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Lenders can no longer afford to hide their heads in the sand when it comes to “green” lending. Doing so may result in damage to the corporate brand, shareholder mutiny and customer disapproval.

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Environmentally Responsible Lending

BY MYRA A. THOMAS

Today, lenders are getting used to navigating turbulent business waters. From the current credit crunch to the downturn in the economy, financial institutions need to be prepared for the cyclical and sometimes unsure nature of the industry. But none of the challenges ahead appear as heady, complicated, and certainly uncharted, as the growing concern over the responsibility of financial institutions when it comes to environmentally responsible lending practices.

Just what is the level of accountability of an asset-based lender or factor, or any type of lender, for that matter, when dealing with a client? Often, the answer to the question lies in the very nature of the client's business and just how large an environmental footprint that client leaves. With awareness of global warming and pollution issues at an all-time high, financial institutions cannot avoid the obvious moral and ethical issues, as well as potential liability and opportunity risk inherent in any business by playing flamingo and completely ignoring environmental concerns.

Plus, notes Dean Jeffery Telego, executive co-director of the Environmental Bankers Association (EBA), an Alexandria, VA-based nonprofit trade association, lenders face potential reputational and image risk to the corporate brand by not addressing these issues, and, in turn, they also risk the goodwill of the public and the increasingly vocal numbers of shareholder activist groups focused on environmental concerns. The Environmental Bankers Association addresses environmental risk management issues and due diligence policies, representing the financial services industry, including bank and nonbank financial institutions, insurers, asset management firms, and a variety of other companies servicing the industry.

A Mixed Bag

Getting a handle on the vast number of environmental concerns presented by a diverse client base, while keeping an eye on the business bottom line can be a difficult process, admits Telego. Each potential client might present a differing concern, depending on the nature of the enterprise. Still, being on top of the potential loss exposure of an environmental impact of your client protects and preserves net income and assets of the bank, while performing the needed environmental risk management, he notes.

But just where do environmental policies fit into the lending picture? Environmental risk and due diligence issues as they relate to credit or trust risk management are addressed in most bank credit policy manuals. Now, corporate governance practices, including corporate social responsibility and sustainable product finance, are fast-becoming a growing concern for financial institutions, and environmental lending practices are incorporating many of these principles and practices into these efforts. Additionally, evolving environmental laws and regulations and voluntary industry standards have pushed lenders to be more conscious than ever of the impact of their clients, especially if their financing efforts are linked to an environmentally sensitive project, where, for example, carbon disclosure is made mandatory by the states or energy and greenhouse gas emission audits are required metrics for underwriting a utility risk, says Telego.

Today, environmental lending policies are beginning to incorporate more focus on sustainable development practices and procedures, as a way to address the challenges from shareholder resolutions or be able to quantify the bank's or their client's energy efficiency or greenhouse gas emissions. These policies are set up in a different manner by each and every financial institution, based on their risk tolerance, book of business, and underwriting standards, says Telego. Generally, current environmental lending policies owe much to the recognition of pollution problems, cleanup costs and direct liability issues that affected lenders post-Superfund legislation and subsequent related U.S. court decisions after the 1980s, Telego notes. The Environmental Protection Agency's (EPA) Superfund program established a policy for cleanup of the nation's uncontrolled hazardous waste sites, established by the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

The banking industry's policies further evolved as a result of the lender liability regulations getting codified as the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, says Telego. The 1985 through 1992 court decisions made lenders potentially liable directly for environmental cleanup on a foreclosed business site if they either owned or participated in the management of the environmental risk issues of the business. He says, "No one wanted to be in a position to take over a site and be stuck with the cost of remediation or devalued collateral." The various court decisions and increasing environmental regulation propelled due diligence efforts of lenders into a new direction.

A Look Ahead

Now, many of the largest U.S. financial institutions, such as Bank of America, CitiGroup, JPMorgan Chase, Wells Fargo and Wachovia, as well as shareholder

groups and environmental organizations, are "broadening the definition of environmentally responsible lending practices," notes Telego. Today, the policy is growing to encompass issues of sustainability and concerns over climate change. "We're now talking about sustainable finance or financing green buildings or considering how to change our patterns in-house to run more green," he adds. The evolution of the policies is also changing the hierarchy inside of the largest financial institutions. Says Telego, "Today, there are environmental risk managers on staff at the banks who then answer to the chief risk or credit officer."

Probably the more pressing issue for financial institutions remains the lack of a uniform way to measure and define just what sustainable development or environmentally green means. The universal or national, super-regional and money center lenders are comfortable with being able to quantify or bracket the environmental risk using technical, legal and risk financing techniques. However, there is no set benchmark or metric yet accepted by the industry en masse to measure exactly certain business environmental risks, such as greenhouse gas emissions of a client. So, what's a lender to do?

For now, Telego notes that many of the larger banks in the U.S., Europe and beyond have voluntarily signed onto the Equator Principles, an environmental standard for project financing established under the auspices of the World Bank Group's International Finance Corporation (IFC). Other financial institutions have individually committed to various initiatives and benchmarks, like the Carbon Principles, as well (Editor's Note: For more on the Carbon Principles, see pg. 12).

