



FEDERAL RESERVE BANK *of* KANSAS CITY

December 22, 2016

## **Supervision and Regulation (SR) Letter 16-17: Supervisory Expectations for Risk Management of Reserve-Based Energy Lending Risk**

**Attention:** Chief Executive Officer of Each Tenth District State Member Bank and Bank Holding Company with Energy Lending Exposure

**In Brief:** The Federal Reserve has issued guidance to reinforce the importance of sound energy lending risk management practices irrespective of market conditions, and to update financial institutions about key risks and risk management factors specific to reserve-based lending (RBL).

**Highlights:** RBL is a type of financing secured by oil and gas reserves and repaid using the proceeds from the sale of those reserves. Lendable oil and gas reserves are based on a borrower's "proved reserves" borrowing base, which includes proved-developed producing reserves, proved-developed nonproducing reserves, and proved-undeveloped reserves, all adjusted for certain risk factors.

All financial institutions engaged in RBL should maintain a robust risk management program to ensure associated risks are appropriately identified, measured, monitored, and controlled. An appropriate risk management program should include prudent underwriting standards and concentration limits for RBL, and should be effectively integrated into capital planning practices. In addition, risk management programs should include timely market condition analysis to better manage and control the risks associated with RBL and to determine borrower repayment capacity. The SR letter details several market factors which should be considered as part of this analysis. Moreover, institutions with significant RBL exposure should have in place a variety of risk management practices to effectively monitor individual borrowers and the portfolio as a whole, as outlined in detail within the SR letter.

Expectations for the sophistication of risk management systems vary based on the specific risk characteristics, complexity, and size of the institution's RBL exposure. In general, there are higher risk management expectations for financial institutions with significant RBL exposures. An institution should assess the effect, if any, of its RBL activities on its overall financial condition, including capital, the allowance for loan and lease losses, and liquidity.

**Contact:** Please direct any questions concerning the new guidance to your Federal Reserve Bank of Kansas City central point of contact at (800) 333-1010.

**Internet Link:** A copy of the Federal Reserve Supervision and Regulation Letter SR 16-17 is available on the Board's public web site at: <http://www.federalreserve.gov/bankinforeg/srletters/sr1617.htm>