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Much Ado About Lending: A Backwards Look at the OCC's 2016 Leverage Test

By Jeff Nichols, Laura Martone and Reem Abdelrazik

Two years ago, after a slew of bankruptcies in the energy sector triggered by a dramatic drop in commodity prices during the worst downturn for U.S. energy producers since the 1980's, the Office of the Comptroller of the Currency (**OCC**) issued new guidance that proposed changes to underwriting analysis and loan risk rating determinations by national banks and federal savings associations of loans secured by oil and gas reserves (**RBLs**).[1] Driven by a concern that banks were not appropriately capturing risks associated with increased overall leverage in the exploration and production (**E&P**) industry, the guidelines introduced new metrics by which bank examiners were supposed to evaluate the repayment risks on RBLs.[2] In particular, these revised guidelines introduced a leverage test, which was the largest hurdle for E&P companies to overcome.[3]

The Leverage Test through the Years and a 2018 Update

The changes to the guidelines added to the anxiety being felt throughout the energy industry and resulted in a large majority of E&P borrowers being categorized as "classified" or otherwise non-passing credits. When the guidelines were originally published in 2016, we analyzed a group of 58 E&P companies based on publicly available data and predicted how they would fare under the OCC's leverage test that had recently been announced.[4] Based on that review, we predicted that, in 2016, over 91 percent of the companies reviewed would not pass the OCC's leverage test. Those companies had an average leverage ratio 6.0x – much higher than the 3.5x needed to be deemed a passing credit.[5]

In September 2017, we updated our initial review,[6] which revealed that 2016 and 2017 very closely tracked our initial predictions, and which suggested that we would start to see an uptick in companies passing the leverage test by 2019.

In August 2018, we once again updated our review.[7] At the time of the update, 2018 was turning out to be better than we predicted, with approximately 74 percent of the companies passing the leverage test (compared to 58 percent predicted as of September 2017), and an average leverage ratio of 2.9x (compared to 3.4x predicted as of September 2017). Calendar year 2019 also looks better than we previously predicted, with approximately 87 percent of the companies passing the leverage test (compared to 74 percent predicted as of September 2017), and an average leverage ratio of 2.4x (compared to 2.9x predicted as of September 2017). By the time we reach 2020, we estimate that the average leverage ratio of the companies we reviewed will be 2.2x and approximately 89 percent of those reviewed will ***pass*** the leverage test – this would be quite a turnaround in four years, given our 2016 prediction that 91 percent would ***fail*** the leverage test in that year. Similarly, the data indicates that approximately $11.2 billion in debt would need to be shed to bring the non-passing companies into compliance with the leverage test in 2020, which is a far cry from the $108.25 billion that we predicted for 2016. The graphs

[1] *Oil and Gas Exploration and Production Lending*, OFFICE OF THE COMPTROLLER OF THE CURRENCY (Jan. 27, 2017).
[2] Laura Martone and Jeff Nichols, *E&P Companies Continuing to Stumble Under the SNC Review*, HAYNES AND BOONE (August 26, 2016). The authors wish to thank Tony Montano of The Mitchell Group, who provided the data and calculations used for the analysis set forth in the articles referenced herein, as well as this article.
[3] *Id.*
[4] *Id.*
[5] *E&P Companies and the OCC's Leverage Test – October 2017 Update*, HAYNES AND BOONE (Nov. 3, 2017).
[6] Laura Martone and Jeff Nichols, *E&P Companies Poised to Fare Better Under OCC's Leverage Test*, Haynes and Boone (October 31, 2017)
[7] The August 2018 update was conducted from publicly available data from 54 E&P companies.

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in this article detail the predictions from our initial 2016 report through the subsequent updates in 2017 and 2018.

Passing Vs. Non-passing Credits – 2016 Projections

Passing Vs. Non-passing Credits – 2017 Projections

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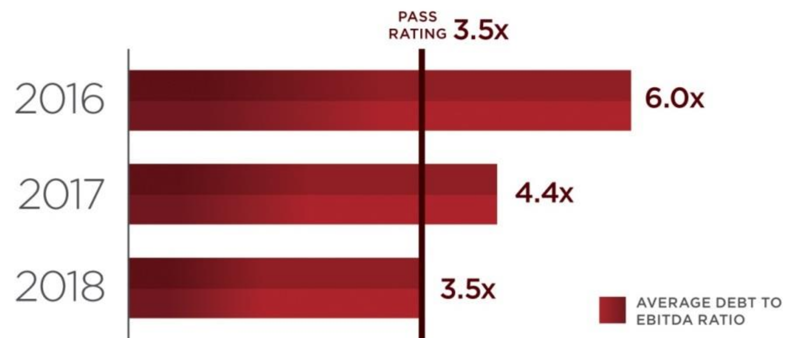
Passing Vs. Non-passing Credits – 2018 Projections

