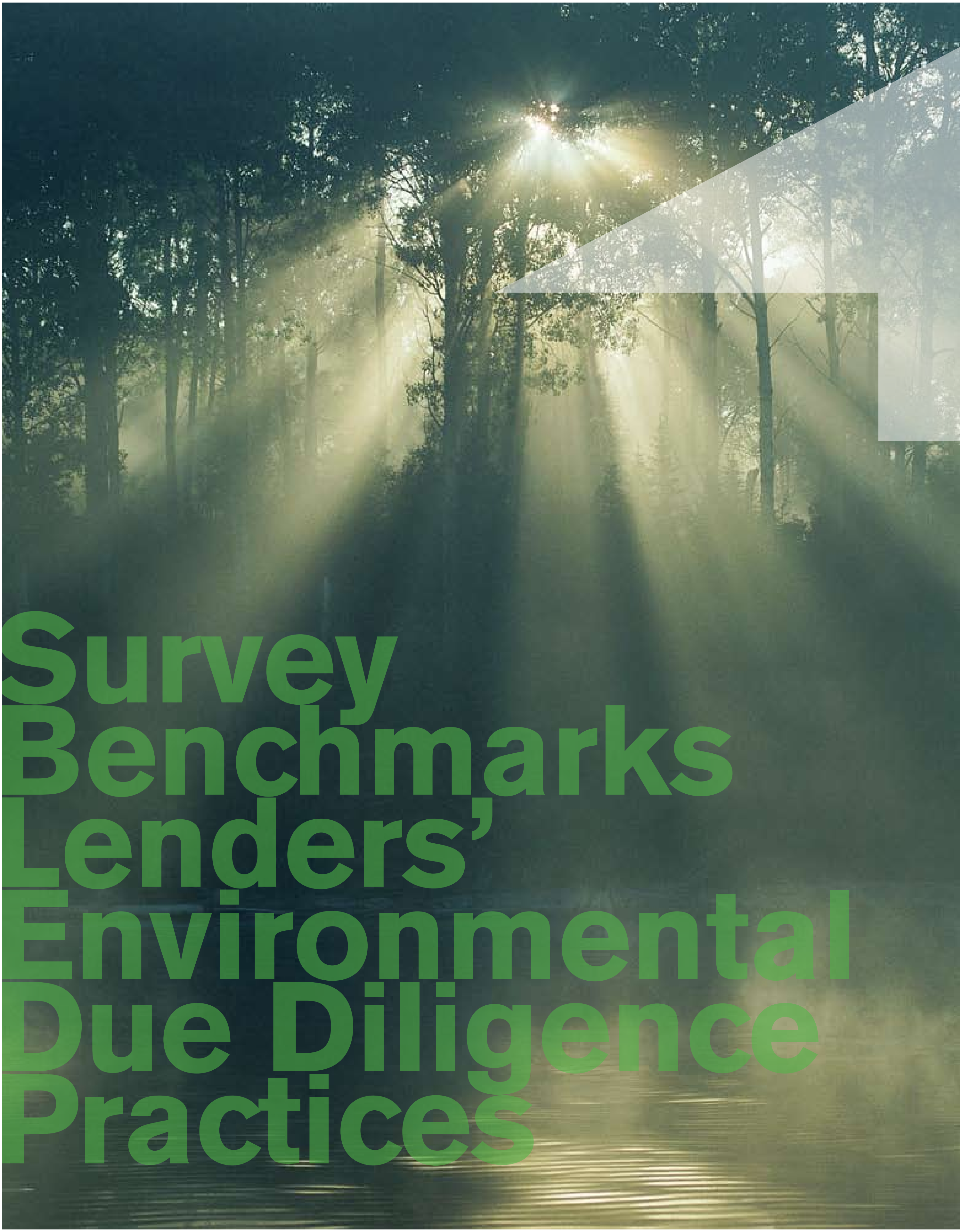


Survey Benchmarks Lenders' Environmental Due Diligence Practices

Environmental risk is a credit risk. Ninety-four percent of banks surveyed have a formal environmental policy in place. Is your existing policy sufficient? If you don't have such a policy, is it time to create one?

