior debt interest payments current to avoid acceleration of such debt, more so than its ability to repay principal under such loans which typically have later maturities. Given the bank's senior position over the borrower's collateral, banks were not directly concerned whether a borrower's junior and unsecured debt would be repaid except to the extent such loans provided capital to further develop the company's reserves.

Over the last five years, a number of larger oil and gas companies that invested in development of shales and other unconventional exploration and production plays have accessed billions of dollars in the public debt market in unsecured notes, significantly increasing these producers' total debt. Most energy lenders participate in RBLs to these public debt issuers. Measuring the repayment test against a borrower's total funded debt rather than total secured debt can have a significant impact on bank's loan portfolio.

In preparation for the SNC February review and consistent with their discussions with the Agencies energy banks assessed their borrowers' RBLs using a total funded debt repayment test. Dozens of loans to borrowers with significant unsecured public debt were downgraded accordingly. Subsequent to these loan classifications and the February SNC review, the March 2016 Handbook guidelines were published. Under the new guidelines it appears the Agencies have stepped back from a total funded debt repayment test to a total secured debt repayment test. If total secured debt is now the proper repayment test metric, banks may have lowered the ratings of, and set aside reserves for, hundreds of millions of dollars of RBLs that would not otherwise been downgraded.

New Assessment Ratings Standards

The March 2016 Handbook provides that the base case determination of a borrower's cash flow to repay its secured debt should be measured by the borrower's projected future net revenue ("**FNR**") less G&A and interest expense on all debt. FNR generally is defined as the sum of proceeds from future production and hedge revenues less lease operating expense, production and ad valorem taxes, and CapEx. In determining the amount of secured debt to be repaid, the guidelines provide that the examiner should include the full amount of current borrowing base under the RBL. (26, footnote 12) Provided however, where it is unlikely that the borrower will draw the full RBL commitment, examiners may also run repayment scenarios "reflecting actual or anticipated usage on the RBL." (34) The March 2016 Handbook does not provide guidance on how examiners will treat availability under the RBL borrowing base above projected CapEx nor how the examiner will be able to engineer how effective the borrower's use of such funded CapEx will be on its ability to repay the RBL. Further, rather than using the bank's price decks for determining FNR, the guidelines provide the review should use current NYMEX strip pricing "on an unrisked and undiscounted" basis of the borrower's total proved reserves. (26) The March 2016 Handbook does not provide guidelines on how far out into the future the examiners should run NYMEX pricing. Hedged values, as well as proved developed non-producing and proved undeveloped reserves that can be developed from cash flow and availability under the borrower's credit facility, can be included in a borrower's projected FNR. (26) Additionally, a borrower's ability to repay its secured debt will be reduced by any unsecured principal debt repayment obligations due prior to maturity of the secured debt obligations. (34)

For a loan to be rated "Pass," the borrower must have at least 40 percent of its total proved reserve's economic life ("**Reserve Life**") remaining after repayment of the RBL. Any RBL requiring 60 percent to 75 percent of Reserve Life to repay is rated "Special Mention" and beyond that the loan is "Classified." In addition, the borrower must have at least 25 percent Reserve Life remaining after payment of total secured debt for the loan to be rated "Pass." If 75 percent to 90 percent of Reserve Life is required to

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repay total secured debt, then the loan will be rated "Special Mention." And a borrower's RBL is "Classified" if more than 90 percent Reserve Life is required to fully retire its total secured debt. (36-37)

In addition to the secured debt repayment test, the March 2016 Handbook sets forth factors and borrower characteristics for rating RBLs, including financial ratios based on a borrower's total funded debt. (36-37) The guidelines note that the enumerated factors such as the financial ratios are not meant to be "'bright lines' … Examiners must use judgment and reasonableness when making final regulatory rating decisions; each borrower is unique." (36)

The new assessments provide that credits are rated where "leverage metrics have increased or exceed industry norms." Under the guidelines any loan to a borrower with:

a. total funded debt/EBITDAX of 3.5:1 or less being a "Pass," between 3.5 to 4.0:1 being "Special Mention" and more than 4.0:1.0 being "Classified."

b. total funded debt/capital 50 percent or less being a "Pass," between 50 percent and 60 percent being "Special Mention" and more than 60 percent "Classified."

c. total committed debt is less than 65 percent FNR being a "Pass," between 65 percent to 75 percent being "Special Mention" and greater than 75 percent being "Classified." (36-37)

If a credit is rated "Classified," that portion of the loan commitment(s) covered by Risked FNR is rated "Substandard," any incremental amount up to the amount covered by Unrisked FNR is "Doubtful," and any amounts in excess of Unrisked FNR is rated as a "Loss." "Risked FNR" is based on reserve risking at the bank engineer's discretion using such metrics as the bank determines in evaluating oil and gas reserves collateral.