Average Leverage Ratios – 2016 Projections



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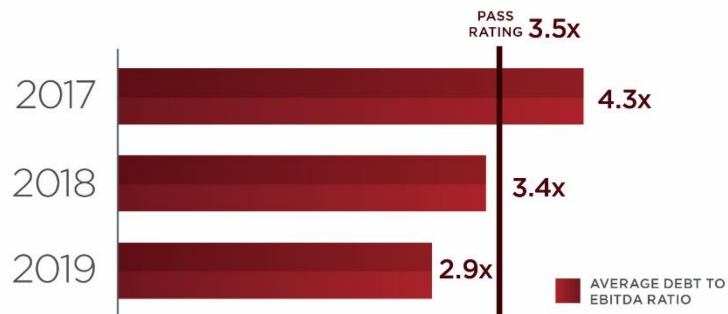
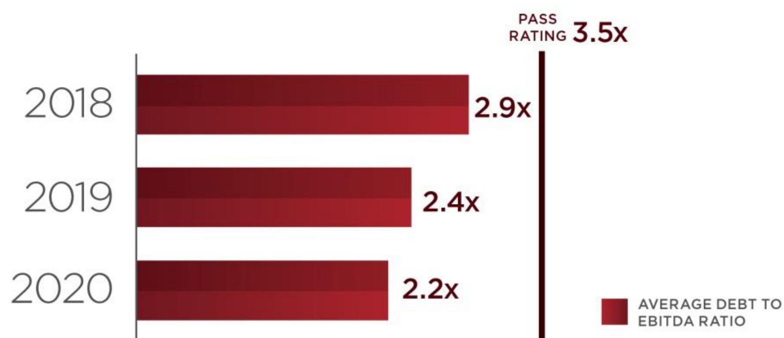
Average Leverage Ratios – 2017 Projections



Average Leverage Ratios – 2018 Projections



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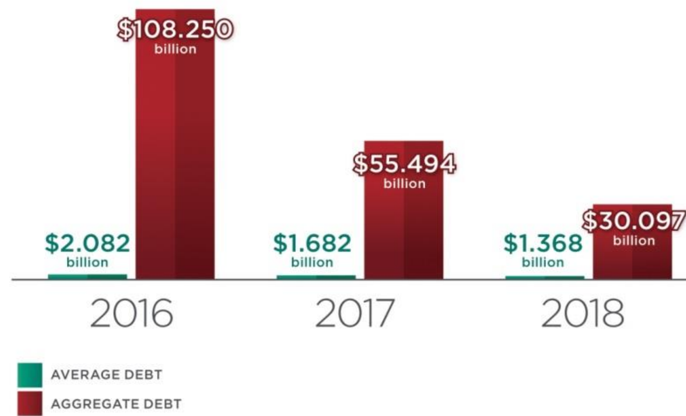
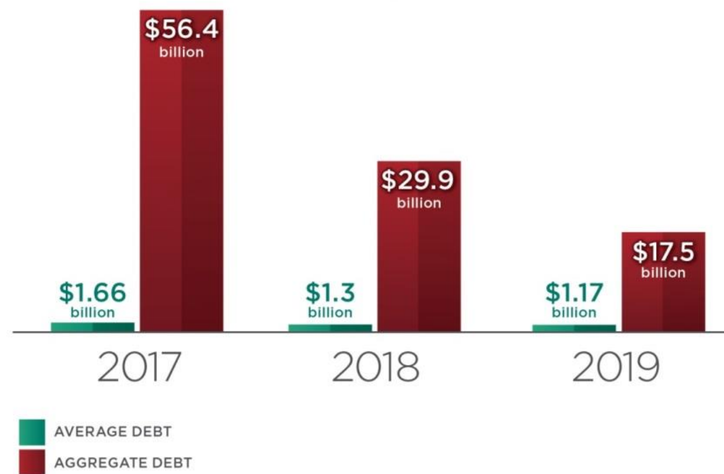
Debt to Shed – 2016 Projections