BY DEREK EZOVSKI

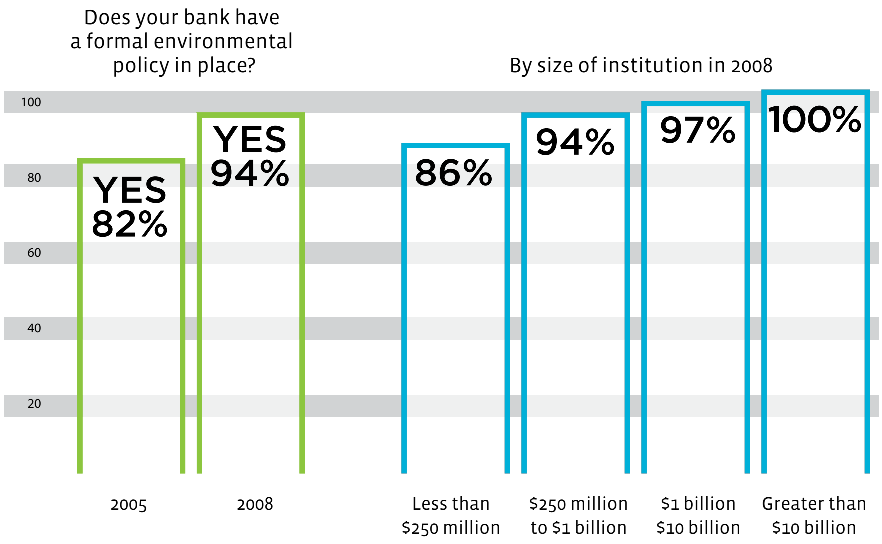
The combination of current market conditions and pressure from regulators to better manage commercial real estate risk has caused lenders to tighten underwriting standards, including environmental due diligence, a new survey finds. Today, environmental risk management is such an integral part of the commercial underwriting process that 94 percent of banks have a formal environmental policy in place — up 12 percent from three years ago. According to the survey, conducted by Milford, CT-based Environmental Data Resources, Inc., the larger the bank, the more likely it is to have an environmental policy. (See Figure 1).

Environmental due diligence reflects more than just a desire to appease regulators. Today's lender is acutely aware of the business risk environmental contamination presents. Environmental risk is a credit risk. For lenders, the concern is fourfold. First, contamination can adversely affect the value of the property used as collateral; second, it can have a negative impact on the borrower's creditworthiness and ability to repay the loan; third, contaminated property can expose banks to direct liability for cleanup costs as well as unnecessary litigation; and fourth, it can damage a bank's reputation, brand and image. Indeed, most of the nearly 400 risk managers, vice presidents and loan officers who participated in EDR's January 2008 "Benchmarking Survey of Financial Institutions" said they put an environmental policy in place to address such risk management concerns (51 percent); because it is "best bank practice" (50 percent), and because environmental due diligence policies appease FDIC regulators (40 percent). (Multiple answers were allowed.)

One reason environmental risk management is taking on a greater significance in today's uncertain economy is that contamination has more of an impact on property values in a period of falling prices. The availability of so-called desktop due diligence — environmental data that lenders can access quickly and inexpensively from their

More Interest in Formal Environmental Policies

Percentage of lenders with formal policies increased 12% in 3 years
Likelihood of having policy increases with asset size of institution



Source: EDR's Benchmarking Surveys of Financial Institutions, 2005 and 2008.

desktop computer — is also driving the trend. Whatever the reason, the movement has taken hold. Nearly every lender who participated in EDR's survey (91 percent) characterized their environmental due diligence standards as more stringent heading into 2008, and 60 percent are conducting some form of environmental due diligence on a greater number of loans than they were a year ago. Smaller banks, defined as those having assets of less than $1 billion — those comprised the majority of the survey sample — tend to be more conservative than larger institutions.

