

# Outside Forces Driving Lenders to Take Another Look at Environmental Policies

by Derek Ezovski

**E**ver concerned with minimizing risk, most banks routinely scrutinize the commercial real estate they accept as collateral. Within the past 15 years, strict federal, state and local environmental liability laws have sprung up, ensuring that environmental due diligence is now a typical component of the commercial-mortgage origination process. Such diligence is prudent, in a worst-case scenario, contaminated property can wreak havoc with a bank's bottom line. Recent calls from regulators for stricter risk-management practices in commercial real estate underwriting, coupled with the

EPA's new "All Appropriate Inquiry" environmental rule, which took effect November 2005, have put the spotlight firmly on banks' risk-management practices, particularly environmental due diligence. Luckily for lenders, as environmental laws are getting tighter, the tools for evaluating environmental contamination are becoming more effective.

## **Environmental due diligence: A snapshot**

The level of environmental due diligence performed on commercial real estate varies from bank to bank and

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from loan to loan. In today's highly competitive environment, cost and time constraints play a major role in a bank's choice of environmental due-diligence options.

Around one-third of commercial loan originations today undergo a Phase I environmental site assessment. This typically includes a site visit, interviews with the property owner/occupants and a review of current and historical government records, plus a written report of the findings prepared by an environmental professional. Phase I's are highly effective environmental due-diligence tools; however, they can be costly—typically around \$2,000 per property—and time-consuming. For these reasons, some lenders feel they're not justified, especially on small-balance loans or properties that appear to present little risk.

Absent a Phase I, many commercial properties are subjected to a more limited type of assessment called a transaction screen, or they are scrutinized with the help of a database/records review or an environmental questionnaire. Sometimes environmental due diligence is skipped entirely, usually because the property is perceived as low risk (vacant land and multi-family residential properties often fall into this category) or because the bank wishes to remain competitive with other financial institutions and simply doesn't want to tack any time or cost onto the already tight loan-approval process.

### **Forces driving environmental due-diligence examination**

The rapid rise in CRE lending means higher concentrations of commercial properties on banks' balance sheets, and this is making regulators understandably nervous. After all, similar CRE concentrations were in place in the late 1980s and early 1990s and were widely blamed for the massive bank failures that took place during that time.

Highly profitable, yet highly cyclical, CRE can leave banks extremely vulnerable, as the earlier disaster proved. Yet today, according to the FDIC, the financial institutions it insures have greater CRE concentrations now than the levels displayed during the last CRE cycle of the late 1980s/early 1990s. Although these banks are currently exhibiting strong performance, regulators are concerned that high CRE loan volumes coupled with relaxed underwriting standards might once again lead to disaster. Thus, the FDIC, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and the Office of Thrift Supervision jointly proposed risk-management guidance in January 2006. In the document, regulators warned that institutions holding higher CRE concentrations

are expected to have "commensurate risk-management practices in place and maintain appropriate capital levels."

For many bankers, the feds' stance is prompting a reevaluation of their risk-management policies, including those that cover environmental due diligence. "We've increased our attention on environmental issues, particularly with regard to commercial property financing," said

Kent Schrader, a senior vice president with Virginia Heartland Bank in Fredericksburg.

Doug Potts Sr., MAI, echoed Mr. Schrader's sentiment. "Commerce Bank is in the process of comprehensively reviewing and rewriting its commercial loan environmental policy as we speak," he said. Mr. Potts is a senior review appraiser in the bank's Clayton, MO, office.

Melanie Joy, a commercial real estate manager of originations and underwriting with Middletown, CT-based Liberty Bank, took note of the feds' recommendations, but determined that her bank's environmental risk-management policies were sufficiently stringent. "I have been spending time on our environmental policies. We have not tightened our environmental risk-management practices because our level of commercial real estate is significantly less than the proposed guidance. Also, most of our transactions require Phase I reports, so our environmental practices seem adequate," she says.

Michael Bell, the director of Environmental Services for Capital Crossing Bank in Boston, also re-examined his bank's environmental policies after the feds issued their guidance document, and, like Ms. Joy, found them to be adequate. "We did not feel the need to alter our program despite the feds' recent warnings," he said. "The bank follows a stringent environmental due-diligence program when we consider purchasing loans. Our research focuses on the loan's collateral, but also investigates adjoining properties of concern."

In light of regulators' warnings, today's lenders would do well to take a look at their ratio of CRE loans, examine their specific risk tolerances, and decide whether a review of their environmental policies is in order.