Debt to Shed – 2017 Projections



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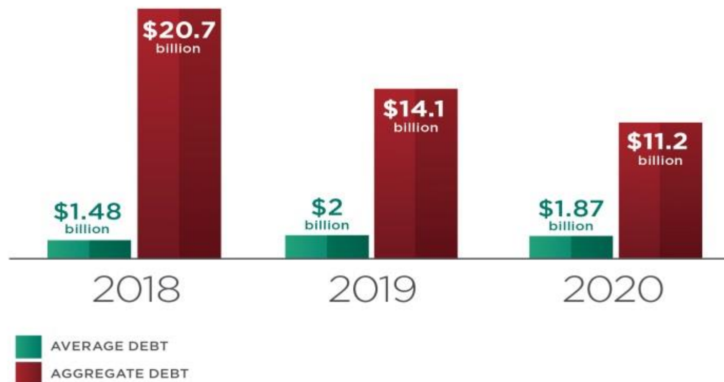
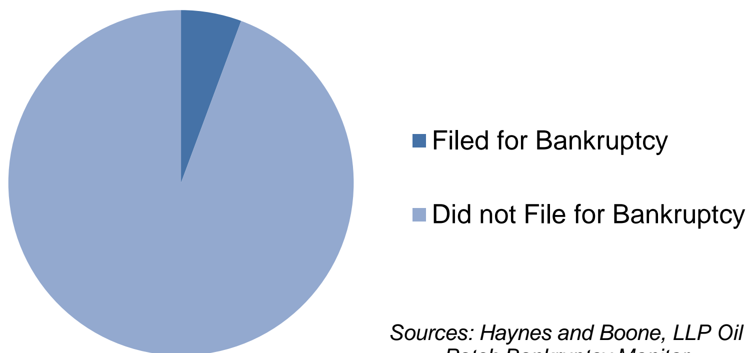
Debt to Shed – 2018 Projections



Now, we have the benefit of hindsight. At the time the guidelines were published, few believed that the test failure rate would accurately predict the rate of defaults on loans, and now we can test that belief with historic data.

Reading between the Chapters

One way to gage the validity of the test is to look at the number of bankruptcies filed by the E&P companies that failed the test. Strikingly, of the original 53 E&P companies that failed the OCC test in 2016, only three have filed for bankruptcy as of March 31, 2018. If filing for bankruptcy is a valid gauge of the accuracy of the test, then 95 percent of the companies that failed the test were false positives.



Sources: Haynes and Boone, LLP Oil Patch Bankruptcy Monitor

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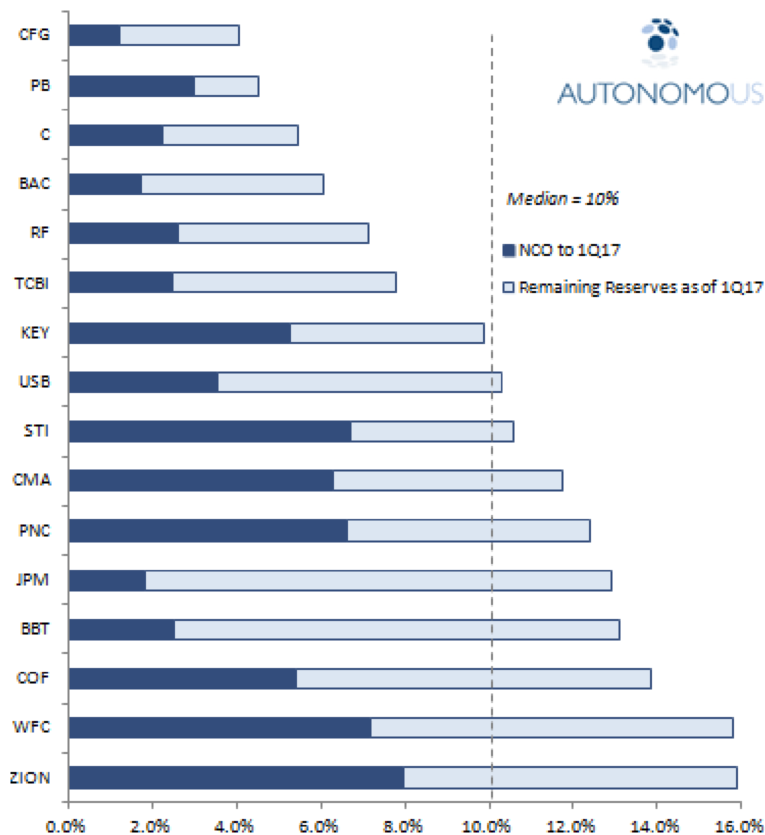
This is not to say that there were not a significant number of bankruptcies filed by E&P companies during the downturn. In fact, in their Oil Patch Bankruptcy Monitor, Haynes and Boone has tracked 160 American oil and gas producers that have filed for bankruptcy since the beginning of 2015 (a number that has significantly reduced in the last year).[8] However, it does suggest that the OCC's leverage test did not accurately measure which of these E&P companies were at a higher risk of filing bankruptcy.

