# Risks Mount for Eleventh District Banks amid Energy Weakness

By Kelly Klemme and Edward C. Skelton

**ABSTRACT:** Relatively low energy prices have slowed economic expansion and diminished prospects for Eleventh District banks. Though regional institutions outperformed their peers nationally in 2015, loan growth slowed and profitability declined, leading to a guarded outlook for 2016.

The business environment has become more difficult for Eleventh District banks amid weak oil prices, challenging institutions that have heightened energy sector exposure.[1] Tepid economic growth and a downbeat forecast also point to commercial real estate lending as an emerging area of concern.

This trying environment follows a slight profitability decline and slowing loan growth among district banks in 2015. Even so, they outperformed their counterparts nationwide.[2]

## Higher Provision Set Asides

From 2009 to 2014, district banks improved their asset quality and were able to set aside less money to ensure against possible loan losses (known as provision expense), thus boosting profitability. In 2015, banks began increasing loan-loss reserves amid concerns over energy-related credits.

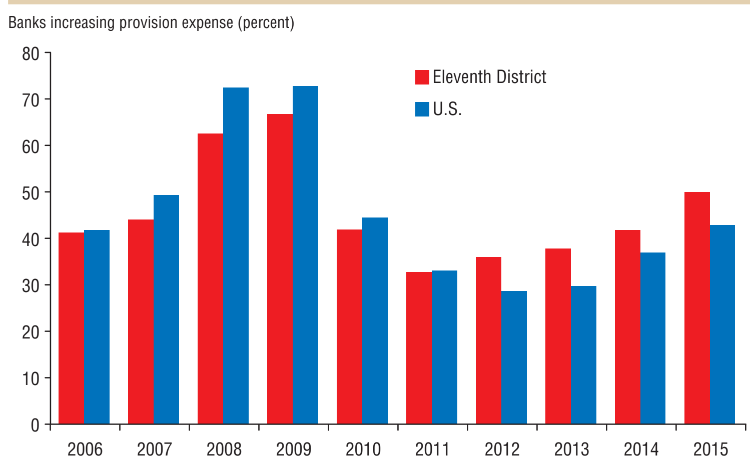
The increase in provision expense at district banks parallels increased losses in commercial and industrial (C&I) loans, which include loans to oil and gas companies. Half of district institutions—275 in all—increased provision expense last year, up from 42 percent, or 240, in 2014 (*Chart 1*).

Nationally, 43 percent of institutions boosted provision expense in 2015, up from 37 percent in 2014. Within the district, the increase was concentrated among so-called regional banks, those with assets greater than $10 billion. District banks in this size group accounted for two-thirds of the uptick in provision expense, well above their market share, which amounted to 46 percent of bank assets.

District institutions also reported an increase in the percent of loans that are noncurrent—past due 90 days or more or no longer accruing interest. At year-end, 0.93 percent of loan portfolios at district banks were noncurrent. While well below the national level of 1.53 percent, this was up from 0.85 percent at year-end 2014 and the pre-financial-crisis low of 0.54 percent in 2006.

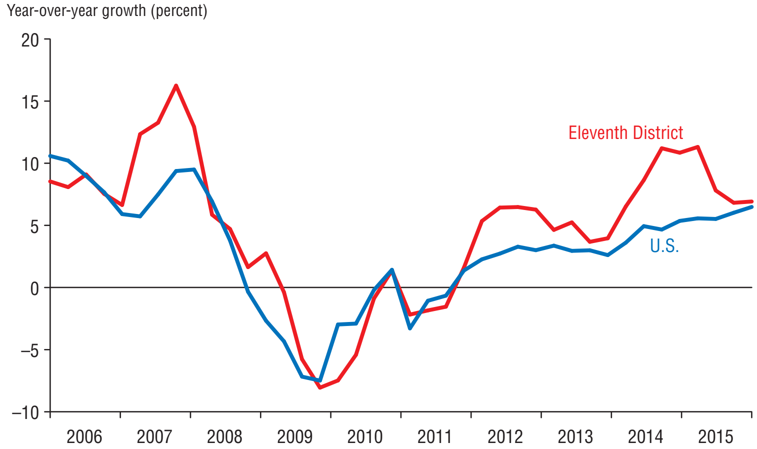
C&I loans played a role in the rise. While noncurrent C&I loans have