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RBL Loan Classification Summary

Test	RBL Loan Rating				
	Pass	Criticized	Classified		
		Special Mention	Substandard	Doubtful	Loss
Repayment RBL	<.60 Reserve Life	.60 - .75 Reserve Life	>.75 Reserve Life		
Repayment Total Secured	< .75 Reserve Life	.75 - .90 Reserve Life	>.90 Reserve Life		
Funded Debt / EBITDAX	<3.5X	3.5 - 4.0X	>4.0X		
Funded Debt / Capital	<.50	.50 - .60	>.60		
Committed Debt / Total Reserves	<.65	.65 - .75	>.75		
			Debt <100% RiskedReserves	Incremental Debt Above Substandard <100% Unrisked Reserves	Remaining Debt >100% Unrisked Reserves

OCC's Example Loan Classification

Example Collateral Valuation (in Thousands)
Discounted PV_9 NYMEX strip

Valuation basis	Hedges	PDP	PDNP	PUD	Total proved
Unrisked NPV	$10,000	$50,000	$20,000	$40,000	$120,000
Risk adjustment factors	100%	100%	75%	50%	
Risked and adjusted NPV	$10,000	$50,000	$15,000	$20,000	$95,000
				Total collateral value:	$95,000

Example 1: OCC Classification (in Thousands)
Borrowing base commitment amount on RBL is $125 million

Loan classification	Commitment	Pass	Special mention	Substandard	Doubtful	Loss
RBL	$125,000			$95,000	$25,000[4]	$5,000
Total	$125,000			$95,000	$25,000	$5,000

Example 2: OCC Classification (in Thousands)
Borrowing base commitment amount on RBL is $75 million; second-lien term loan is $50 million

Loan classification	Commitment	Pass	Special mention	Substandard	Doubtful	Loss
RBL	$75,000			$75,000		
Second-lien term loan	$50,000			$20,000	$25,000	$5,000
Total	$125,000			$95,000	$25,000	$5,000

[4] The $25 million of doubtful represents the difference between the unrisked NPV and the risked NPV. If the borrower's prospects for further developing PDNP and PUD reserves to producing status are unlikely or not supported by a pending event, this amount should be reflected as loss. (39).

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Conclusion

As a result of the March 2016 Handbook guidelines, oil and gas producers should expect that it will be more difficult to obtain bank financing and more difficult for current borrowers to obtain amendments, waivers, extensions or increases in their current RBLs from their existing lenders. These impacts are already being felt by producers as banks have begun to apply the new guidelines in their loan policies and procedures.

The lower a loan's credit rating, the more reserves a bank must set aside. This makes it more expensive for the bank to keep a negatively rated loan on its books. On a one-off basis, if a bank takes steps to remove the loan, either through a sale of the loan or exercise of remedies in the event the loan is in default, such action would not ripple through the independent producer industry. However, because the new guidelines represent a course change for evaluating energy banks' portfolios, the impact of the new guidelines could be more like a tsunami than a ripple. The tougher standards will require greater scrutiny and analysis by bankers and their credit officers. For example, a year ago examiners were rating as "substandard" a credit where debt to EBITDAX was greater than 5:1. The more stringent 4:1 will likely send a number of RBL borrowers to the penalty box.

Historically, energy lenders have looked to the borrower's ability to repay outstandings under the RBL when internally reviewing their loan portfolio. The new instructions for bank examiners to utilize the total availability under the RBL borrowing base will put more pressure on loan evaluations. Many borrowers use their RBL as 'dry powder' to finance opportunistic property acquisitions and purposefully keep utilization of their RBL low. Under the new guidelines a borrower's loan may be penalized for maintaining this cushion of availability.

If banks, as a result of the new guidelines, require producers to pay down their RBLs (either through lower borrowing base amounts or acceleration of loans), the producers will have to cut back on CapEx, sell assets or raise equity. If a significant portion of producers whose loans are criticized under the new guidelines put some or all of their properties on the market at roughly the same time, the effect will be to depress market prices and reduce the amount available for the borrowers to pay down loans from asset sales. Also, if producers cut back on CapEx, they will be less able to replace their existing production by developing the PDNP and PUD reserves, thereby further reducing their FNR and ability to repay their loans. Less credit available to producers will also restrict their ability to hedge future oil and gas prices, exposing the producers (and their lenders) more to the ups and downs of future commodity price cycles. Any of these foreseeable responses to the new guidelines will have the likely consequence of locking in losses for the bank's production loans.