### **All appropriate inquiries**

Another significant change prompting lenders to update their environmental policies is EPA's highly anticipated All Appropriate Inquiries rule. Today, anyone wishing to claim liability protection under the Comprehensive Environmental Response, Compensation, and Liability Act's innocent landowner, bona fide prospective purchaser



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or contiguous property-owner defense must follow ten prepurchase steps as outlined in the AAI rule, as well as a series of post-purchase requirements over the course of property ownership, or risk forfeiting CERCLA liability protection.

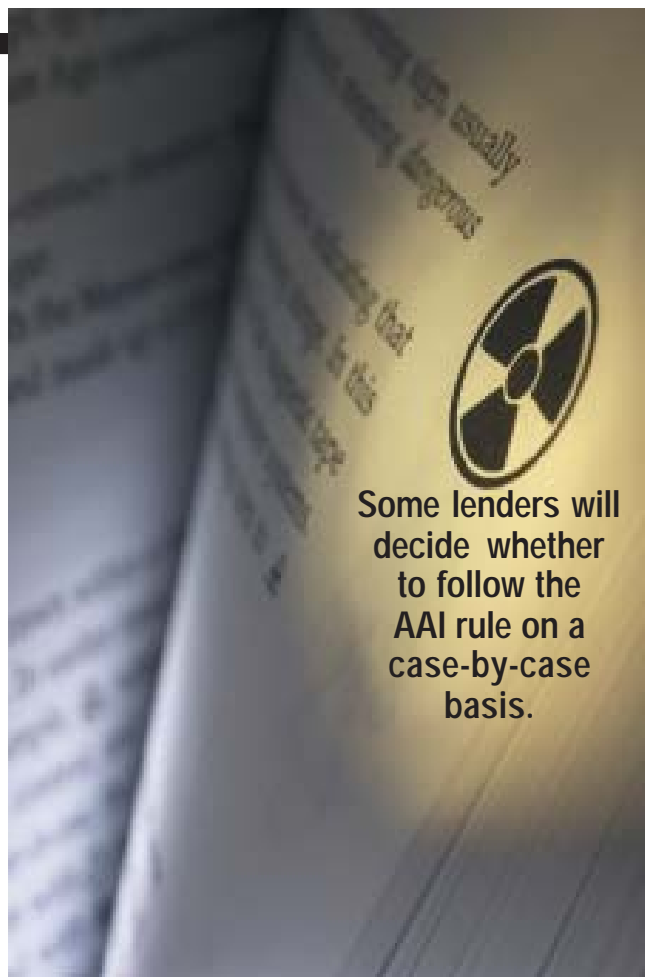
While lenders are protected from liability under secured creditor exemptions, borrowers are not. Along with stricter professional qualifications for environmental consultants, which is causing quite a buzz in environmental-consulting circles, the AAI rule adds a number of steps to the Phase I investigation that go above and beyond current practice (ASTM Standard E 1527-00). Among the more significant changes are the action items required of environmental professionals during the Phase I; the user's (i.e., the person seeking liability protection) responsibilities, and the environmental inquiry's shelf life. For example, a number of the ten AAI steps, such as consideration of whether the purchase price is indicative of an environmental concern, reflect information that the user must share with the environmental consultant. Under the AAI rule, consultants must search additional data such as local and tribal records, plus records of activity and use limitations on the property. They must also conduct interviews with past owners, operators and occupants of the property, and even neighbors in certain cases. As can be expected, Phase I pricing is expected to rise along with the added levels of scrutiny.

(It should be noted here that ASTM, the organization that wrote the original Phase I site assessment standard, has updated its guidelines in response to AAI; EPA has deemed ASTM E 1527-05 as sufficient protocol for satisfying the AAI rule.)

#### **Awareness driving change**

In lending circles, awareness about the AAI rule and the new Phase I standard of care is growing, but is not yet widespread. Among those who carefully tracked the developing guidelines and watched the rule unfold, several of them — generally large national lenders — have already crafted a bank response. Some will require borrowers to follow AAI for Phase I's on the premise that "if the borrower is protected, so is the bank." Mr. Bell is one of these early adopters. "I intend to rely on AAI-compliant Phase I's because I want to gain as much information about collateral before I take ownership," he says. "Additionally, I am interested in securing whatever protections AAI provides."

Some lenders will decide whether to follow the AAI rule on a case-by-case basis. "AAI will definitely impact the process for certain types of the bank's loans, but not all," says Mr. Potts. "AAI is primarily a transaction-driven standard for purchases of real estate, but many bank loans do not involve purchases. Our revised policy covers the spectrum of transactions we deal with, and not all may involve AAI-level inquiry, especially loans that are already on the books."



