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Technical Brief for Commercial Real Estate Lenders

Policy Development for Community Banks on the Rise

Increasingly, amid intense regulator pressure, financial institutions at the smaller end of scale are implementing their first policies for managing environmental risk in commercial lending practices. This trend is in stark contrast to the largest financial institutions in the country, like Wells Fargo, Bank of America, US Bank and others, that have long-standing sophisticated policies that have been in place for a decade or even more. EDR Insight's recent quarterly surveys of financial institutions reflect that more and more community banks are following in the footsteps of their larger counterparts and adopting institution-wide policies that define clear environmental due diligence policies for new originations, refis, foreclosures and property purchases.

> *"Our bank just adopted its first guidelines for environmental due diligence for commercial loans with mortgages."*
>
> *"Bank-wide we just underwent significant training for our first-ever policy for new loans and refis. Mostly based on SBA."*
>
> *"We drafted a new environmental policy that will be rolled out in 4Q 2012 which will address environmental issues on all commercial real estate. This is a significant event!"*
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> Source: EDR Insight's Quarterly Benchmarking Surveys of Financial Institutions

Following in the Footsteps of National Institutions

In today's risk-averse environment, knowledge of contamination on or around a commercial property being used as a collateral can hinder—or even halt—the loan origination process. The cause for pause is real. Contamination at a property securing a loan transaction can lead to loan default, direct liability for cleanup costs, and litigation. It can also, in the case of foreclosure, leave the lender with a stigmatized property that may be difficult to sell.

For these reasons, more community lenders are making the evaluation of environmental risk a mainstay in their due diligence practices. This trend is partly attributable to a growing awareness of environmental risk and an increase in available data for assessing a property's potential for contamination. Regulator pressure is another strong driving force. Smaller banks are joining the larger institutions that have already made environmental risk management a strategic priority. As a result, smaller lenders are being more proactive than ever before in writing their first—or updating their existing—environmental risk management practices to reflect the latest technical information and the bank's own risk tolerance.

Policies Take Root as Originations Ramp Up

Today, four and a half years into the commercial real estate downturn, property fundamentals are finally showing gradual signs of improvement. Investor confidence is improving, property prices are on the upswing and more borrowers are starting to shop around for capital. The majority of institutions expect loan originations for commercial properties to increase this year over 2012. Amid this environment of gradual improvement, a greater percentage of commercial loans will undergo the scrutiny of environmental due diligence.

Although banks are starting to extend credit on commercial properties again, they are doing so cautiously. Many institutions adopted a more firm approach to environmental underwriting in the downturn and are now holding them steady, reflective of a still-high aversion to all types of risk. As one risk manager at a mid-sized institution observed recently, "There's a sense that these deals have to be whiter than white for us to touch them. No one wants to take on risk yet."

> **Notably, 70 percent of institutions today base decisions about how much due diligence is required for a new origination based on current or past use rather than loan size.**

Reflective of this mindset, many environmental policies today include a specific mandate not to loan on sites perceived as having a high environmental risk (e.g., former gas stations, dry cleaners and industrial sites). As lenders have become more sophisticated in how environmental risks are assessed, loan size has become less important when determining how robust the environmental investigation should be. This is an important change for lenders given that environmental contamination does not recognize loan value. A former dry cleaner collateralizing a $250,000 loan, for instance, could have serious environmental issues, while an office building backing up a $2 million loan might have no problems. As a result of growing awareness, many institutions have instead adopted an SBA-like tiered approach to due diligence that assigns different levels of scrutiny based on a site's past use in place of loan size. Under this approach, property uses associated with a perceived low-risk start at less stringent levels of due diligence, while higher-risk uses automatically begin the process with a Phase I environmental site assessment in compliance with the federal All Appropriate Inquiries (or ASTM E 1527-05) protocol. Notably, 70 percent of institutions today base decisions about how much due diligence is required for a new origination based on the current or past use rather than loan size. This is a significant change from the earliest environmental policies of last decade.

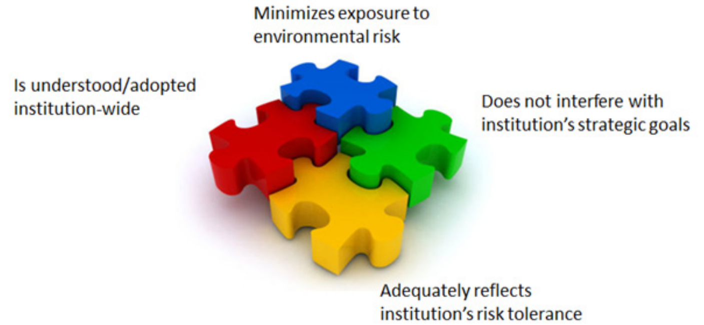
Risk Management Drivers

At the forefront of most risk managers' minds today is the growing pressure from regulators on institutions to effectively manage all types of risk exposure. Most institutions have been examined by a regulatory agency such as the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency or the Federal Reserve Board in the past few years. Many of these examinations asked institutions specifically about how they manage environmental risk.

Due to either a growing awareness that property contamination can have a detrimental impact on collateral value, a general aversion to risk in a fragile market, increasing regulatory pressure or a combination of the three, community banks are getting more formal about their environmental due diligence practices.

In addition, ASTM is about to update its Standard Practice for Phase I Environmental Site Assessments (E 1527-05) for the first time in eight years. While many risk managers are not yet aware of the key areas of change or the impact these revisions may have on their due diligence practice, the release of the standard will likely prompt many institutions with policies that reference the 2005 version of E 1527 to update requirements to reflect the more recent protocol.

Elements of Successful Risk Management Strategy



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The way that institutions manage risk has undergone significant changes since the start of the market downturn, in response to a mix of regulatory and economic forces. The adoption of more environmental policies at the smaller end of the bank-size spectrum is a positive development. Formal policies are an effective way to manage regulator pressure, protect the bank's own liability and that of its borrowers, and adhere to industry best practices. In addition, there are more eyes on risk management today than ever before so consistency and having an established process in place communicated throughout the institution are critical for effective implementation.

Questions or comments?

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