Regulators Encourage Sound Environmental Risk Management Practices

When it took effect November 1, 2006, the U.S. Environmental Protection Agency's All Appropriate Inquiry (AAI) rule marked the first time in history that the rules for conducting a Phase I environmental site assessment were codified in a federal regulation. Aside from bringing about sweeping, albeit anticipated, changes in the way environmental site assessments are conducted, AAI and its equivalent, ASTM's E 1527-05 standard, made waves in the regulatory community as well. Most notably, the Federal Deposit Insurance Corporation updated its environmental guidance document (FIL-98-2006) for the first time in 13 years. Widely regarded as a leader when it comes to environmental requirements, FDIC's reaction to the AAI rule triggered other agencies to follow suit. The Office of the Comptroller of the Currency (OCC) is revising the environmental component of its *Construction & Commercial Lending Handbook,* and the Office of Thrift Supervision (OTS), which released its current policy back in 1989, has indicated it plans to formally respond to AAI. The National Credit Union Administration (NCUA) is also revisiting its guidelines. Even the Federal Reserve announced it will address AAI.

The U.S. Small Business Administration (SBA), which also got in on the act, issued a procedural notice requiring that "...7(a) lenders and Certified Development Companies comply with EPA's AAI final rule as part of their prudent lending practices...when a Phase I is required pursuant to SOP 50 10." At the time of this writing, SBA was in the process of revising the environmental component of its main loan processing standard operating procedure, SOP 50 10, an effort that the agency says is nearly complete.

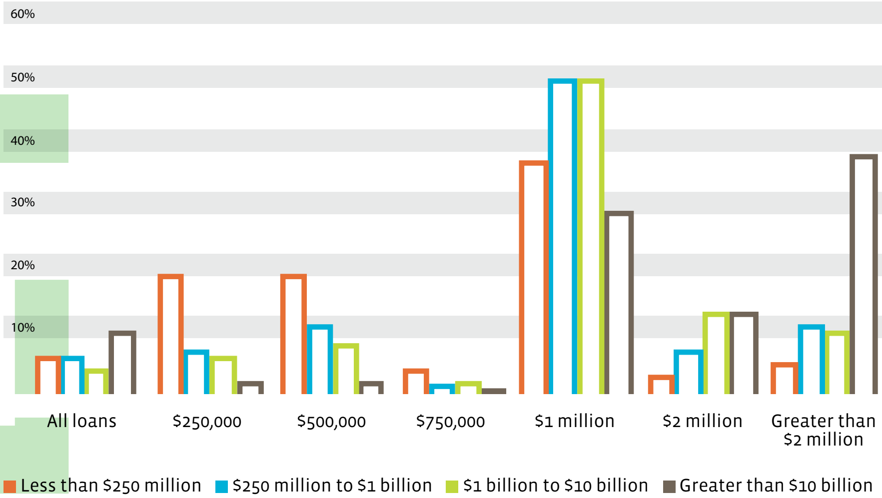
Dangerously high concentrations of commercial real estate loans can trigger regulatory scrutiny. In the wake of the market turmoil resulting from last year's rise in defaults of subprime residential loans, regulators are more focused than ever on the risk profiles of lending institutions. Indeed, the move toward tighter underwriting that began amid regulatory pressures has been cemented by the current economic situation. "Strong risk management can help banks be a source of strength for our economy during difficult times, and a trusted source of financial services for consumers," said Sandra Thompson, director of the FDIC's Division of Supervision and Consumer Protection in the agency's Winter 2007 issue of *Supervisory Insights.*

Given current market conditions, lenders are reporting that FDIC's examiners are routinely asking more questions about their environmental policies than ever before. According to the survey, 85 percent of lenders underwent a regulatory examination last year; of those, more than half (60 percent) were asked specifically about their environmental policies. Lenders who have sound environmental practices in place, based on today's regulations, can effectively demonstrate to regulators that they are being proactive in managing environmental risk.

While EPA's AAI rule, "Standards and Practices for All Appropriate Inquiries" (40 CFR Part 312), is driving federal regulators to update environmental risk management guidelines, interestingly, less than one-fifth of lenders say AAI and its equivalent, ASTM's revised Phase I environmental site assessment standard (E 1527-05), drove them to implement an environmental policy. But increased scrutiny from regulators is keeping environmental due diligence at the forefront of lenders' minds: 65 percent report that they plan to revisit their environmental policies within the next two years.