The OCC's March 2016 Handbook guidelines come at a time that producers are in the greatest need for flexibility with their lenders on their debt obligations and to be able access new bank capital due to the lower commodity price environment. For producers on the margins, it can mean the difference between survival or bankruptcy. If these guidelines tie the banks' hands and force producers to liquidate assets or file bankruptcy, the end result for banks may be to cause recognition today of greater production loan losses than has historically been the case.[5]

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[5] Standard & Poor's reported that, during 1995-2002, lending to the E&P segment of the oil and gas industry had been relatively safe, compared with other industries, because of low default rates and the potential for good recovery on defaulted debt. Standard & Poor's, "*Utilities & Perspectives, Global Utilities Rating Service*," Vol. 11, No. 43 (October 28, 2002). In 2006, S&P tracked more than 15 bankruptcies of U.S. E&P companies for the period between 1996-2005, and reported that 77 percent received full recovery, 15 percent recovered more than 85 percent and 8 percent recovered less than 85 percent. Standard & Poor's, "*S&P's Default and Recovery Analysis of U.S. Oil and Gas E&P Sector Provides Implications for the Future*," March 26, 2006, 7. Moody's, reviewing 25 years of energy loan recovery rates from 1988-2012 reported, "Where E&P recoveries do stand out is for senior secured bank debt including RBLs. … [A]verage bank debt recoveries for E&Ps were 94.7 percent, a significantly better outcome than the average 80.2 percent bank debt recovery in the broader corporate database. Bank lenders were generally made whole in the E&P defaults.

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Historic high recovery rates from prior downturns have been due in large part to the cyclicality of commodity prices. Loans that default at the bottom of the cycle have had a high recovery rate for first lien secured lenders who exercise patience and wait for the cycle to recover rather than aggressively exercising remedies when prices are at their lowest. A bank's ability to exercise patience is in part dependent upon the cost to the bank for holding onto the loan. The worse a loan is classified the more reserves the bank must hold and, therefore, patience comes at a higher cost. Because of the more restrictive guidelines, banks will have to weigh higher current reserve costs against expectations for future price recoveries.

There is also a secondary repercussion from the more restrictive credit standards set out in the March 2016 Handbook. At the least, the new guidelines will mean it will be harder and take longer to get new deals done. If the guidelines force a wave of distressed oil and gas properties onto the market following the spring borrowing base review season, the problems for the banks can be further compounded by healthier producers' lack of access to bank credit to finance property acquisitions. Without willing and financially able buyers for the assets, sale prices will fall lower, with the net result being lower recovery rates for the distressed producers and their banks. Texas endured a long and very slow economic recovery following the mid-1980s S&L-triggered real estate bust when billions of dollars of improved and unimproved commercial real estate flooded the local markets at a time when the financial institutions were least able to help finance a recovery.

The ultimate degree and impact of the new guidelines on producers and banks is hard to predict. One possible outcome is that banks may choose to no longer compete to be the first lien lender to producers who also owe (or plan to access) second lien and unsecured notes. Given that banks will be required to hold greater reserves against loans to producers with EBITDAX 3.5:1 and higher, many producers will find it hard (if not impossible) to get financing from institutions regulated by the Agencies. This does not necessarily mean that oil and gas companies will be without access to borrowed capital. Restrictions imposed by the guidelines on commercial banks will create opportunities for alternative capital sources including mezzanine lenders and private equity sources. One impact for certain, therefore, is many producers can expect to pay more for leverage going forward. The question remains however, to what extent commercial banks will be able to compete effectively with non-bank lenders for the larger oil and gas production loans.

The Agencies perform a necessary and important role in the safety and soundness of federal lending institutions. Monitoring and evaluating the commercial banks active in making reserve based loans is a part of this regulatory oversight. If, however, the impact of these new supervisory guidelines restrict the ability of energy bankers to work with their current producer-borrowers or to make new oil and gas acquisition loans to new producers, guidelines in the March 2016 Handbook may have more negative unintended consequences than the benefits the Agencies seek to achieve.

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In the case of senior secured bank debt, the average recovery was 98.5 percent." Moody's Investor Services, "*Special Comment: North American Corporate Defaults and Recoveries Oil and Gas Reserve-Based Loans Outperform,*" January 16, 2013.

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