BANKING AND THE PETROLEUM INDUSTRY

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Commercial banks, as we understand them, did not come into being until the 16th century, A.D.

Two thousand years before the birth of Christ, the ancient Babylonians were using deeds, leases of land, wills, accounts, notes, mortgages and receipts for storage. These were engraved in clay tablets, which were then baked until hard.

Interest was set at twenty per cent for loans of money (measured weights of silver or gold). At this time wages for skilled workmen were equivalent to about thirty-five cents a month, based on wheat that sold for seven cents a bushel.

There were no banks in the strict sense of the word, but certain powerful families carried on the business of lending money. Loans were made on signatures, property and crops, which were mortgaged to insure repayment.

A great step forward in banking was made (570-546 B.C.) by issuing gold and silver coins, minted and guaranteed at their face value by the state.

Paper was invented in China about 105 A.D., which made possible the issuance of paper money, certificates of deposit, bills of exchange and simplified records of all kinds that could be easily stored and transported.

Our modern safe deposit facilities originated in Greece. The only safe repository for valuables was the Temple, and regular and substantial charges were made for this service. In a limited sense, the priests soon became bankers, because they were lending their own funds at interest.

Interest remained illegal in Rome for more than 250 years, having been forbidden by an edict issued in 342 B.C. But, enforcement of such legislation was impossible. In 88 B.C. interest was legally fixed at one per cent per month and in 50 B.C. this rate was made standard throughout the Roman Empire. This rate was a far cry from the twenty, thirty and even fifty per cent rates prevalent before that time.

Finance collapsed completely with the end of the Roman Empire, and throughout the Dark Ages banking lay under an eclipse. Letters of credit (drafts) were used during the early twelfth century Crusades, and money lending was common.

Italy is the mother of western banking as it is practiced today. Banking fell largely into the hands of private families; as early as the fourteenth century, the Bardi family of Florence had established agencies as far north as England and Germany.

Following the discovery of America, the flow of precious metals from this new land to Europe in the sixteenth century soon became five times the total output of the Old World. Most of this bullion found its way to northern and western Europe, where it was to give huge impetus to the growth of the industry.

But in the cities of South Germany, a new group of financiers rose swiftly to power. Firms like the Fuggers and Welsers established branches in Spain and bought the whole of incoming bullion fleets from the government at a huge discount, months before they arrived. The wealth accrued from banking activities enabled such men to purchase huge interests in industrial, trading and mining enterprises, and to run their affairs on a grand scale, unprecedented in history. Thus did America, through her gold, give extension to private enterprise while she was yet struggling in the earliest stages of colonization. And private enterprise was the economic way of life that was eventually to make a part of America, the United States, by far the wealthiest and most powerful of the earth's nations.

The Rothschild family, for 150 years, has been a good example of a family bank. Members of this family still are carrying on private banking business here and in Europe. It is reported that Nathan Rothschild, a member of the family banking corporation, was once asked, "What is the secret of your financial success?" He is reported to have replied, shaking his head sadly, "Oh, I always sold too soon."

The Bank of North America, organized under the leadership of Robert Morris, began business in Philadelphia on January 7, 1782, and this bank, together with the Bank of Massachusetts and the Bank of New York, both of which were founded in 1784, marked the real beginning of American banking.

After two tries at a U.S. Government bank, the first in 1791 and the second in 1816, banking conditions fell to a low level. Hundreds of state banks came into being, and during the period 1840-1843, one fifth of the banks failed.

The National Banking Act was passed on June 3, 1864, with three main objectives:

1. To obtain uniform currency
2. To provide a market for government bonds
3. To improve banking conditions

This Act required banks to keep specified reserves which were principally backed by merchandise instead of adequate reserves; and this requirement probably helped bring on the panic of 1907, which resulted in the Federal Reserve Act on December 23, 1913.

This law permits member banks to borrow from the Federal Reserve, at a discount rate, which can be changed by the Federal Reserve at any time.