Thresholds for Phase 1 ESAs

The most common loan size threshold above which a Phase 1 is always required is $1 million



Source: EDR's Benchmarking Surveys of Financial Institutions, 2008.

"Regulator pressure is clearly impacting lenders' behavior," said Dianne Crocker, EDR's senior economist and managing director of the company's Market Research group, which authored the survey. "In the wake of the market turmoil resulting from the subprime mortgage mess, regulators are more focused than ever on the risk profiles of banks. Caution has returned to commercial lending, and quantity has taken a backseat to quality. Today's commercial lender has become increasingly proactive when it comes to evaluating risk, particularly the environmental exposure associated with real estate. The fact that nearly twice as many lenders characterize their environmental due diligence standards as more stringent today than in the past (91 percent in 2008 vs. 53 percent in 2003) is particularly notable."

Environmental Due Diligence Policy Trends

About two-thirds of lenders report revising their environmental policy within the last two years, with mid- and large-size institutions more likely to have made changes than smaller banks. Among lenders who revised their policies, they added new levels of environmental due diligence (76 percent); added requirements for borrowers to complete Phase I ESAs in compliance with EPA's federal AAI rule (40 percent); and adopted EPA's definition of 'environmental professional,' meaning they require the environmental consultants they hire to meet EPA's qualifications requirements (26 percent). (Again, multiple responses were allowed.)

Thanks in part to the protections they're afforded under the secured creditor exemptions in the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), lenders are more concerned with business environmental risk than CERCLA liability. To gauge business risk, lenders frequently add nonscope considerations, defined as items outside the scope of a traditional AAI- or ASTM-compliant Phase I environmental site assessment, to their environmental due diligence reports. EDR's survey found that an asbestos assessment is the most commonly added nonscope issue, requested by 60 percent of lenders, followed by lead-based paint surveys (54 percent), regulatory compliance audits (48 percent) and vapor intrusion assessments (21 percent).

Because most respondents lack the resources to employ a full-time environmental risk manager, over half (56 percent) ranked the opinion and analysis of an environmental professional as the most highly valued component of the Phase I ESA. Thirty percent of lenders regard the Phase I ESA's government records and historical research component as the most important part of the inquiry; while fewer than 1 in 10 (8 percent) consider interviews with property owners and operators to be the most valuable component of the Phase I.

Turnaround and Price

Lenders report that the average turnaround time for an environmental consultant to complete the Phase I ESA is 11 to 15 business days. Turnaround time continues to be an important issue for banks, who often must close deals quickly due to competitive considerations.

Over one-third of lenders (37 percent) pay $1,500 to $2,000 for a basic Phase I ESA; approximately one-fifth pay $1,000 to $1,500 (22 percent) and 16 percent pay $2,000 to $2,500. About one-third of lenders (31 percent) pay $2,000 to $2,500 for a Phase I "plus," described as an environmental site assessment report that includes additional considerations that are outside the scope of the ASTM standard. Eighteen percent pay $1,500 to $2,000 for such a report, another 20 percent spend $2,500-$3,000.

Many lenders say they pay a premium for a rush job.

Report Updating and Storage

When it comes to the age of an environmental inquiry, three-quarters of lenders (75 percent) have requirements regarding the acceptable length of time an environmental report is considered valid. More than half (51 percent) say a current report can be no older than one year prior to the anticipated transaction date, while more than a quarter (27 percent) require the report to be no older than six months. Forty-three percent of banks require the environmental report to be updated when its age exceeds "current" status.

When it comes to archiving environmental reports, nearly half of all lenders (46 percent) store environmental due diligence reports in hardcopy only, while another 32 percent store the report on their local server database in addition to hardcopy. Three percent of lenders exclusively store reports online.

