AN EVER-EVOLVING APPROACH TO

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ENVIRONMENTAL RISK MANAGEMENT

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I'M A SPORTS fan, and I love watching my kids' games. One of my favorite activities in my so-called downtime is cheering on my daughter's soccer team. Nothing quite matches the thrill of watching a group of five-year-olds running in every direction. They are clearly having a blast and burning off a lot of energy. But that chaotic energy isn't always well placed or used in the most efficient manner.

Commercial real estate lending can seem similar at times. As a lender or risk management professional, you are pulled in many different directions on any given day. The clock is running, and as you work to close a hot deal, you worry about beating out the competition, pricing appropriately, applying rigorous credit analysis, and performing appropriate due diligence, including site visits and appraisals. All of this is happening while your client is breathing down your neck to get the loan to closing. No wonder you feel like you're running around in circles!

Environmental analysis is an important yet frequently overlooked component of any risk management program and one that borrowers rarely understand. But with a few adjustments, the environmental due diligence process can be repositioned as a service to enhance the borrower relationship and create lasting value over the long term. This article shares some hot trends in the environmental space as well as some best practices.

Why an Environmental Review?

There are several reasons why financial institutions involved in commercial real estate (CRE) lending should have a robust and well-considered environmental risk management program.

1. **Lender Liability:** The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA, also known as "Superfund") was enacted in 1980 as the federal government's solution to cleaning up sites contaminated by hazardous substances and pollutants. However, it really didn't make an impact on the banking industry until a decade later, when the U.S. Court of Appeals for the Eleventh Circuit handed down its ruling in the case of *United States vs. Fleet Factors Corp (1990)*.

   The court determined that, despite the statutory exemption for secured creditors that was included in CERCLA, a lender may be held liable based simply on having the opportunity to influence a debtor's business operations. With that decision, lenders were placed squarely in the crosshairs of liability for environmental contamination, forcing banks to be more aware of their role. This interpretation kick-started the development of environmental due diligence practices at commercial banks, a process that has trickled down over time to community banks and credit unions.

WITH THE GROWING THREAT OF CLIMATE CHANGE AND THE DESIRE OF INDIVIDUALS AND COMPANIES TO REDUCE THEIR CARBON FOOTPRINT, MUCH FOCUS HAS BEEN PLACED IN RECENT YEARS ON GOOD CORPORATE CITIZENSHIP AND "GOING GREEN."

2. **Risk of Default:** Environmental reviews may seem like a nuisance when trying to close a commercial real estate transaction in 60 days, but you will be glad for this piece of risk management if the worst-case scenario arises and the loan ends up going bad. When the bloom is still on the rose, it is hard to think about a loan going into default, but it does happen. And if you are forced to foreclose, a clean property will be worth a lot more on the market than one requiring remediation.

   Additionally, good environmental reports include information about adjoining-property risks. Standard due diligence includes a history of past commercial use and remediation that can highlight potential risks of secondary contamination of the subject property. Although you or your borrower may not technically be liable for contamination from surrounding commercial sites, it is still something that would need to be dealt with down the road if the subject property goes into foreclosure and ends up on the market.

   On balance, you and your borrowers are both better off conducting environmental due diligence up front on the subject property.

3. **Impact on Reputation:** Few crises are more media-ready than an environmental cleanup. If your institution has a loan on the property, or if you had to repossess a property due to borrower default, your bank's name will also be dragged through the mud. The public may very well question why your bank didn't complete full due diligence at the time of the project's initial funding or refinancing.

Hot Trends in Environmental

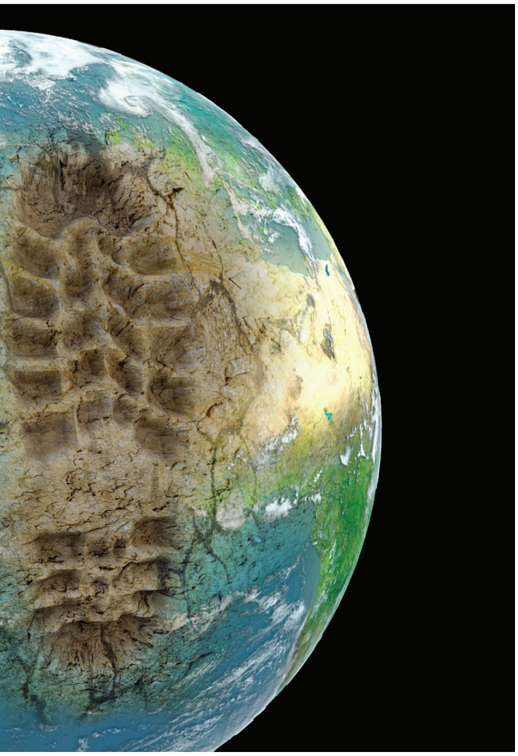
Now that you understand why an environmental risk management program is so important, let's discuss a few areas that have been getting a lot of attention recently.