**Chart 1** More Banks Increase Loan-Loss Provisions



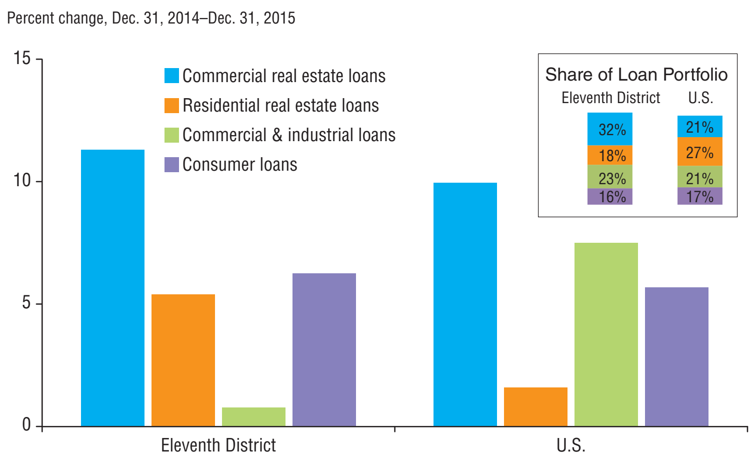

SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

**Chart 2** District Loan Growth Off Lofty Highs




SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

**Chart 3** Eleventh District, U.S. Bank Loan Growth Differs in 2015




NOTES: Commercial real estate loans are loans for construction and land development, loans secured by multifamily property and loans secured by nonfarm nonresidential property. Residential real estate loans are loans secured by one- to four-family residential property. Shares do not sum to 100 because a small "other" loan category was excluded.

SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

increased since the beginning of 2014, the pace quickened in the second half of 2015. They now account for 32 percent of district banks' noncurrent loans, up from 19 percent in 2014 and 13 percent in 2013.

C&I loans have become the largest single component of noncurrent loans at district banks, surpassing both noncurrent residential real estate and commercial real estate loans for the first time since 2005. District banks with assets exceeding $10 billion—many with a relatively high energy lending exposure—accounted for almost three-fourths of the noncurrent C&I loan increase in 2015.

Bank call reports do not provide a detailed breakout of energy loans from the broader C&I loan category, but the increases in provision expense, noncurrent C&I loans and C&I loan losses are consistent with information from recent regulatory filings and investor conference calls indicating further increases in energy-related set asides.[3] Rising energy-related provisioning reflects increased chances of loan losses—a trend likely to continue through 2016.

## District Loan Growth

Low energy prices have slowed economic expansion and likely affected district banks' C&I portfolios, contributing to sharply slower loan growth (*Chart 2*).

However, district banks still posted solid loan growth in 2015. The decrease in C&I portfolio health is also reflected in the low C&I growth rate among district banks (*Chart 3*). By comparison, U.S. banks' residential real estate portfolios grew the slowest.

Commercial real estate (CRE) portfolios have been an area of particular strength.[4] Robust commercial real estate activity is a result of heightened demand for commercial projects and the resulting rising rental rates.[5] Year-over-year growth was 11.3 percent at district banks in 2015 and 10.0 percent for banks nationwide. CRE loans make up 32 percent of loan portfolios in the district and 21 percent in the nation.

Moreover, noncurrent CRE loans remain very low—0.63 percent of the CRE portfolio in the district and 0.76 percent in the nation. However, noncurrent loans are a backward-looking measure and do not reflect current or future conditions. The strong CRE loan growth rate also improves the noncurrent rate because it increases the denominator with new loans that are unlikely to be noncurrent.

