Environmental risk management

A Growing Trend in Commercial Lending

Environmental risk management is a growth business, and has increased overall growth in lending and assets at institutions that have developed such a program. It has enabled lenders to look at opportunities they may have been forced to label as too risky in the past.

BY DARRELL DELAMAIDE

In 2004, HSBC, the London-based bank that is one of the largest financial institutions in the world, decided to go carbon-neutral, and embarked on a program of energy efficiency, purchasing "green" energy from renewable sources, and obtaining carbon offsets for remaining emissions. Carbon-neutral means the bank seeks to reduce and offset its carbon emissions to zero, so that it essentially has no carbon footprint.

HSBC, along with ING Group, has represented the financial sector among leading global corporations—Dell and Google are two U.S. firms—to take this step. It is part of a company's overall corporate social responsibility strategy —an increasingly important component in a company's image and one that has a tangible effect on stock prices as investors look for evidence of a commitment to sustainable development.

Carbon strategies have not yet become de rigueur in the United States, but they will be, and it will impact environmental risk managers (ERMs) in commercial lending institutions, who may see the scope of their responsibilities expanded to include this new risk.

"We're behind Europe in this, but we're gaining," says Dean Jeffery Telego, executive co-director of the Environmental Bankers Association and a risk management consultant. Telego reckons that three years ago, the U.S. was a good ten years behind Europe, but now is only four or five years behind.

Europe, unlike the U.S., subscribed to the Kyoto Protocol to reduce carbon emissions and set up an Emissions Trading Scheme that mandated caps for certain industries. Financial services was not one of the industries subjected to this regime, but some of the bigger institutions have felt compelled by market pressure to voluntarily cap emissions.

As Congress gets closer to legislating a cap-and-trade program for the U.S.—some Democratic leaders are predicting a new law as early as the fall of 2009—the pressure will increase for companies in most sectors to account for their emissions. For banks and other lenders, this means that environmental risk managers, who now spend most of their time on due diligence for new loans, will have more duties.

"ERM professionals are in a strategic position to bridge the gap between environmental risk management and corporate social responsibility within a commercial bank and between the bank's various lines of operations," says Telego.

It is a logical next step in an evolution that has seen ERM at commercial lenders go from a part-time occupation to a full department with several staffers and penetrate from only the very largest institutions down to mid-sized regional banks.

ILLUSTRATION: WILL ILLO FORFOOD

John Rybak, environmental risk manager at BB&T Bank in Winston-Salem, N.C., says that he was all by himself when he joined the bank in 2006, but that the regional bank, concentrated in the Southeast of the U.S., now has three full-time ERM professionals.

The fact is, environmental risk management is a growth business, and has buoyed overall growth in lending and assets at banks that have developed a program. "Ten years ago, banks just wouldn't touch a project with an environmental risk," Rybak says.

Now, his team looks at numerous opportunities at gasoline stations, textile factories or dry cleaners and, because it has policies and procedures for dealing with them, is able to help the bank grow its portfolio. "Our comfort level has grown as we became more familiar with the risk," Rybak says. "The more you do it, the more you can find ways to make it work."

The idea is not to be an obstacle to new business, but to be a resource for finding solutions to a problem, he says. Identifying an environmental risk can alter the terms of a prospective loan, but doesn't have to kill it altogether.

Among the solutions that the bank can use, Rybak says, is to insist on the borrower taking care of the risk, either before or after the loan is made. In the latter case, the bank may demand an escrow account to cover the risk or hold back part of the loan until the risk is eliminated.

"It doesn't usually impact the rate," Rybak says, "because that's irreversible." The other solutions allow for the money to go back to the borrower. Other options are to swap out for other collateral or to get a guarantee regarding the risk. The important thing is that the bank is protected against this kind of risk.

"Banks, including regional banks, have gotten smart enough to see that these risks can play a role in taking the collateral back," Rybak says.

Much of the current work of ERMs is to develop policies and procedures for the bank regarding due diligence, says Pam Eddis-Klein, environmental risk manager at Countrywide Bank, whose department works with commercial loans, not residential mortgages.

"We make recommendations on loans," she says, which senior bank managers can follow or not, depending on how they evaluate the other aspects of the transaction. But the policies and procedures establish a consistent basis for handling each transaction, she says.

The newest risk to gain prominence as part of environmental due diligence, Eddis-Klein notes, is vapor intrusion – when gases from volatile chemicals in the soil or groundwater penetrate into a building, causing an indoor air concern, much the way radon gas does. Banks are busy considering this issue now, attempting to quantify the risk and find the appropriate response, she says.

EBA's Telego agrees. The risk presents several concerns for lenders, he says. A vapor intrusion condition can adversely affect the value of the property used as collateral. It can also have a negative impact on the borrower's creditworthiness and ability to repay the loan. The condition can lead to complications if there is a foreclosure, and a vapor intrusion claim can damage a bank's reputation, brand and image, Telego says.

Vapor intrusion can also be quite damaging to borrowers, prompting tenants to break leases and leaving them open to lawsuits. As consumers become more sensitive to environmental risks, Telego says, they will compel lenders and borrowers to pay more attention to them.

"We have reached the tipping point," Telego says. "Consumers will drive this market."

Lending institutions are tracking insurers in this development, just as they did in developing their initial environmental due diligence, he notes.

The coming wave of foreclosures will underscore this point, Telego argues. While foreclosures in the commercial sector are not likely to reach the scale in residential, ERMs will increasingly be called upon to deal with risks in foreclosed properties. Banks will find themselves beefing up their ERM departments to handle these issues.

This will set the stage for banks to pay more attention to green buildings and other efforts to reduce emissions and protect the environment. "This will be one of the driving forces in the next five to ten years," says Countrywide's Eddis-Klein. "Banks are going to be moving into that arena."

The principles of risk management that have served banks in their due diligence in the loan life cycle so far will be extended to these new spheres, says Telego. He lists five stages in risk management: risk identification, qualitative and quantitative risk assessment/evaluation, risk control/prevention, risk finance/transfer, and risk monitoring/risk communications.

"In this era of corporate social responsibility and a focus on sustainable finance and banking, ERM professionals are positioned to capitalize on environmental credit risk management expertise and knowledge of sustainable development to be value generators within their institutions," Telego adds.

Most of these professionals have backgrounds in environmental consulting and have adapted their expertise to the demands of banking. BB&T's Rybak, for instance, received his training in environmental studies before beginning his first banking job as environmental officer with Key Bank in New York. Countrywide's Eddis-Klein was an environmental consultant who cut her teeth in the loan business at Bonnet Resources Corporation.

"Once we brought this kind of expertise to the credit culture," Rybak says, "we were inundated with business." That seems likely to continue. **TSL**

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