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John Reed's LDC and Hancock's energy reserve build

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Hancock Holding Co. has preannounced two quarters back-to-back for about $87 million of reserve-building for its $1.6 billion energy-related loan portfolio. As of April 8, its shares had fallen 26% over the past year. Hancock has plenty of company among banks in what used to be called the oil-patch (Louisiana, Oklahoma and Texas). BOK Financial Corp., Cullen/Frost Bankers Inc., IBERIABANK Corp. and Texas Capital Bancshares Inc. have fallen 15% to 28%. Houston-based Green Bancorp Inc. closed at $7.03 on April 8, down 38% over the past year and more than 50% from its well-timed August 2014 IPO price of $15.00 per share.

Absent a cataclysmic event Hancock's oil & gas saga is not going to merit an asterisk in banking history even if the 2016 first-quarter $45 million reserve build proves to be the second in a series of installments. Hancock and its 2011 merger partner Whitney Holding Corp. survived the 1980s downturn and went on to prosper in the 1990s. More notable is the broader narrative of the disappointing performance of Hancock since it merged with Whitney, but I digress.

The energy story among lenders, so far, is a slow-moving story that appears to be a long way from a cathartic cleansing. Thus far, it has been about incremental reserve building. Moody's did not make a case for a wash-out in a report it released April 7. Moody's estimated that in a worst-case scenario the combined losses of JPMorgan Chase & Co., Goldman Sachs Group Inc., Morgan Stanley, Citigroup Inc. and Bank of America Corp. would require an additional $9 billion of provisioning. The combined pretax, preprovision net revenues of the three universal banks were $91 billion in 2015. Goldman's and Morgan Stanley's combined 2015 pretax income was $17 billion. Moody's math seems manageable for the five, although the absence of lush underwriting fees for leverage loans, high-yield bonds and equities for many energy clients are a secondary casualty.

The math could be more problematic for the regional banks based in Louisiana, Texas and Oklahoma. Further the tertiary impact the longer the downturn lingers will increase as CRE and other areas of the portfolio are impacted. I have no idea how bad the downturn will be. If oil prices are poised to move back to $50 per barrel and $2.50 per BTU for natural gas, maybe the cycle peak in provisioning is at hand, though I doubt it. Citigroup's and other money center banks' experience in the lesser developed country (LDC) crisis of the 1980s may be instructive in terms of benchmarking expectations.

Citibank and other banks (some of which are legacy institutions that form JPMorgan today) were conduits for petrodollars that were deposited by OPEC and other oil-producing nations that reaped a windfall from the sharp move higher in oil prices during the 1970s. The banks lent the funds to Latin America and other developing economies that required capital and had limited access to capital markets.

I assume the profits were great, as was the case with the lending boom to the energy sector the past decade. Rapid loan growth and few loan losses can be intoxicating for bankers and investors, at least initially. Credit bubbles eventually pop. The tipping point was Paul Volcker and a mandate to bring inflation down. Short-term rates were pushed to unimaginable levels, the dollar rose, oil prices tanked, and the LDCs were broke. Actually, they probably were broke well before Mexico raised its hand in August 1982, and said no more debt service.

The Federal Reserve's history of the era notes that regulators provided forbearance to avoid full provisioning and loss recognition (and implicitly build capital) while negotiations occurred. Citibank CEO John Reed proved to be the next tipping point and perhaps signaled the beginning of the end to the crisis when he surprised the market by making a $3.3 billion provision in 1987. Others followed. A couple of years later, then-Treasury Secretary Nicholas Brady developed a novel approach to bring closure to the crisis in which LDC borrowers swapped commercial bank loans for "Brady Bonds." The borrowers obtained a haircut on what was owed, the banks got a tradable bond that was usually backed by a U.S. Treasury.

What might be a comparable event — on a small scale — to Reed's dramatic announcement? A move by one of the banks to sell unsalvageable positions that is then followed by others. Apparently after Reed recognized the obvious, LDC debt prices fell as more supply hit the market. However, the recognition of the obvious set the stage for the market to clear, which was further aided by Brady's plan.

Maybe my analogy to the LDC saga is a bit of a reach. Latin American LDC debt represented 176% of capital among the larger U.S. lenders then, while all LDC debt represented 290%, according to a Fed retrospective look at the era. Hancock's $1.6 billion energy-related portfolio represented 74% of subsidiary Whitney Bank's (i.e., where the loans reside) year-end Tier 1 capital and loan loss reserves.

Absent a sustained rebound in the price oil, such a move might prove to be a market-clearing event both for borrowers and lenders. The logical buyers are private equity firms and better-capitalized energy companies that will convert debt to equity and merge weaker companies into stronger ones. As for bank investors, Hancock and other oil patch banks appear to be inexpensive based upon 2016 earnings estimates and tangible book value; however, valuation is not a catalyst. A rip-the-band-aide-off scenario could set the stage for a resumption of EPS growth and a sustained rebound in their shares. I think that case is harder to make under an installment approach to reserve-building.

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