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STATEMENT ON

THE DECLINE IN OIL PRICES AND ITS
IMPACT ON THE BANKING INDUSTRY,

PRESENTED TO *The*

Senate COMMITTEE ON ENERGY AND NATURAL RESOURCES,
UNITED STATES SENATE

BY

RB
ROBERT V. SHUMWAY
DIRECTOR
DIVISION OF BANK SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

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Mr. Chairman, members of the Subcommittee, we appreciate this opportunity to discuss the impact the precipitous decline in oil prices is having on the banking industry and to outline the steps the FDIC has taken and is taking to assess this situation. Before I discuss the impact we see on banks with loan concentrations in the oil and gas areas and particularly banks located in the Southwest, I would like to take a few minutes to discuss the trends we perceive in the oil and gas industry.

Economic Trends In the Energy Industry

While oil prices have fallen dramatically over the past four months to the lowest levels in over seven years, fundamental forces have been adversely affecting the oil industry since the early 1980s. On the supply side, we have seen the emergence of a large and persistent surplus of oil production capacity with significant increments of production in Alaska, Mexico, and the North Sea coming on-stream. As a result, non-OPEC producers have increased their share of the world oil market. Non-OPEC producers are, for the most part, medium and high-cost producers who supply at or near capacity. OPEC, on the other hand, is composed of the marginal or swing producers, supplying the extra oil required in the world market. Since 1979, daily OPEC production has declined dramatically from 31 million barrels to roughly 16 million barrels due, in great part, to a decline in world oil demand and Saudi Arabia's willingness to limit its production in order to prop up oil prices in the marketplace.

On the demand side, three fundamental forces have been at work. First, the rate of growth in the economy of the industrial world has declined substantially within the last ten years with annual growth rates about one-half of what was

experienced between 1960 and 1973. Second, the demand for energy has declined as a result of government-sponsored conservation programs implemented in the early 1970s and changes in the habits and behavior of consumers to conserve energy. Over the last ten years, energy demand has grown at only a fraction of the rate experienced between 1960 and 1973. And third, the demand for oil has declined as the availability of alternative energy sources, most notably natural gas, has increased.

The steep decline in oil prices during the first quarter of 1986 culminates a four-year period in which competition has been intensifying among energy producers while the previously noted energy demand has been moderating. The recent decline in oil prices is due, in great part, to Saudi Arabia increasing its daily production from two to four million barrels a day, reversing its policy of accommodating the other 12 OPEC nations who have been producing oil above their agreed upon allotments in order to maintain needed revenue levels. In doing so, Saudi Arabia has demonstrated a willingness to try to enforce cartel discipline.

Prices have been quite volatile over this period with the one-month futures contract price of a barrel of West Texas Intermediate oil, considered the U.S. benchmark, declining from \$31.72 on November 21, 1985 to \$12.72 on March 14. Oil prices had declined some \$6 between mid-November and year-end 1985 on the strength of widespread increases in output among producer nations and price-shaving by members of the 13-nation OPEC cartel. When it became clear in mid-January that Saudi Arabia intended to further expand its oil output, the spot price fell more than \$5 per barrel in two days. This launched the world oil market into a spiral which sent prices well below \$15 per barrel. In recent weeks oil prices have been

somewhat more stable but, under existing demand conditions, any new rounds of competition among the low-cost oil producing OPEC nations and other producers could generate further steep declines in oil and natural gas prices.

At present, most forecasters do not anticipate a prolonged price war, but all recognize it as a realistic possibility. While there is less consensus among oil forecasters now than at any time in the past, the most likely scenario we have seen appears to be that prices will remain near current levels or perhaps rise modestly until the end of the decade. Major producer nations will probably seek to avoid destructive competition through production agreements, and energy conservation is likely to lose some of its momentum over this period. For the longer term, it appears that, even in the absence of new oil and gas discoveries, average price increases of three percent annually are about as large as can be expected. This suggests that inflation-adjusted oil prices will be unlikely to recover their 1984 levels by the year 2000, and they could remain vastly lower than their 1981 peaks. Therefore, even without considering the very real threats which could precipitate another oil price plunge, the near, and possibly the more distant, future appears to hold much lower energy prices than had been expected until recently. A growing minority view, however, sees energy shortages reoccurring by the mid-1990s with OPEC again assuming control of world oil prices and the U.S. again becoming dependent on the Middle East to meet its energy needs.