Conducting Due Diligence

The survey found that $1 million is the most common loan-size threshold above which a Phase I ESA is always required (see Figure 2). Larger banks were more likely to raise thresholds for Phase I ESAs, meaning they're less conservative, likely because they have environmental risk officers on staff who can determine when other forms of environmental due diligence will suffice. Typically, smaller banks don't have the resources to keep an environmental professional on staff, necessitating added caution.

Seventy-one percent of lenders maintain an in-house list of prequalified environmental consultants that they refer to when hiring-out environmental due diligence services. Banks' reliance on outside environmental professionals is increasing, with 97 percent of lenders reporting that they expect to rely on outside environmental consultants more this year than in previous years.

Lenders have more options for conducting environmental due diligence today than ever before — tools for assessing the likelihood that a property is contaminated are available to fit most every time frame and budget. It is not uncommon for current environmental policies to include a matrix that specifies the different levels of due diligence (e.g., questionnaire, transaction screen, AAI-compliant Phase I, etc.) that are warranted for loans of different sizes and property types. In some cases, banks are using a two-tiered approach to environmental due diligence. They conduct a quick, inexpensive preliminary screen upfront, such as desktop due diligence, then proceed to a full Phase I ESA if the desktop report uncovers a red flag. Lenders who participated in the 2008 benchmarking survey report conducting desktop reviews more frequently than other types of environmental due diligence. Reliability and efficiency were listed as the top reasons.

Emerging Issues

Like most industries, the environmental due diligence industry is constantly evolving. To gauge banks' understanding of emerging environmental due diligence issues, EDR's survey asked lenders whether they were aware of important developments including vapor intrusion, MISMO and green mortgages.

Vapor Intrusion

EDR's survey found that three out of four lenders are aware of vapor intrusion, the indoor air quality issue that develops when rapidly evaporating, or volatile, chemicals from polluted soil and groundwater make their way into the indoor air of overlying buildings. This number will likely increase now that ASTM International, the organization responsible for developing the two other widely used environmental due diligence standards (the Phase I environmental site assessment standard (E 1527) and the transaction screen assessment standard (E 1528)), has released a national standard for the assessment of a vapor intrusion condition (E 2600). Of the 22 percent of lenders who are aware that ASTM has published a vapor intrusion standard, 71 percent plan to use the new standard as a screening tool for vapor intrusion along with an E 1527-compliant Phase I environmental site assessment.

"Vapor intrusion can harm human health and pose a serious business risk. Within a year, most Phase I studies conducted in urban areas and many in suburban areas will include a screen for vapor intrusion that will rely on the new standard," says Anthony Buonicore, PE, chairman of the ASTM committee that developed the vapor intrusion standard.

While vapor intrusion screening should be an integral part of the environmental due diligence process, according to the survey results, only one in five lenders has added vapor intrusion language to their bank's environmental due diligence policy.

MISMO

The Mortgage Industry Standards Maintenance Organization, or MISMO, is a nonprofit subsidiary of the Mortgage Bankers Association created to streamline data transfer across the real estate industry. MISMO has been working to develop free eXtensible Markup Language (XML–next generation HTML) standards for data transfer in residential and commercial real estate. The residential and commercial marketplaces, which have been implementing XML standards into the underwriting process since 2000 and 2001, are benefiting from transferring data efficiently and accurately. Data now commonly processed in accordance with MISMO standards within lending institutions include rent-rolls, appraisals, deal structure, financial statements, and property details. Environmental site assessment data is following suit, now that the release of the first available XML standards on ESAs for commercial deals have been released.

Lenders are far less familiar with MISMO standards than they are with vapor intrusion. While participation in the MISMO standards has grown exponentially in the past several years, EDR's survey found that only 22 percent of lenders are familiar with MISMO's effort to develop standards for XML-based data transfer, and only 4 percent employ MISMO protocols for their environmental, appraisal or construction divisions.

Green Mortgages

Sixty-two percent of lenders are familiar with so-called green mortgages, i.e, loans with preferred rates for environmentally friendly or energy efficient investments. Of those lenders who are aware of green mortgages, most (92 percent) have no plans to offer them to buyers. TSL

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