The national banks increased rapidly with a corre-

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sponding decrease in state banks. However, since the national banks could not lend money on real estate or engage in trust activities and more capital was needed to incorporate, the number of state banks started to increase. By 1914, there were 14,512 state banks and only 7,495 national banks; but, the national banks held about 75% of all banking resources.

The federal bank examiners make an examination of each national bank. If the examiners think any loan will be a loss in whole or in part, the bank will be required to write off all or part of this loan against its "reserve for loan losses." This action means the examiners do not consider the loan an asset of the bank.

The foregoing is a brief history of the banking industry and how essential banks are to industry; however, before the advent of banks in Alaska, the liberal credit policy of the Northern Commercial Company (which was really a series of trading posts) provided the North's banking system. Valuables could be left at any company store for safekeeping. Miners could pour their dust down the funnel of the gold scales at Company stores and "cash out" without waiting seven months to a year for outside banks or the mint to remit. Customers could obtain drafts or request checks written either for their personal use or made out to other creditors for them by Northern Commercial Company.

The Oil Loan

The bankers were slow to consider recoverable oil and gas in the ground as satisfactory security for a loan. An acquaintance of mine recently told me that his father had always told him to confine his business to things he could see, such as trees and solid minerals, which could be exposed to view. This is the reason he never got into the oil and gas business. However, he finally found himself the Chairman of the Board of a small royalty company because someone found and produced oil and gas from fee lands owned by the corporation.

Mr. John D. Rockefeller, Sr. has been quoted as saying that he did not want anything to do with the production phase of the oil business because it was too risky. But, he felt there were plenty of people who would take the risk and provide him with sufficient crude to run through his refinery. He built an empire following this philosophy.

The only reason in the world that a fully integrated company should own any production of its own would be as a protection to its other investments in gathering systems, refineries, wholesale and retail outlets.

Years ago, I felt that by this time, all of the major companies would have divested themselves of their own production, retaining the right to purchase the oil from these properties for the life of the reserve. This, of course, has not happened, and we begin to wonder why, since a small independent operator can produce crude so much cheaper than a major company. The depletion allowance could well be a reason the majors have continued as producers.

As you know, for several years, the folks who have need for crude, the fully integrated companies, have set up acquisition departments and they have acquired a number of producing properties.

However, more recently, one of the majors changed, seemingly overnight, to a program of disposing of certain of its own producing properties. In some instances the properties disposed of were isolated properties which were costing too much to operate. I understand that this change came about because the company had been convinced that it could find producing properties cheaper than it could buy them. This is a complete reversal of the general thinking that prevailed a few years ago.

Other companies have also been selling their properties, especially those which have no reserves. No deep rights were transferred to the purchaser under these integrated company sales of production.

There has also been a sale of some properties in which all deep rights were conveyed to the purchaser, and the selling company did not reserve the right to purchase oil which might be produced later from the deeper formations. I know of one instance of this kind, and there may have been some circumstances which influenced the integrated company to dispose of these deep rights.

In some of the boom fields, new refineries, within or adjacent to the field, were a part of the boom era. As production declined, these refineries were abandoned due to lack of sufficient production to operate economically.

The East Texas Field was probably the last boom field in which there was also a boom in local refinery construction and operation.

The fully integrated companies have various means of acquiring capital which are not available to the small independent operator. Most of these companies grew out of the efforts of an individual who finally combined what he had with others, formed a corporation, thereby acquiring sources of capital not available to him as an individual. We still have a few of these individuals who are well known to all of us, who continue to operate as an individual; but, most of them have acquired so many assets they represent a good lending risk to a bank and to other lending institutions.

In order to better understand how several independents may acquire the status and enjoy the credit advantages of integrated companies, the following example is presented:

Messrs. Anders, Boyd, Carter and Dean are independent operators; each own interests in oil and gas properties and they have decided to form a corporation and assign all their interests to the corporation. The name "ABCD Oil Company" was selected and the amount of stock was two million shares, with one million shares to be exchanged for the properties of the four individuals. They selected a petroleum evaluation engineer to determine the present value of each property, and a certified public accountant to determine the cash portion, total assets and liabilities for each of the four in the corporation. The number of shares of stock each received for his property will be

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determined by this information.