In spite of a more difficult environment, district bank profitability continued to exceed national bank profitability, although the gap narrowed (*Chart 4*).

District banks earned a return on average assets of 1.09 percent in 2015, down from 1.16 percent in 2014 but still slightly higher than the 1.05 percent nationally. Greater profitability among district banks has been driven by higher net interest income. For district banks, net interest income was almost 60 basis points (0.6 percentage points) higher than for banks nationwide at an annualized 3.31 percent of average assets (*Chart 5*). With the help of slightly lower tax expenses, this was more than enough to offset lower noninterest, or fee, income and higher noninterest, or overhead, expense.

Higher net interest income and lower fee income reflect the concentration of banks with assets less than $10 billion—so-called community banks—in the district. Their profits are driven by lending rather than fees or trading activities.

## Commercial Real Estate Concerns

Fueled by strong loan growth, banks' commercial real estate lending concentrations are rising again. Although CRE lending has been generally driven by fundamentals and backed by more capital, the increase has raised concerns about the relative amount of such lending. In December, regulators issued a statement reinforcing prudent risk management practices for CRE lending.[6]

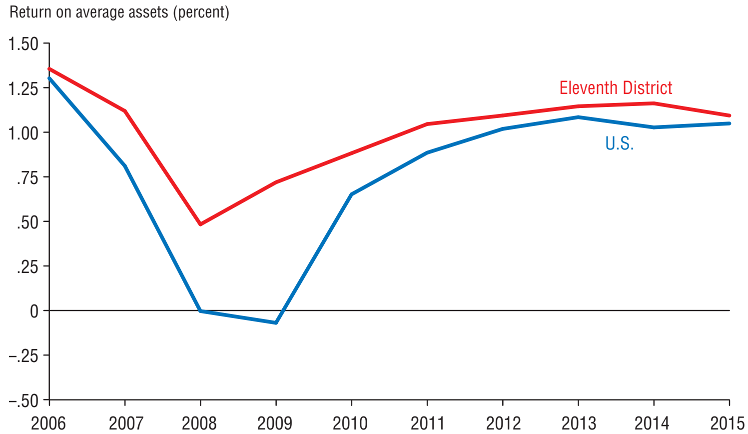
The increase in CRE loan concentration has been particularly pronounced among district institutions (*Chart 6*).

CRE loans were 188 percent of risk-based capital at district institutions at year-end 2015, up from 170 percent at the end of 2012 and above the 111 percent for institutions nationwide at the end of last year.[7] (Risk-based capital is a regulatory measure of bank capital available to protect an institution against loss.) Higher levels of CRE lending are nothing new, and regulators generally are sensitive to the risks this portfolio poses.

The CRE buildup pales in comparison to banks' exposure 10 years ago, when CRE loans were 245 percent of risk-based capital at district banks and 145 percent of risk-based capital at banks nationwide. In response to these elevated levels, federal banking regulators in December 2006 issued guidance on concentrations in commercial real estate.[8]

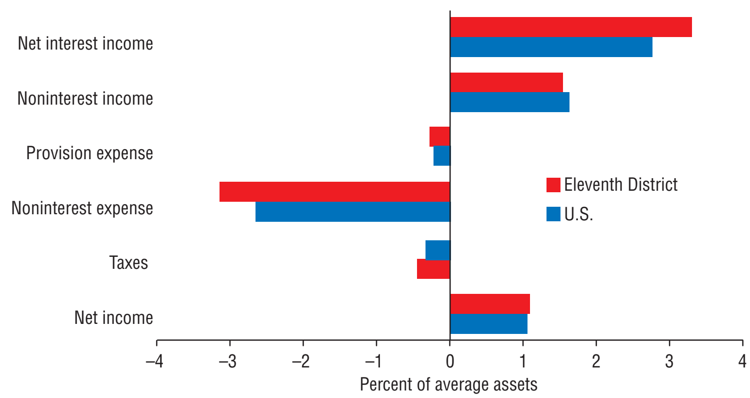
The guidance, used to identify institutions for further supervisory analysis, says a potentially significant CRE concentration exists if: 1) Construction and land development loans equal 100 percent or more of risk-based capital, or 2) If total non-owner-occupied CRE