Other lenders will rely on the secured creditor exemption — amendments to CERCLA that state that lenders and secured creditors must actually "participate in the management of the facility" to be held liable as an "owner or operator" of a contaminated site — or their already-stringent environmental due-diligence policies that go beyond AAI. Still others are taking a wait and see approach, but are nevertheless actively reviewing their policies to see whether changes are warranted. "My bank is currently evaluating the need to update our environmental policy because of the EPA's AAI rule and the changes to the ASTM standard. Our bank tends to be risk-averse, so we may be requiring that our Phase I reports comply with AAI/ASTM E 1527-05," says Ms. Joy. Mr. Schrader is among those bankers who are taking a wait and see approach: "It is probably a bit early for me to address bank policy changes as a result of new [AAI] guidelines," he says. "Those policies are generally set at the holding-company level."

Larry Schnapf, a New York City-based environmental lawyer and author of *Environmental Liability: Managing Environmental Risk in Corporate/Real Estate Transactions and Brownfield Redevelopment*, says that lenders perform environmental due diligence to assess business

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risk, not to set up a defense to CERCLA. Therefore, he says, AAI might not be a strong driver for banks, unless the ratings agencies decide to adopt the rule. "Lenders aren't getting much more data [with AAI], and a lot of them already go beyond AAI's scope anyhow," he says. "Competition and time pressures are making it harder to do a full-fledged Phase I. Banks can't afford delays."

Mr. Schnapf feels that environmental due diligence is valuable, however, especially with the CRE market poised for change. "As the real estate market cools, valuation becomes ever more important to banks. They need to know: How much will cleanup cost? Can the borrower afford it? Will the property hold its value or not?" He adds, "The key reason banks perform environmental due diligence is to make sure that the borrower is okay. Banks are concerned with their borrower's cash flow and that the property won't be devalued if contamination is discovered. They need to know what's on the property from a business-risk perspective."

Mr. Schnapf also points out that AAI is not a requirement for the secured creditor exemption. He cautions banks, though, that they may need to heed the rule in certain situations. "If a lender is going to take actions that could cause it to lose its immunity from liability, for example if it forecloses on contaminated property and does not take steps to sell it in a commercially reasonable manner, then the lender would be like any owner of property and would want to ensure that he or she complies with AAI. There is no bright line test in this situation. Bankers wishing to remain conservative should exercise an abundance of caution so that if they lose their secured-creditor defense they have another to fall back on. I think many lenders will not use AAI/E 1527-05 for conventional loans, but may use it prior to foreclosure," he says.

### Due-diligence options

Whether the feds' recent warnings cause lenders to re-examine their environmental policies or AAI prompts a reevaluation, the good news for lenders who are updating, or even writing an environmental policy for the first time, is that today there are more options for conducting environmental due diligence than ever before. For lenders concerned that the CRE market will soon face a downturn, there are simple, cost-effective tools for evaluating environmental risk that return results quickly. These tools, often used for low-value loans or on properties that normally would receive no due diligence, afford banks avenues for achieving peace of mind while still maintaining a competitive edge. They include:

- **Transaction screen:** Typically performed by an environmental professional and primarily used for lower-risk properties, the transaction screen no longer satisfies its original purpose of qualifying a purchaser for CERCLA liability protection. But, because it contains a site visit, which can answer

questions about the current condition and past operations of a property raised during the historical research and government records search portion of the review, the transaction screen can be a highly effective tool. At an average cost of \$750 to \$1,000, the screen is also cost-effective.

- **Database reports:** When a full-scale environmental investigation is not warranted, lenders can still learn a great deal about their business-risk exposure by ordering reports of government records and historical information for the property in question. Most of these reports are priced under \$500, and can uncover such issues as leaking underground storage tanks, landfills, or former high-risk operations (e.g., dry cleaners or industrial facilities) on the target property or operations of concern on adjacent properties. These reports are ideal for screening seemingly low-risk properties that might otherwise receive no environmental due diligence. If no red flags are found, the lender has peace of mind; if potential risks are uncovered, the lender can address them early in the transaction by taking environmental due diligence to the next level, say by conducting a site visit or hiring an environmental consultant to do a complete Phase I ESA. There are a handful of national vendors who provide these types of reports.
- **Online data services:** A new tool for lenders is the online data service. Designed for low-value loans or low-risk properties, these services allow subscribers to tap into environmental databases from their desktops. A quick-address entry will return results for the property, alerting the lender to environmental red flags.

### Conclusion

In light of recent regulatory changes and the very real possibility of a downturn in commercial real estate, lenders would do well to make sure their environmental policies are in line with their banks' risk-tolerance philosophies. Those properties that formerly received an E 1527-00-compliant Phase I may warrant the added scrutiny of an E 1527-05 or AAI-compliant Phase I. And for transactions that don't require a full-blown Phase I, rather than skipping environmental due diligence, one of the lower-cost, quick screens might not be a bad idea. ▲



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