1. **Vapor Intrusion:** Vapor intrusion is defined by the EPA as "a migration of volatile chemicals from contaminated groundwater or soil into an overlying building."

   Years ago, the EPA was primarily concerned with seepage—dangerous solid or liquid compounds bubbling up into a property or contaminating the groundwater. But more recently vapor intrusion has shown up on the radar screen as regulators have focused more scrutiny on the real dangers of gaseous migration of volatile and semi-volatile organic compounds, as well as inorganic substances such as elemental mercury, radon, and hydrogen sulfide. From a practical standpoint, the main impact on banks' environmental risk management programs is that the latest Phase I Standard, ASTM 1527-13, now requires that the reports include an evaluation of any potential vapor encroachment to the subject property. It is also causing reopeners—requiring additional cleanup on sites that had previously been closed.

2. **Brownfields:** Brownfields are a perennial "hot topic." A brownfield is defined by the EPA as "a property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant." There are roughly 450,000 brownfields in the United States, and the cleanup and redevelopment of these sites is a core focus of the EPA's mission.

   The 2002 Small Business Liability Relief and Brownfields Revitalization Act provides some protections for purchasers and lenders against unlimited liability under CERCLA for the cleanup of contaminated sites. These protections extend to pre- and post-foreclosure actions on contaminated properties. However, lenders must be careful to stay within the safe harbor rules and especially avoid "participating



in the management" of the site, which may result in transference of liability from the property owner to the lending institution.

Another environmental hot topic is underground storage tanks (USTs) containing petroleum-based products. In June 2015, the EPA updated and strengthened its 1988 rule regarding USTs. The new rule contains additional provisions for secondary containment, operator training, and periodic operation and maintenance of UST systems, among other requirements.

3. **Insurance:** Another area to watch is insurance. Most general commercial policy binders exclude coverage for liability from environmental issues. However, some insurance companies, including major issuers such as Zurich, XL, and Chubb, offer environmental liability policies that cover contamination and other environmental hazards. If this is a concern of your borrowers, refer them to a reputable commercial broker that has experience in this area or to an environmental risk management firm for advice and guidance.

4. **Energy efficiency:** This discussion would be incomplete if it didn't include the boom in demand for energy-efficient facilities, or "green tech." With the growing threat of climate change and the desire of individuals and companies to reduce their carbon footprint, much focus has been placed in recent years on good corporate citizenship and "going green." Leadership in Energy and Environmental Design (LEED)-certified construction got the ball rolling with this initiative. Since then, numerous local and state governments have begun offering valuable incentives for such projects.

   With growing demand and ever-tightening regulations in this area, expect energy efficiency and "green" construction and design to have an increasing influence on commercial property values as time goes on. However, the biggest driver of energy efficiency in the current market is the fact that it actually saves CRE owners money in the long run. For this reason, it has become even more commonplace in the industry to see retrofits of existing buildings with energy-efficient equipment and features.

Five Keys to Environmental Risk Compliance

There are always ups and downs in an environmental risk management program. Here are five keys to help you get started.

1. **Craft a clearly defined environmental review policy.** A good environmental risk management program begins with a well-crafted policy. Banking regulators, including the OCC and the FDIC, have provided guidance as to what should be included in an environmental policy. Be sure to consult your regulator's website for the latest guidance that applies to your financial institution.

   Additionally, the U.S. Small Business Administration (SBA) provides a true road map with specific requirements for lenders to follow, such as when to use a questionnaire, Phase I, or RSRA (records search with risk assessment). Whereas the regulators provide only general guidance, the SBA offers a detailed, prescriptive policy with best practices that is worth consulting even if you don't engage in SBA lending.

   Here are some key elements you should include in your bank's policy:
   - Designation of a staff member responsible for oversight of the program.
   - Reference to current environmental laws and requirements.
   - Guidelines for collateral due diligence of environmental risks on properties held in the portfolio.
   - Defined levels of due diligence required for different types of real estate transactions.
   - Criteria for evaluating environmental risk factors and the circumstances under which a loan would be declined.
   - Use of a subject-matter expert to help with the process.

