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CloserLook

Falling oil prices: Should banks be worried?

Oil prices down by 60 percent, worries of state-level economic impact, and, in the background, fears about unforeseen consequences for financial firms: bankers who remember the 1980s probably feel a strong sense of déjà vu—and more than a little concern. The industry's wariness is hard-won. The last time oil prices fell so much and so quickly (not including the exceptional circumstances of the Great Recession) the result in some areas was catastrophe. Between 1980 and 1989, nine of the 10 largest Texas bank holding companies—and almost 30 percent of the state's banks in total—failed.[1]

So it's no surprise that the fall in oil prices has riveted industry observers. Financial projections based on price levels of just a few months ago now look uncomfortably rosy. But on the other hand, low prices at the pump may give the consumer economy a boost in the medium term, compensating for revenue losses in areas such as direct lending to the oil sector.

These countervailing factors make thinking through potential impacts important. History offers a guide, but the structure of the banking industry has changed so much over the last 30 years that comparisons might not be accurate. Interstate banking, and generally increased diversification among banks, presumably lessen the chances of an '80s-style regional banking crisis.

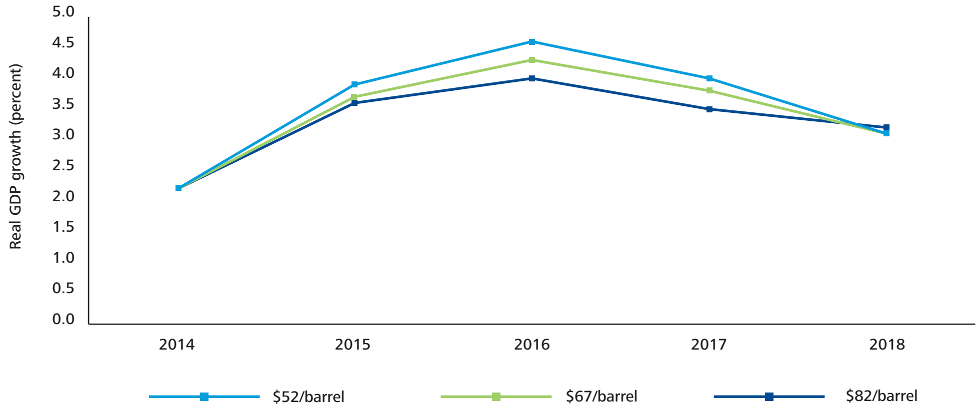
On balance, the impact on the overall US banking industry is probably moderate. But banks concentrated in oil-related industries or geographies are likely to face meaningful challenges. Outlined below is an examination of the likely effects of low oil prices on different banking activities and potential strategic implications for banks.

Price trends and economic impact

Oil prices are likely to stabilize at a lower level. Deloitte MarketPoint analysis indicates that market forces will gradually bring West Texas Intermediate (WTI) prices per barrel to an estimated 2015 average of $62, increasing slowly thereafter.[2]

At the macro level, calculations show that the net impact on the US economy will likely be positive (Figure 1). Despite the shale boom, the US is still a net oil importer, and lower global oil prices directly benefit both consumers and many industries. Globally, the World Bank estimates a 30 percent decline in oil prices leads to 0.5 percent output growth.[3]

Figure 1: Economic impact of oil price levels on US GDP growth



Source: Deloitte calculations using the Oxford Economics Global Economic Model. Price levels refer to Brent crude prices per barrel, which are assumed to be somewhat higher than WTI.

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Less positively, states benefiting from the recent boom in oil production could see a significant economic slowdown. In 1985 Texas derived $42 billion from activity related to oil and gas extraction—14 percent of the state's GDP.[4] The 2013 share is eerily similar: 13 percent of the state's GDP. There is no way to know whether Texas or any other oil-dependent state will necessarily face a serious recession this time, but signs of at least a moderate economic downturn may already be evident.[5]

On balance, then, expect to see two possible broad economic consequences: a modest uptick in growth and employment across the nation if oil prices stay low for a while, but sharp localized downturns.

Lower prices create pressure on lending and capital markets activity

The impact of lower prices on domestic banks won't necessarily follow the broader economy. Exposure even among similar firms varies widely, and assessing the net effect is difficult. Many areas of a bank's business might feel the effects, either directly or indirectly, but it seems safe to say a greater impact is likely to be felt in two areas: lending and capital markets.

Lending: Managing concentration challenges

Direct dollar figures for energy-related bank lending are difficult to get, but banks highly concentrated in direct loans to the oil industry (especially to upstream companies) are obviously at risk. The more prudent of them will have already taken steps to hedge or otherwise mitigate this concentration. But the decline in global oil prices has been surprisingly large and steep, perhaps surpassing the estimates of many institutions.

New stress testing of portfolios (outside the normal CCAR process), already under way at many banks, is the first step in accounting for this shock. The sharp decline also raises important questions about model risk. Most assumptions probably would not have accounted for this kind of sudden drop, highlighting the potential drawback of traditional risk models.

Even banks without outsized energy lending portfolios may suffer, if they derive a good chunk of their business from any of the oil regions. In the 1980s, some of the most severe damage resulted from related commercial real estate lending losses, rather than direct losses on oil and gas loans.[6] Performance and demand for other categories of loans—whether consumer credit or business lending—may also suffer, as oil-patch woes potentially bleed over into local economies.