**Chart 4** Profitability of District Banks Drifts Lower in 2015



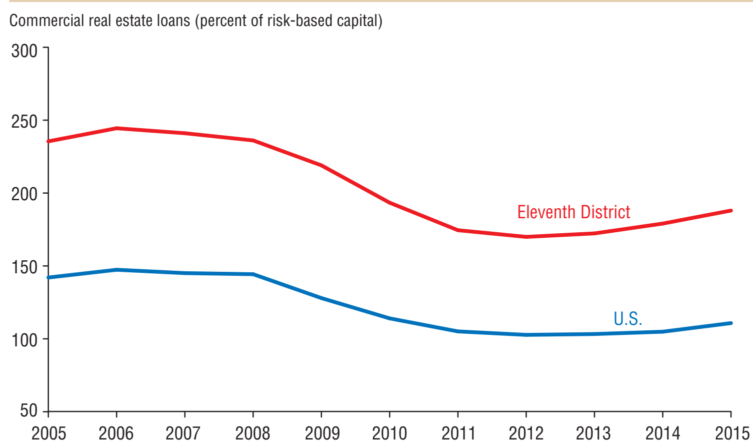

SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

**Chart 5** Net Interest Income Drives District Banks' 2015 Profit




SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

**Chart 6** Commercial Real Estate Loan Concentration Rising




SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

loans equal 300 percent or more of risk-based capital and have grown 50 percent or more over the past three years. The overriding goal of the guidance is to ensure institutions manage commercial real estate risks prudently.

To the extent low energy prices hurt economic activity, commercial real estate weakness could be a byproduct.

Following the 2006 guidance, banks' commercial real estate concentrations, weighted by risk-based capital, declined steadily for about five years. While CRE loan concentration is up since 2012, strong capital growth has limited the relative rise. Among district institutions, CRE loans have expanded 25 percent since 2006, but capital has jumped 62 percent; nationally, CRE loans have risen 12 percent, while capital has increased 49 percent.

So, while banks have extra cushion to address potential problems, a cycle of higher real estate prices is generating more CRE activity (and lending). The question becomes when and how the cycle will be interrupted.

Observing the share of banks with CRE concentrations above the regulatory thresholds can shed light on both the impact of the initial guidance and the recent rise in concentrations (*Chart 7*). By year-end 2015, the share of district institutions with CRE concentration measures above at least one of the thresholds had grown to 16 percent.

Nationwide, the share of institutions exceeding at least one of the thresholds had also grown, but only to 8 percent. In fact, 4 percent of district institutions were above both thresholds, compared with 1 percent of banks nationwide.

By comparison, in the previous five-year period, 2007–12, the share of institutions exceeding the guidelines fell from 27 percent to 6 percent in the district and from 28 percent to 5 percent nationwide.

## Energy Takes Its Toll

The persistence of relatively low oil prices has begun taking a toll on district bank customers. Oil-price hedges become less effective the longer prices stay low, and the cushion built by energy firms during the good times gets thinner. Cash flow becomes stretched and collateral loses its value, further pressuring borrowers.

Regional banks with high energy concentrations have been the hardest hit. Credit evaluators Standard & Poor's and Moody's took negative ratings actions on several regional banks with high energy exposure in February, citing weaknesses in their energy portfolios and the effects of the prolonged price slump. At the same time, regional banks increased their energy-related provisions and accelerated the pace of previously announced provisions. This combination of ratings agency actions and bank public statements sends a signal that losses are building faster than previously anticipated.

