

Technical Brief for Commercial Real Estate Lenders

Latest Environmental Risk Aversion Index Reflects Uncertain Market

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Aversion to environmental risk by commercial real estate lenders continues to be elevated in today's highly uncertain economic climate, although the recent tightening of environmental due diligence standards eased in the latest quarter. The EDR Insight Environmental Risk Aversion Index, a measure of the extent to which financial institutions are tightening or relaxing environmental due diligence, normalized in the latest quarter after several quarters of steady tightening. In periods of high risk aversion, lenders are asking more questions about what specific environmental issues mean and, in a growing number of cases, requiring more investigation or even testing to eliminate unknowns.

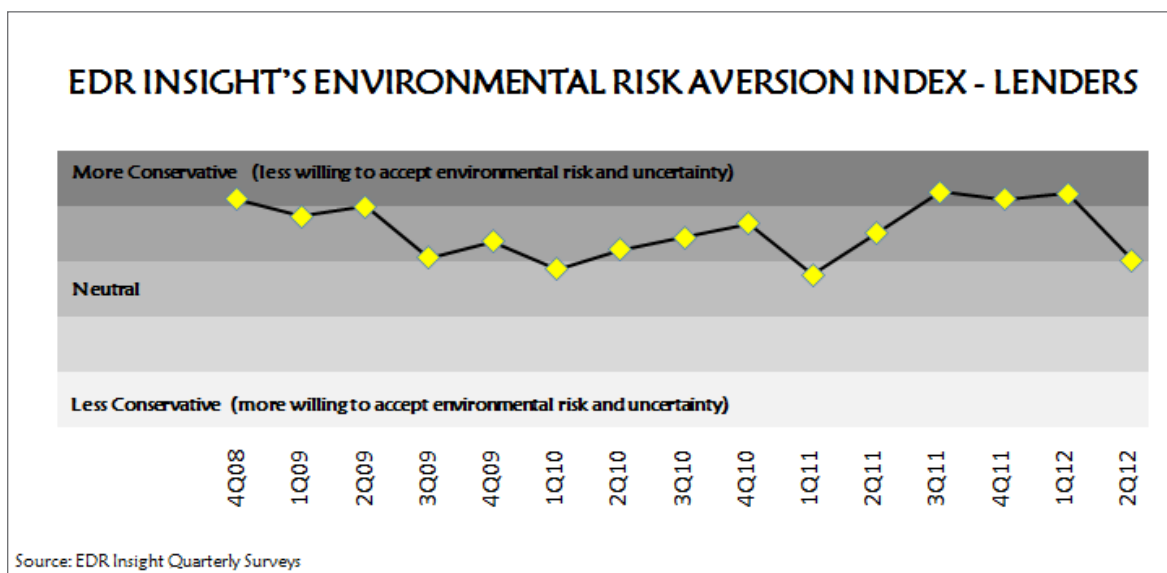
Ernst & Young: Make Risk Management "Everyone's Business"

A stronger emphasis on risk management coincides with a recent Ernst & Young survey of major financial institutions. Their study concluded that the lending industry is still responding to the financial crisis, noting that improving risk management policies is a "work in progress." Perhaps not surprisingly, their latest survey, Ernst & Young's 3rd since the start of the financial crisis, showed that attention to building a strong risk culture has remained high for those financial institutions most affected by the downturn with 53% of respondents reporting a "significant increase in attention" to risk over the past 12 months.

EDR Insight Risk Aversion Index

Like the Ernst & Young study, the EDR Insight Environmental Risk Aversion Index tracks how lenders' attitudes toward risk are changing in response to market conditions. Based on quarterly survey data from lenders, as well as from the environmental consultants who serve them, the index has historically correlated very well with broader market trends. For instance, hope in late 2010 turned into optimism by the start of 2011 as a number of key economic indicators signaled that the general economy and commercial real estate were finding a foothold from which to build a recovery. Amidst signs that the market was finally improving, lenders and investors were bullish about deal making in the new year and risk aversion relaxed, as reflected in a downturn in the index. Then, mid-2011 market unrest, debt problems in Europe, disappointing economic barometers here in U.S. and problems in the CMBS market injected a lack of confidence into the market and resulted in many industry players scaling back their forecast for the remainder of 2011. Wary lenders responded by tightening their environmental underwriting, a trend that continued through 1Q12.

