

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

September 19, 2018 Jeff Nichols, Reem Abdelrazik

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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**). 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. In particular, these revised guidelines introduced a leverage test, which was the largest hurdle for E&P companies to overcome.

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. 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.

To read the full alert click on the PDF linked below.

[Much_Ado_About_Lending_A_Backwards_Look_at_the_OCCs_2016_Leverage_Test.PDF](#)