The Office of the Comptroller of the Currency issued regulatory guidance in March to address the risks associated with lending to upstream oil and gas exploration and production companies and provided examiner guidance on prudent risk management of this lending activity.[9]

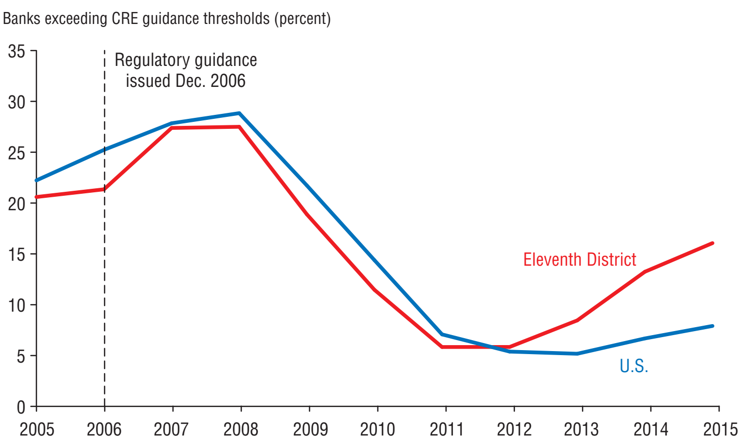
The guidance codifies standards related to leverage, debt service, controls, the borrowing base and borrower repayment capacity, including liquidity, collateral valuation and cash flow. Additionally, banks must treat exploration and production loans as reserve-based loans rather than asset-based loans, as some banks previously treated them.

This is an important distinction because under the formerly used asset-based valuation, a loan can be judged on either the borrower's financials or the collateral backing the debt, while reserve-based loans are primarily graded on the borrower's repayment capacity.[10] Eliminating the value of the collateral backing the loans tightens the loan grading methodology, making it more likely that a loan will be downgraded and a bank will be forced to provision against future losses.

Market participants view the guidance as regulatory tightening. However, this perception more likely stems from the extended oil price decline's erosion of energy loan performance and the resulting regulatory response. One part of the guidance—regarding the treatment of proven undeveloped reserves—represents an easing of standards. The guidance now gives 25 to 50 percent credit for proven undeveloped reserves, which were previously excluded from the loan grading.

Recent energy portfolio trends stand in marked contrast to the initial reaction to falling oil prices. The original assessment was that the decline

**Chart 7** Greater Share of Eleventh District Banks Exceed Commercial Real Estate Thresholds




NOTE: Regulatory guidance suggests a potentially significant commercial real estate (CRE) concentration exists if: 1) construction and land development loans equal 100 percent or more of risk-based capital, or 2) if total non-owner-occupied CRE loans equal 300 percent or more of risk-based capital and have grown 50 percent or more over the past three years.

SOURCE: Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

would be transitory, with borrowers and lenders well-positioned to weather the storm. Even a relatively sharp decline was expected to cause only limited damage, provided it was a short-term event. Through early 2015, borrowers who faced a loan-to-value squeeze due to falling collateral values were able to access the debt market or pay down their loans. Banks also benefited from their customers' use of hedges that shielded borrowers from falling oil prices.

The impact of the 2008–09 oil price decline—a 65 percent drop—provided the basis for the consensus initial expectations. While noncurrent C&I loans and C&I loan losses both increased in 2009, asset quality bounced back quickly (*Chart 8*). Only seven banks failed during that period.

A year ago, district banks appeared to have a heightened resiliency to lower oil prices due to better risk management, a more diverse economy and an improved regulatory environment.[11] But as the oil price decline that began in the second half of 2014 has lingered into 2016, its impact on some banks has become more pronounced.