A Dip in the Reserves

Another measure of the accuracy of the leverage test is to look at the reserves that banks set aside in respect of their oil and gas loans. As previously mentioned, 91 percent of the 58 companies mentioned above originally failed the leverage test; however, the banks had set aside median reserves of only 10 percent as of the first quarter of 2017. This is an apples to oranges comparison, because the leverage test uses the number of companies, and the reserves are based on dollar amounts of loans, so a small number of companies could have big loans which could profoundly affect the loan reserves while minimally affecting our leverage test. Still, the relatively low levels of reserves and charge-offs are at odds with the leverage test's predictions.



[8] Oil Patch Bankruptcy Monitor, HAYNES AND BOONE (Oct. 31, 2017).

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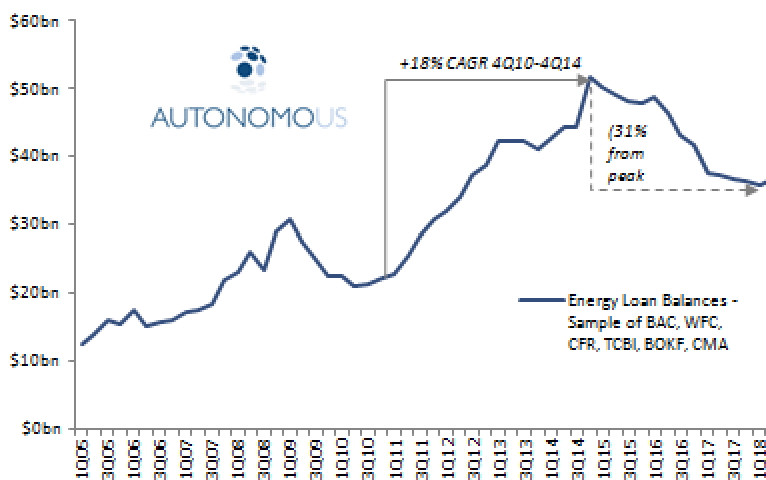
Banking on New Capital Sources

As noted above, the number of E&P companies who failed the leverage test made a marked improvement since the guidelines were first released in 2016. This improvement is expected to continue as loan balances continue to drop from its peak height in 2014.



With banks tightening up on their lending standards, this improvement has not been solely with the help of traditional banking sources. Instead these companies have been raising capital from private equity firms or bond issuances, paid down their debt load through strategic asset sales, or used non-debt techniques like farmouts, drillcos or joint ventures. In fact, according to a survey conducted by Haynes and Boone in the fall of 2017, 70 percent of the reserve-based lending activity to independent E&P companies in the industry was private equity driven.[9]

This may not always be the case, however, as there are signs that bank debt may return soon, due to the increased use of hedges to lock down oil prices. These hedges assure banks that E&P borrowers will be able to sell the oil they produce at a price necessary to repay its debt. Hedges help stabilize the finances of E&P companies, which may facilitate more bank debt soon.

Conclusion

All in all, E&P companies have generally fared better than the 2016 OCC guidelines gave them credit for. It's true that a number of factors could have contributed to their success – not least of which being the vast improvement in the price of oil. However, the low number of bankruptcies among the companies that originally failed the test and the amount remaining reserves available in these companies suggest that the leveraged test was not an accurate measurement of E&P companies' abilities to repay their loans. The leverage test, and the angst it brought energy lenders and borrowers alike, it would seem, was much ado about nothing.

[9] Borrowing Base Redeterminations Survey: *Fall 2017*, Haynes and Boone (Oct. 4, 2017).

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