Fortunately, due to structural changes in the industry—such as interstate banking, business diversification, and improved risk management practices—even losses on concentrated portfolios may not pose the same threats to safety and soundness seen in the 1980s. For example, Texas-domiciled banks have commercial real estate loans equivalent to 173 percent of risk-adjusted capital, which is below both the typical regulatory cautionary risk limit and below comparable concentration metrics of the 1980s.[7]

Impact on investment management

Of course, the impact of low oil prices goes beyond mainstream banking. High-yield bonds, collateralized loan obligations (CLOs), and private equity are also feeling the effects, but in different ways. For instance, high-yield bond spreads widened considerably over the last few months, driven by concerns about potential defaults. The oil and gas sector makes up around 15 percent of the high-yield universe—indicating these fears may be justified.[8]

Some oil and gas companies have taken steps to find new funding sources and bolster their liquidity position.[9] But those leveraged companies that have not fortified their balance sheets will most likely face harder times if oil prices don't recover for a while; redeterminations in the spring and fall may add clarity on their positions.

Similarly, the collateralized loan market seems relatively safe at the moment. As Standard & Poor's reports, "based on our review in December 2014 of roughly 700 US CLOs, the average CLO exposure to loans issued out of the oil and gas sector was only about 3.3 percent."[10]

The news for private equity firms, however, appears mixed. Having invested heavily in the energy industry in recent years, many firms will likely face losses in their portfolios. Potential opportunities to invest in distressed energy companies should provide some upside[11] and some leading private equity firms are building up their cash levels to do so.

On the bright side, banks not concentrated in oil-rich states may benefit from consumer savings at the gas pump in a number of ways, including demand for new loans (particularly auto loans) and lower delinquencies, but these effects will likely take time to play out more broadly.

There is one other opportunity in declining oil prices. Banks that have not been negatively affected by the decline may find M&A opportunities among distressed peers, allowing relatively low-cost expansion into markets that remain highly attractive in the long term.

Capital markets: Prepare for a short-term decline in activity, consider long-term strategy

Much has been made by industry observers of how dependent investment banks may be on revenue from the energy sector.[12] This concern may well be justified. Looking again to the historical comparison, the potential problem is clear: from 1985 to 1986, US oil and gas M&A deal value fell 66 percent, not reaching the precrash level until 1998.[13] While few expect this kind of deep plunge, annual oil and gas sector M&A and equity underwriting are positively correlated with oil prices by multiple metrics, indicating a short-term decline in activity (Figure 2).

Accordingly, a sustained decline in global oil prices may have some unfortunate consequences for investment banks, especially those specializing in oil and gas deals. Underwriting revenue in particular may suffer, at least in the short term. A depressed deal market, signaled by declining deal volumes in 4Q 2014 totals, may take some time to recover. When it does, perhaps later in 2015, the spur will likely come from buyers attracted to favorable pricing and distressed situations.[14]

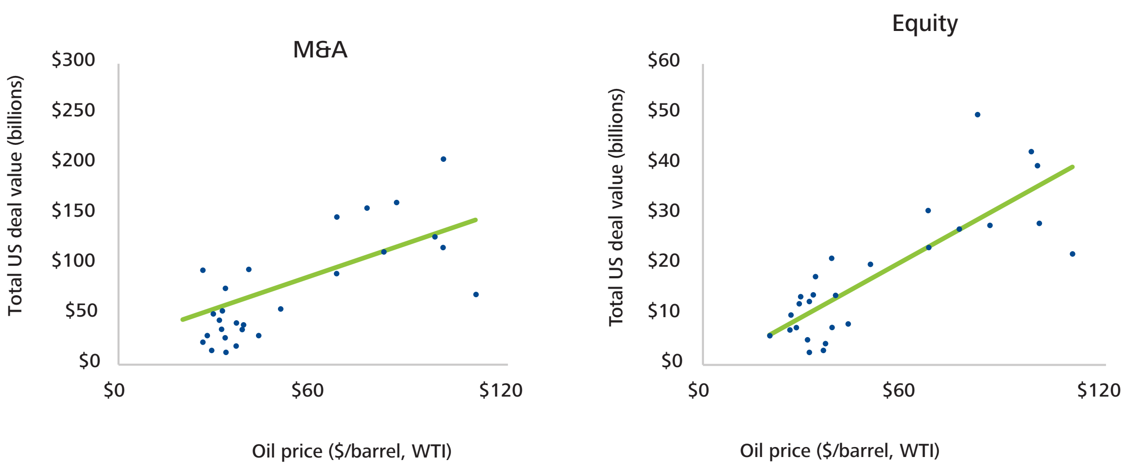
Unfortunately, investment banks can't do much to counter these difficulties in the short run. Aggressive cost controls or pricing plays might backfire when the market picks up again, and any efforts to diversify will take time to bear fruit. The key, then, is to use this moment as an opportunity to consider whether the energy sector is a longer-term strategic priority, and invest or draw down accordingly.

What next?

Lower global oil prices are a net positive for the US economy and will likely prove a net positive for many banks and other financial institutions. However, for some US regions and financial institutions, lower oil prices may generate formidable headwinds to growth and performance. Banks with large global operations, while enjoying the benefits of lower oil prices, may also face some additional challenges flowing from greater exposure to geopolitical risks.

The greatest unknown, of course, is just how sustained these lower prices will be. Based on current information, it appears prices will remain lower than past years for at least a year or two, but commodity price predictions are famously challenging. Regardless of the duration of this lower price level, however, banks must respond as best they can. For many, this will be a pleasant adjustment to improving prospects. For others, less rosy scenarios prevail, making quick decisions based on robust data and analytics essential to weathering the storm.

Figure 2: Correlation between oil prices and energy sector capital markets activity, 1986-2013



Source: Deloitte Center for Financial Services, US Energy Information Administration, and Thomson Reuters MergerMarket database. All dollar values adjusted for inflation.

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Endnotes

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