Thus, each of the former independent operators now own stock in a corporation which in turn owns the property they owned separately.

Each of the four corporation owners will be a member of the Board of Directors which in turn will elect the following officers: President, Vice President, Secretary and Treasurer. These operating officers will manage and determine the company policies.

The corporation could sell some of the second million shares, but this would reduce the equity of the original incorporators.

It is decided to make an oil loan with an oil bank, which would put its own value on the properties and may lend up to ½ of present value of the properties. The company may not need all of this money at one time: so a master note is signed for the total amount which could be loaned, and the money drawn out as needed. Monthly payments plus interest would probably be required by the bank. The Corporation would give the bank a mortgage on all its properties, and the bank would probably require that the mortgage be applicable to all properties acquired after the signing of this mortgage. The bank may even require all four of the original incorporators to sign the note personally.

The financial arrangement made with the bank is ideal until the corporation reaches the point where it does not have sufficient security or present income to satisfy the bank for additional loans against the company properties. In other words, the corporation may find itself completely "loaned up" with the bank.

The four original stockholders are concerned about maintaining their present equity position in the corporation; so they decide not to sell any of the stock to others. Instead, they decide to sell interest bearing convertible subordinated debentures to private or institutional investors, if possible, otherwise, to the public, and use the money derived from this sale to pay off the bank and secure a release of the mortgage. These interest bearing convertible subordinated debentures are in effect an unsecured loan to the corporation, which may be converted into stock within a certain time limit at a stated price per share.

The corporation has thus exchanged a mortgage loan for an unsecured loan. It is now in the position to, and does, go back to the bank and sign a new mortgage on the property, also a new note, making it possible to borrow from the bank as it did in the first instance. This procedure can, and is, often repeated several times.

Eventually, it may be desirable to sell some capital stock as a means of providing more capital and to increase the number of stockholders. State and federal regulations must be complied with in order to provide funds for growing corporations as outlined above.

In my experience in oil banking, I found a number of our customers would get themselves into financial difficulty by drilling too many wells and drilling them too fast. I remember telling some of these fellows that they were working too hard at their business and they ought to take a six-month vacation to let their income reduce their debt, and incur no liabilities during this six-month period. Along the same lines, I want to quote part of an article in the U. S. News and World Report, May 27, 1967 issue:

"U.S.: 'Riches to Rags in 20 years'... How did the U.S. manage to slip from the pinnacle it occupied at one time to its present position? How did it dissipate not only a great lead in material wealth and financial stability... ?"

The answer, in its simplest form, given by bankers and economists: "By trying to do too much, too fast."

I was interested to find that most of the borrowers with whom I dealt during my 12 years in an oil bank thought they were never going to die, and if they did die, they were going to be able to take their wealth with them!

Interest

Interest has been defined as the rent paid for the use of borrowed money. The lender, within a stated time, expects to receive all of his money back, plus interest.

Interest was legalized in France and England after the discovery of America.

The tremendous need for borrowed money in the petroleum business is illustrated by the records of forty-five representative American oil companies which show an indebtedness of almost $13 billion in 1967, and some $620 million were paid by these companies in interest for the use of this money. The total sales of these companies during 1967 was $84 billion. These companies had 800,000 employees and 3,000,000 stockholders.

Interest is a legitimate operating expense, just as rented equipment or office space are legitimate business expenses.

A modern bank, in some ways, is like a warehouse combined with a rental agency: It is a safe depository for your own money; it has additional money which you may rent, if you can satisfy the bank that you can pay back the principal plus interest; you can use this borrowed money for whatever needs your business demands.

A bank borrows money to carry on its business. In 1967, 38 representative banks in the United States had borrowed some $1400 million and paid $62.5 million for the use of this money. These same banks had 227,000 employees and 865,000 stockholders.

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