2. **Develop strong procedures that all staff will follow.** Although it is important to have a comprehensive and well-considered policy, not every step in your environmental risk management program should be laid out in explicit detail. You want your policy to be flexible enough that you can function efficiently and make operational adjustments on the fly without having to go back to your board with changes every six months.

   This is where robust, detailed procedures come into play. You will want to document every step of the environmental review playbook. The goal should be for any loan officer, regardless of experience, to be able to pick up the procedures binder and fully understand the workflow—from the initial fee conversation, to the types of review tools to be used for which types of properties, to the management of exceptions (if any are allowed). Key aspects include having a regularly updated approved-vendor list and a pricing matrix. Once the procedures are fully documented, establish a rigorous and regular training program for your staff. No one should be left in the dark.

FROM DEVELOPING YOUR
POLICIES AND PROCEDURES TO TRAINING YOUR TEAM AND DECIDING HOW TO PRESENT THE SERVICE TO YOUR CUSTOMERS, THE DEVIL IS TRULY IN THE DETAILS.

3. **Collect borrower fees up front.** Discussing fees up front with a prospect can be harrowing. There are document prep fees, commitment fees, appraisal fees, and attorney fees, in addition to a fee for the environmental review, and you may wonder when the borrower is going to cry foul. But it is imperative to order the environmental review as early in the process as possible, whether you are doing a limited desktop review or ordering a full Phase I. Be sure to collect your fees up front in order to minimize any dispute or collection issues later on in the process.

   This is also the best time to have an honest discussion with your borrower about the environmental process and what to expect. For example, explain that the cost of an initial desktop review is $500, but if anything unusual or concerning is discovered, the next step would be a Phase I, which can cost up to approximately $2,500. Use the matrix that you developed and share the expected costs at each level with your customer. It is important to remember that hope is not a strategy, and the last thing your borrower wants is a surprise right before the closing date.

4. **Present the environmental review as a value-added service.** A great way to change the tone of the fee conversation is to position the environmental review as a service. The environmental screen is not simply a box to check off on the closing checklist. If done right, it can provide your borrower with valuable data *prior* to purchasing the property. Business-use history and risk of contamination may be identified, as well as the potential for mandated remediation. This is important and valuable information for the purchaser; he or she may decide to go back to the seller and require that certain financial or actionable steps be taken before the deal is done.

5. **Ensure ready access to expertise.** Regulators emphasize that "persons responsible for evaluating environmental risk possess relevant knowledge, skill, and competence."[1] Often, financial institutions will assign responsibility to an individual in-house who does not have the requisite background, skills, or desire to oversee an environmental risk program. That individual may wear many hats, and the environmental review program would likely fall to the bottom of his or her list of priorities. That would be a mistake.

   According to the FDIC's guidance, "Whenever the complexity of the environmental issue is beyond the expertise of the institution's staff, the institution should consult legal counsel, environmental consultants, or other qualified experts."

   Most small institutions don't have the volume to justify hiring an environmental expert or assigning the responsibility to a dedicated and well-trained full-timer on staff. That is where outsourcing may be a good alternative. There are reputable firms that specialize in nothing but environmental review and consultation. Better yet, it doesn't have to be an expensive option. With a fee-based model, the expense of an environmental review is transferred directly to the borrower, making it a cost-neutral program for the bank.

   Even for large banks, outsourcing on a fee basis can pay dividends. Under this service model, banks pay only for the service they use. During times of heavy volume, using an outside resource can help keep the closing process moving without requiring the hiring of additional staff. And when the pipeline is low, a variable-cost model will help keep expenses down.

Conclusion

There is a lot to consider when implementing an environmental risk management program. From developing your policies and procedures to training your team and deciding how to present the service to your customers, the devil is truly in the details.

In many cases, especially for small institutions, this program is too complex for one person on staff to handle. Environmental risk management firms provide the tools to help banks service their borrowers.

Environmental reviews are challenging, and they can seem like just another five-year-old on a chaotic ballfield. But with proper planning and due diligence, your team can work together to log some important wins for your bank. ®

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Note

1. Office of the Comptroller of the Currency, Comptroller's Handbook, "Commercial Real Estate Lending," section on Environmental Risk Management, pp. 70-71.