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Technical Brief for Commercial Real Estate Lenders

No Stone Unturned: Refinancing 2012's Loan Maturities

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Refinancing activity in 2012 is making a comeback, along with the environmental due diligence conducted to support it—not surprising, considering the $362 billion in commercial real estate loans scheduled to mature this year on top of the $346 billion that matured last year. Trepp, LLC estimates that 63 percent of these loans are underwater, meaning they have principal balances greater than the value of their collateral. By comparison, 34 percent of the $326 billion of maturities in 2010 were underwater before reaching their maturity dates, and only 20 percent of 2009's $321 billion of maturities. The 40 percent decline in property values since the market's high in 2007 has caused loan-to-value ratios to soar. As the volume of commercial property loans needing refinancing climbs, the battle for available capital is intense. Due to stresses in the commercial real estate market, lenders have become more conservative in their underwriting standards than they were when today's loan maturities were first originated back in 2007. The purpose of this Technical Brief is to highlight some of the environmental challenges that are coming to the surface as lenders scrutinize the collateral used for loans originated in the market's heyday through the lens of today's environmental policies.

Based on recent outreach by EDR Insight to both commercial real estate lenders and the environmental due diligence professionals who support them, the most common problems arising on refis are:

- The environmental report conducted at origination cannot be found or is of poor quality.
- Recommendations made by environmental consultant at origination were never followed.
- Property neglect or deferred maintenance over the course of the loan created new environmental conditions that need to be addressed.
- Prior due diligence does not meet today's more stringent environmental standards.

No (or poor quality) environmental reports from loan origination

Many of the loans maturing this year were five-year loans originated during the market peak of 2007. Given the fast pace of deal making then, it is easy to understand the difficulty some lenders have in locating the original loan documentation. Even if the original environmental report is found, lenders and their environmental consultants are finding issues that were not investigated at the time and now require due diligence. On some projects, red flags are surfacing that escaped notice during the original due diligence. Mike Kulka of PM Environmental (Berkley, MI) shared that: "I just had a 2004 Phase II ESA that we completed that needed a new Phase I ESA. The original Phase I was completed by a credible firm but they simply did not note a UST clear as day on a Sanborn map. We relied upon our previous Phase II to adequately address the RECs so we assumed no other concerns.

Now it is being done as an SBA loan, and we have to investigate the UST as none of our borings are near the former UST."

In some cases, the bank may also have originated a loan without having any environmental due diligence completed, but bank policy now dictates that all refi applications be accompanied by an appropriate level of environmental due diligence.

Recommendations from original due diligence not followed

In reviewing old environmental reports, the lack of appropriate follow-up on recommendations made by environmental consultants at the point of origination is a common and significant issue for many risk managers today. These recommendations might include: additional investigation to fill a data gap, soil sampling to determine the presence and extent of contamination on a property, or a review of agency files that could not be completed prior to origination. Part of the problem is the lack of staffing or resources to monitor a borrower's property over the course of a loan. There are also instances in which the consultant's recommendations were waived by bank personnel eager to approve the origination. And now, faced with a refi request, many lenders are confronted by the need to pick up where the original due diligence left off.

Poor property maintenance led to new environmental issues

During the downturn, given high vacancy rates at commercial properties and the financial difficulties many owners face, adequate property upkeep and maintenance has led to environmental issues being identified during refi requests. Neglected properties can attract illegal dumping of wastes, some of which may be hazardous, or the presence of meth labs or unauthorized occupancy. Deferred maintenance can lead to structural issues, such as roof leaks or water damage including mold, or damage to asbestos or lead based paint at the property.

Tighter underwriting in 2012 raises new red flags

Lenders' underwriting for all types of risk was less conservative in 2006 and 2007 than it is today, which has implications for what is being done on this year's refi requests. For example, Holly Neber, President, AEI Consultants (Walnut Creek, CA) is seeing "a lot of new Phase I ESAs for refinance purposes, either with the original lender or a new lender. We find that property owners face challenges when the prior Phase I was done on a rush basis without the benefit of a full agency records review and the new, more thorough due diligence results in new information coming to light."

In reviewing the original due diligence, there are also environmental conditions that raise concerns today that may have gone unnoticed before—or were not viewed as particularly risky at the time. Vapor migration is one such risk that has grown in terms of awareness since many of the loans coming due this year were originated five or more years ago. The risk of vapor migration is surfacing as a concern on many refis because contamination from the vapor pathway may exist today, but may not have at the time of loan origination. What was believed to be a low level of contamination at the time may now exceed the screening level for vapor intrusion. And, at many financial institutions, vapor intrusion may not have even been part of bank policy back at the time of loan origination, but is today.

The current risk-averse mentality also has implications for evaluating prior due diligence from both the borrower and lender perspectives. "In the case of a new lender," observed Neber, "a new risk tolerance may apply to the issues that were not considered material to the original lender at the time of the purchase and original loan. For borderline issues, the property owner then has to decide if they want to proceed with additional investigation on a property they already own for the benefit of the new lender and their more conservative approach. They must carefully weigh the benefits of the new financing with the worst case scenario of discovery of a previously unknown issue."

Another common issue is that, as the result of significant consolidation in the banking industry, environmental due diligence conducted by the prior parent needs to either be redone or updated to comply with the new parent bank's credit policy and standards.

Refi Scopes of Work

There is considerable variability in the types of environmental due diligence warranted by refinancing requests from one bank to another. At some financial institutions, the environmental due diligence requirements for refis can differ significantly from the scope of work used for originations, foreclosures or property purchases by the bank. According to Kulka, "Many of the large banks have their own scopes that selectively pluck the relevant components of a Phase I ESA. For instance, we might be asked to review Sanborns, aerial photos, city directories and complete a site visit for a lesser fee and less time, which makes all players at the table happy."

It is not uncommon for banks, even if the original due diligence report can be found, to require a search of current environmental records on the property, given the risk that adjoining property uses may have changed, or environmental hazards may have been introduced to the property or vicinity. According to a risk manager with a large commercial lender, if the property is perceived as "high risk," the bank will likely order a new Phase I ESA. Otherwise, the protocol is to have a Transaction Screen conducted, or a new site inspection and borrower questionnaire. Specifics of the deal are also material. If, for instance, the refinance loan is more than a set percentage of the original loan amount or is for a 'high risk' property type, then a new Phase I ESA may be automatically ordered.

At his institution, Ed Morales, VP, Environmental Risk Officer at Sonoma Bank (Walnut Creek, CA) noted that "A refi is treated like a new loan. We do not differentiate between the two. We order new due diligence in all cases. The most common problem I see is the age of prior reports. If the environmental report is more than one year old, it is not acceptable and additional work will have to be done." In the five or more years since origination, new environmental issues may have been uncovered, and outdated reports will not reflect the current condition or knowledge of the surrounding area.

With more than 60 percent of loans maturing this year underwater, competition for refinancing capital will be intense. There will be a high number of low-risk properties looking for financing—and others with significant environmental issues. The risk to the lender of refinancing loans will need to be justified and questions will need to be answered. For as long as the EDR Insight Risk Aversion Index remains elevated, and for as long as the market continues to be uncertain, environmental due diligence will play an important role in helping investors, lenders and other stakeholders model the downside of a rising number of refi requests.

NOTE TO READERS:

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Questions or comments?

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