For the bulk of the U.S. economy, the outlook for low oil prices is a positive one. If energy costs remain below their 1985 levels as expected, economic growth in 1986 is likely to be higher, while inflation and long-term interest rates are likely to be lower than otherwise. The magnitudes of these effects are presently

uncertain, but it has been suggested that a full percentage point may be added to 1986 real GNP growth if oil prices remain under \$18 per barrel. There is already some indication from the bond market that the oil price outlook is consistent with a lower interest rate environment. Yields on ten-year Treasury bonds have fallen 200 basis points since November 1985, when oil prices also began to retreat from their 1985 highs. Other forces no doubt are at work in reducing long-term rates, but investor optimism regarding oil prices may remove one obstacle to this process by easing inflationary expectations.

Estimates of energy's impact on inflation are highly speculative, but prices of consumer goods as measured by the consumer price index could decline more than one percent if oil prices remain in the neighborhood of \$15 a barrel for 1986. In any case, the current prices for oil and natural gas could represent tens of billions of dollars in savings to American consumers by the end of this year. As new purchasing power would be freed for diverse uses, this benefit to consumers would undoubtedly redound on the vast majority of domestic industries and most financial institutions.

The Southwest Economy

The prospects of lower oil prices have a radically different implication for the energy-producing regions of our country, principally the Southwest and most notably the States of Louisiana, Oklahoma and Texas. They face a probable extension of the difficult adjustment period which already has resulted in large economic losses in that part of the United States. In 1985 alone, the effects of depressed energy prices held economic growth to under one percent for Louisiana and

Oklahoma, while the previously brisk expansion of the Texas economy slowed to nearly two percent real growth. Louisiana's rate of unemployment hit 11 percent in November 1985 and, by year's end, the unemployment rate in Texas may have exceeded the national average for the first time in 15 years.

The losses extend far beyond the oil and natural gas industries for these regions. Faltering energy prices have depressed real estate markets in several areas of Oklahoma, Texas and Louisiana. Office vacancy rates were as high as 25 percent in Houston and 17 percent in Dallas during 1985, and residential building permits issued in Louisiana declined by more than 25 percent from year-earlier levels. In addition, it has been estimated that Texas will lose \$100 million in state revenue, 25,000 jobs, and \$3 billion in economic activity for every \$1 drop of oil prices below their average levels of \$25 a barrel calculated for 1985. At \$15 per barrel, Texas would lose roughly \$1 billion in taxes, 250,000 jobs, and \$30 billion in gross state product from its \$250 billion economy. Louisiana's economy is similarly dependent upon its energy sector, with nearly 40 percent of state revenues having come from oil and natural gas production in past years. Overall, these state economies are roughly five times more dependent on energy production than the nation as a whole.

Moreover, the secondary effects in these regions are likely to multiply the longer oil prices remain at current levels. The figures just cited may underestimate the long-term economic damage. High vacancy rates will translate into less new construction. Local government revenues will diminish along with the state revenues. In the process, public sector jobs will be lost and the service economy will contract as the ripple effects of low oil prices overwhelm an increasing number of

its customers. Hence, our energy-producing areas appear to face a relatively difficult economic future if oil and natural gas prices remain at depressed levels.

Impact on the Banking Industry

For many banks located in the Southwest and for those other institutions with oil and gas loan concentrations, the overall impact of lower oil prices, to one degree or another, will result in higher levels of nonperforming assets, above normal loan losses, reduced earnings and slowed asset growth. These projections represent a continuation of the general deterioration we have seen occurring in banks located in the Southwest region consisting of Arkansas, Louisiana, New Mexico, Oklahoma and Texas. In 1981, the annual asset growth rate of banks in the region was 18.8 percent or twice the national average of 9.4 percent. However, in 1984, it had dropped to 4.2 percent or 28 percent below the national average of 5.8 percent. Nonperforming assets as a percentage of total assets increased each year from 1982 to 1984 and exceeded the national average for the first time in 1984. Net loan chargeoffs also have been above the national average since 1982.

Earnings and capital trends remain relatively good in comparison to the averages for all banks nationally, however, the Southwest banks may have difficulty maintaining this position over the next few years.