## Continuing Pressure

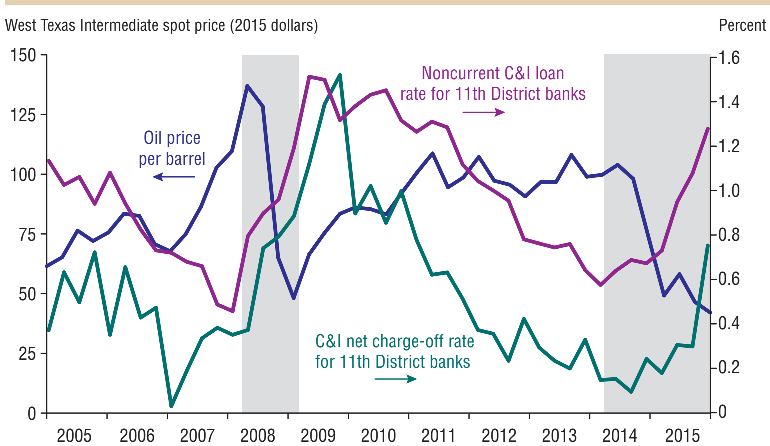
Last year, the gap between district and nationwide bank performance narrowed notably. At the same time, district-specific risks posed by CRE and oil prices seemed to gather steam.

Increased CRE lending suggests district banks' risk management should be monitored closely. Commercial real estate tends to follow a boom-and-bust cycle. The drop in energy prices is affecting CRE activity in energy-centric pockets of Texas. Some banks could be negatively affected if the economy slows further and developers struggle to fill projects financed during the CRE boom.

Another district-specific risk comes from persistently low oil prices. The impact could be severe in the energy-intensive regions of the state. Even banks with minimal direct exposure to energy could be adversely affected due to the broader importance of energy in localized markets. Households in energy-dependent regions face increasingly difficult employment and income prospects the longer oil prices remain low, even if they don't directly participate in the energy sector. As their financial situations are stressed, they are more likely to default.

Whether the risks posed by commercial real estate and oil prices will have a large adverse effect on district bank performance remains to be seen, but the banking industry confronts this challenging period in a strong financial position after a robust performance over the past six years.

**Chart 8** Oil Price Drop Impacts Asset Quality in Eleventh District




NOTE: Shaded areas denote oil price declines.

SOURCES: Energy Information Administration; CME Group; Consolidated Reports of Condition and Income, Federal Financial Institutions Examination Council.

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## Notes

[1] The Eleventh Federal Reserve District consists of Texas, northern Louisiana and southern New Mexico. Data for the Eleventh District banking industry have been adjusted for structure changes such as mergers, acquisitions and relocations.

[2] The banking industry includes commercial banks and savings and loan associations.

[3] Call reports, formally referred to as Reports of Condition and Income, are quarterly regulatory reports containing detailed balance sheet and income statement information.

[4] CRE loans are loans for construction and land development, loans secured by multifamily property and loans secured by nonfarm nonresidential real estate.

[5] For a more detailed discussion of commercial real estate trends, see "Texas Office, Industrial Markets Mostly Healthy Despite Energy Bust," by Laila Assanie, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2016.

[6] "Statement on Prudent Risk Management Practices for Commercial Real Estate Lending," joint press release, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency, Dec. 18, 2015, www.federalreserve.gov/newsevents/press/bcreg/bcreg20151218a1.pdf.

[7] Risk-based capital is used in the calculation of regulatory capital adequacy. For a detailed calculation of risk-based capital, see FFIEC Report Form 31 and Report Form 41, Schedule RC-R, Federal Financial Institutions Examination Council, at www.ffiec.gov/pdf/FFIEC_forms/FFIEC041_201603_f.pdf.

[8] The policy statement was issued Dec. 6, 2006 (as Supervisory Letter SR 07-1) and can be found at: www.federalreserve.gov/boarddocs/srletters/2007/sr0701.htm.

[9] See "Oil and Gas Exploration and Production Lending," Office of the Comptroller of the Currency, March 2016, www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-og.pdf.

[10] Generally speaking, traditional asset-based loans have accounts receivable, securities or another highly liquid asset as collateral. Collateral for reserve-based loans typically has a longer cash conversion cycle. In the case of exploration and production loans, collateral is usually oil reserves in the ground, which are both costly and require experienced operators to obtain.

[11] See "Robust Regional Banking Sector Faces New Economic Hurdles," by Kelly Klemme and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter, 2015.