Rhombus Advisors LLC

Omotunde A.J. Mahoney
+1-973 509 5300

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OIL & GAS FLASH

Petroleum Price Collapse Plants Seeds of Next Banking Crisis

In our Dec. 18th flash-note, one marvelled at the blithe assertion by a ratings analyst[1] that, since the break-even price for independent operators in the upstream oil space is $50-60, there is ***no reason to be concerned" (sic) about the credit exposures assumed by the local banks in financing the oil companies' recent acquisition spree***.

1) It has since emerged that ***the CBN itself was so concerned about this very issue that it had that week issued a confidential memo.*** requiring all lenders for whom the O&G sector accounted for more than 20% of all credit exposure, to assign a 120% risk-weighting to all assets in the sector.

2) The text of the relevant document - see attachment - clearly indicates that ***many of said lenders had been booking assets in the oil and gas sector without even the most rudimentary risk-management procedures in place***.

3) What is even more astonishing is the fact that the ***CBN has now quietly deferred implementation of the new measure***, ostensibly *"in view of the ongoing implementation of the Basel II/III capital adequacy framework."*

4) The truth is probably much more prosaic: ***the collapse in oil prices has largely drained the supply of equity capital*** whose over-abundance was so vividly demonstrated by the frothy M&A deals starring the likes of Seplat, Aieteo and Erotron[2].

5) With total bank exposure to the upstream oil and gas sector estimated at NGN 2.6 trillion (ca. USD 14.5 billion) last December, and bank assets in the downstream (distribution) sector at several multiples of this figure, ***the ingredients of the next banking crisis are already falling into place***.

[1] i.e. during a conference call that day.

[2] It was all the more surprising to learn that last week Seplat raised USD 700 million in a secured 7-year facility from a consortium of local banks to back its planned bid for Afren?

CENTRAL BANK OF NIGERIA
Banking Supervision Department
Central Business District
P.M.B. 0187
Garki, Abuja.

Tel. 09-462 36401 & 09-462 36403
E-mail: bsd@cbn.gov.ng

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LETTER TO ALL BANKS

OIL AND GAS INDUSTRY CREDIT RISK MITIGATION

As you are aware, falling oil prices and the potential for a further decline has been a major concern in recent times. Oil prices have declined from US$ 107.89/bbl in June 2014 to US$ 85.06/bbl in October 2014, and currently trading at US$ 67.33/bbl. The possibility of a further decline should not be underestimated.

Considering the quantum of exposure to the oil & gas sector, combined with risk management deficiencies revealed by the recent Risk Based Supervision exercise, there is a need to proactively guard against a crystallization of these risks. The Central Bank of Nigeria therefore considers it essential to ensure that banks have sufficient capital buffers to mitigate these escalating risk taking activities.

Consequently, as a follow up to our circular of April 2, 2013 referenced BSD/DIR/GEN/LAB/06/017, and titled "RE: REVIEW OF RISK WEIGHTS ON CERTAIN INDUSTRY EXPOSURES IN THE COMPUTATION OF CAPITAL ADEQUACY", the following revision will now apply: -

"Where exposure to the oil & gas sector (as defined by the International Standard Industrial Classification of Economic Sectors as issued by the CBN) is in excess of 20 per cent of total credit facilities of a bank, the risk weight of the entire portfolio in that sector will attract a risk weight of 125% for the purpose of capital adequacy computation".

Banks are to note that these risk weights are dynamic and may be reviewed as economic conditions dictate.

In addition, licensed banks are required to:

1. Prepare and forward to the Central Bank of Nigeria, as at December 8, 2014, the computations and results of a single - factor sensitivity stress test, using the attached template and guidelines, on the impact of volatile and falling crude oil prices on the bank's financial position, performance, liquidity, and prudential ratios.

2. Ensure that:

   a. The projections for volumes of crude oil sales for upstream obligors are backed by independent and professionally prepared reserves estimation reports.

b. Adequate technical data is provided by the obligor for the management of obligor credit risk, including a copy of the feasibility study of the project being financed.

c. Collateral documentations are perfected and copies placed in the obligor's credit file.

d. There is a documented improvement in their monitoring activities of Oil and Gas Exploration & Production exposures.

e. Oil and gas customers have a robust and effective enterprise risk management policy and system. Of key importance is a price risk hedging policy.

f. There is a documented improvement in the mechanisms for continuous gathering, storage, and analyses of information about the state and trends of the oil and gas industry both locally and globally.

g. A comprehensive review exercise on oil and gas obligors is conducted on a periodic basis.

h. Adequate training in credit appraisal is provided for the marketing, and credit risk management units.

i. There is an improvement in the quality of credit file contents, organization and indexing, presentation, maintenance, management, and oversight.

Furthermore, banks are reminded of their responsibility to comply with the sections 3.3 and 3.9 of the Prudential Guidelines 2010.

It should be noted that banks will be assessed for compliance with the above directives as part of the periodic Risk Based Supervision review.

Yours faithfully,

'TOKUNBO MARTINS (MRS.)
DIRECTOR OF BANKING SUPERVISION