As a result of our concern over some of the above noted economic and bank trends, we conducted an informal survey of our regional offices in January 1986 to determine the potential effects on state-chartered FDIC insured institutions if the price of oil should decline substantially. The survey identified those energy

banks with over \$100 million in total assets in each respective region and obtained certain information to help us monitor and supervise those banks more closely. An energy bank was defined as an institution which reported concentrations of at least 25 percent of total capital in oil and gas loans. Obtaining a complete list of so-called energy banks is not as easy as it seems since Reports of Condition (Call Reports) completed by each institution do not contain any segregation of energy loans. Also, there is no common definition for precisely what is an energy bank or, for that matter, precisely what is an energy loan.

The FDIC survey, in conjunction with information on nationally chartered banks received from the Office of the Comptroller of the Currency, identified 563 energy banks throughout the banking industry, 245 of which are state-chartered institutions. We identified over \$61 billion in energy loans in these institutions, \$57 billion of which are held by 59 banks with total assets each of over \$1 billion. In other words, approximately 92 percent of the total energy loans identified from the survey are concentrated in the large regional and multinational institutions across the country. The above total loan amount, however, does not include U.S. bank exposures to less developed countries such as Mexico and Venezuela as well as energy loans in banks not captured by the survey.

Approximately 65 percent of the oil and gas credits held by these large institutions are \$20 million in size or larger. These credits are reviewed annually by examiner teams from each of the three federal bank regulatory agencies under the Shared National Credit Program. The findings of the last review conducted in April 1985 indicate that 17.5 percent of the oil and gas credits were criticized compared to only 5.4 percent of all other industry loans reviewed. As a result of the

decline in oil prices, we expect this percentage to increase at the next review, scheduled shortly.

The 504 smaller community banks identified in the survey are located principally in Texas, Oklahoma and Louisiana, the three states identified as being most dependent upon the energy industry. Our examiners most familiar with oil and gas credits indicated that the greatest risk of loss is present in loans to "independent" oil companies involved principally in exploration and production activities and in loans to the service sector. Available information suggests these types of loans are, for the most part, not very prevalent in smaller institutions. The one exception to this general comment involves the banks in Oklahoma where it is reported many loans are production-type credits. Loans to the ten largest integrated oil companies (the Majors) will be least affected by the drop in oil prices due to the fact that they are more diversified, generally have stronger balance sheets, are able to cut back capital spending and exploration budgets and, therefore, are better able to absorb losses.

While we lack reliable statistics, the smaller institutions in Texas, Oklahoma and Louisiana appear to be most vulnerable to the "ripple effects" in the economy. These community-type banks have less flexibility to diversify their loan portfolios since they are small, mostly independent institutions, operating under limited branching powers. Those banks that have attempted to diversify into such areas as real estate and agriculture are also discovering problems in these industries.

A look at the failed bank statistics for these three states, particularly Texas and Oklahoma, over the past five years also suggests that the region's banking problems may be getting worse than those for the nation as a whole. In 1981, there were no bank failures in this area, but from 1982 through 1985 Texas and Oklahoma experienced 28 and 22 bank failures, respectively, with the largest number of bank failures in each state occurring last year. In 1985, Texas and Oklahoma together experienced 25 bank failures, as compared with a total of 120 in the U.S. as a whole. These two states had 20.8 percent of the 1985 bank failures but account for only 16.6 percent of all banks in the country. Thus far in 1986, these two states have experienced five bank failures. In recent years, Louisiana has experienced only three bank failures -- one in 1984 and two in 1986.

In light of recent economic events, current trends suggest that, at least for the next year, bank problems and failures in this area are likely to continue at levels at least equal to, and quite possibly higher than, those experienced in 1985. We can assure you, though, that the FDIC as well as the other bank regulatory agencies are carefully monitoring the situation through our examination programs, offsite monitoring systems and special surveys of the kind I have previously discussed. Most of the area banks remain in sound condition. For those institutions that are experiencing problems because of economic conditions but are well-managed, the banking agencies are working together to develop initiatives that will help the banks through this difficult period.

To enable us to deal more effectively with failing and failed bank situations, we proposed to the Senate Committee on Banking, Housing, and Urban Affairs on March 13 a legislative package including a Federal depositor preference statute, the

interstate provision of the Garn-St Germain statute be extended to permit the interstate acquisition of failing banks which have assets of \$250 million or more, and that the FDIC be empowered to own and operate a bank for a limited period of time while we put together an orderly acquisition. We believe these recommendations would greatly increase our options for handling bank failures and reduce the overall cost to the FDIC insurance fund, thereby contributing to the stability of the system.