Telego adds, "In practical terms, the next question is how do we develop the accepted metrics for bridging sustainable development with environmental credit risk management? Whatever gets measured gets managed. It seems that the NGOs and shareholders of the larger financial institutions will influence how the standards get established, and how the institutions will implement them under market- and regulatory-based forces. They will want to understand the banks' underwriting process and what metrics are being used for borrowers to assess environmental efficiency and responsibility. Lenders also are realizing the business opportunities and value implications to both their bottom line and brand, image and reputation of being green when they finance the development of LEED certified building on a brownfield site or finance renewable energy sources, such as wind or solar technologies."

Baby Steps for the Industry

According to Jim Coburn, program manager of investor programs for Boston-based Ceres, the financial services industry may have been slow to move on the issue, but the last two to three years have resulted in considerable progress being made in the banking community regarding environmental lending responsibility. Now, concerns over global warming are forcing the matter to the front burner, he says. Ceres is a national network of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges, such as global climate change. Of course, he notes that "the process is very much an evolving one," and one in which the banks still need to make additional headway.

Coburn admits that certain companies present a real and obvious concern for lenders. "For now, utilities are the bulk of the portion of the portfolio resulting in emissions problems," he notes. But, he adds, environmental lending practices must also consider other issues, including water and land use, including impact on forestry and the like.

Additionally, says Coburn, "policy and action are two different things. You have to look at actual governance day-to-day and how the board and those at the top make things happen." Integrating policy into day-to-day business practices can be a bit more problematic, considering the hierarchy at most financial institutions and the uncharted territory of environmentally responsible lending practices. That's why a commitment by those in the C-suite is key, he adds.

The Banking Perspective

Today, the bulk of large lenders have written policies and practices on the books to deal with the vast world of corporate governance issues, including environmentally responsible lending practices. For the largest financial institutions, such as Wells Fargo & Company, those policies and standards are obvi-

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ously a bit more visible and noticeable by clients, the press, and the world-at-large. Stephanie Rico, communications consultant in environmental affairs for Wells Fargo & Company, notes that they are "committed to creating a corporate culture of environmental stewardship where team members consider the environment whenever they make a decision—including lending money."

Today, Wells Fargo addresses environmental lending practices by a number of steps, she says. Specific to lending money, Rico notes that the financial institution currently "pursues and supports environmentally beneficial business opportunities, and engages customers and works with them to address environmental concerns." Part of the policy also meant strengthening Wells Fargo's environmental due diligence "to ensure that companies we lend to in environmentally sensitive industries manage their operations responsibly." Of course, says Rico, alterations to due diligence policies also meant the need to "train credit risk managers about environmental risks and to educate our relationship managers about green business opportunities."

While lenders are still coming to grips with what environmentally responsible lending means, the next stage for financial institutions will be to deal with the growing push to finance sustainability, clean technology, or "green" efforts in business.

The underwriting process for asset-based lenders and factoring organizations, or for every sector of the lending community, requires an arduous and thoughtful due diligence process tailored to the sector or concerns of the client's industry. Rico says, "In asset-based lending and factoring, we consider a great number of things in our due diligence, from the value of the assets being pledged as collateral, to the company's management, business practices, compliance with local, federal and international laws and regulations, etc. At Wells Fargo, environmental issues and considerations have become another important area of focus in that already extensive due diligence process."

The Bottom Line

While lenders are still coming to grips with what environmentally responsible lending means, the next stage for financial institutions will be to deal with the growing push to finance sustainability, clean technology, or "green" efforts in business. And, as these efforts increase, so too has the push to "cap" the environmental impact of businesses. Increasing regulatory initiatives on the federal, state and local levels are beginning to set greenhouse gas emissions target limits, and this will continue to trickle down and alter the lending efforts of financial institutions, says Greg Larkin, senior analyst covering the banking sector in the New York City offices of Innovest Strategic Value Advisors, an international investment research and advisory firm specializing in analyzing company performance based on environmental, social and strategic governance issues.

Larkin notes, "Today, the banks are all responding in a variety of ways to environmentally responsible lending. Some do it well, and others simply don't. We look at publicly filed deals that the banks are involved in, but some lending transactions aren't exposed, such as syndicated deals." He does note that financial institutions cannot merely exist by funding all of the "saints of the world," from sustainability projects to green tech. Understanding the task of the lender also means dealing with the real-world concerns of business.

Obviously, environmental action organizations and banking institutions have differing parameters on exactly what environmentally friendly means. For now, some lenders and investment firms are buying into outside research to help them make environmental lending decisions. Notes Larkin, "Similar to a Moody's or Standard & Poor's, we provide the metrics to lenders and other firms, so that they can put the caps on the sinners." He believes that financial institutions are uniquely positioned and have the needed leverage to impact and alter the shape of business today, serving as the capital to a variety of industries. That could eventually mean placing influence on a utility, for instance, to operate in a more environmentally friendly manner.

But bottom-line considerations will remain the driving force of lending. Larkin admits that for those sitting at a desk and offering the loans or the financing, the banker will always be responsible for deal volume. "That's what bankers do. To close the deal, it has to go through a risk committee, and even if the bank isn't concerned about the environmental risk, there are many others who will be. We're not saying don't lend to a utility, but you need to understand the social, government, regulatory and political risks. If you're not evaluating those risks, you might be blindsided at some point." **TSL**

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