Now, very few lenders are loosening their underwriting, while some are still making their standards even more stringent. Yet, the vast majority are exercising the same high risk aversion that characterized the past three quarters.



Key Findings

- Risk aversion remains elevated with the majority of risk managers (87%) now holding firm with a cautious approach to extending credit on commercial real estate. Another 10% characterized current sentiment as even more risk averse and less willing to accept environmental risk and uncertainty than last quarter.
- Anecdotal input suggests that, due to an overall cautiousness, many banks are turning down more loans than they are originating.
- Notably, there are significant differences from bank to bank. Some banks, especially the larger institutions, have processes and policies in place to manage risk (and have for some time) and have not measurably tightened standards in response to recent changes in the market.

Lenders' Sentiment

- *"Our standards remained high in the second quarter."*
- *"Ours is only a slightly higher environmental due diligence position than last quarter. Our bank has always had rigorous due diligence on environmental matters."*
- *"Our stance has not changed this quarter."*

Environmental Professionals' Sentiment

- *"I completely agree that banks are more risk averse, except for small community banks. They continue to fight for no environmental conditions at a property, regardless of the findings."*
- *"I do not see any real change in national or regional lenders; however, tighter due diligence standards is being seen in community lender transactions."*
- *"Lenders are definitely more risk adverse."*
- *"It all depends on the lender. Some are more conservative than others."*
- *"Banks appear to be looking for reasons not to make loans."*

Uncertain Future

In general, the lending sector continues to view all types of risk warily, with environmental risk being no exception. The high level of market uncertainty, particularly with respect to the European debt crisis, future bank regulations and continued volatility and instability, translates into a lower appetite for risk. These factors give lenders strong reasons to be conservative with their lending practices for at least the next few quarters. The market continues to work through a high volume of commercial real estate loans that are maturing as well as a minor uptick in property investment, both forces that are driving environmental due diligence to the forefront as owners and investors seek financing. Banks' wariness translates into a need to have environmental risks properly assessed and justified up front before moving forward. In the process, environmental consultants and lenders are uncovering environmental issues that went unnoticed before—issues that would not have raised an eyebrow five years ago can complicate a deal now.

One impact of the financial crisis is that the role of risk management in real estate deals has been shoved to center stage. The Risk Aversion Index reflects that environmental risk management has become very important given stresses in the real estate market and the potential likelihood that banks could become the unwilling owner of a commercial property. The Ernst & Young study reinforces this trend, as well, and notes the long-term aspect of "making risk management everyone's business".

As the market continues on its rocky path to recovery, EDR Insight will continue to closely track how environmental underwriting and approaches toward risk are changing. Worth noting is that the Office of the Comptroller of the Currency, in its first Semiannual Risk Review, just released a warning to lending institutions to not "go out too far on the risk curve" in their quest for higher earnings. Pressure by regulators on lenders to maintain strong risk management practices and minimize risk exposure will continue to be intense, particularly as lending levels begin to tick back up slowly. A bank's best protection against regulator pressure is to establish strong environmental due diligence policies and have adequate processes in place for ensuring that protocols are being properly implemented.

NOTE TO READERS:

The author wishes to thank Gary Kulik for providing peer review of this Technical Brief.



Methodology: EDR Insight Environmental Risk Aversion Index: Financial Institutions

The EDR Insight Lender Environmental Risk Aversion Index is the industry's most comprehensive measure of how financial institutions involved in commercial real estate lending are changing their environmental due diligence practices in response to market forces. On a quarterly basis, the index measures changes in the sentiment of commercial real estate lenders toward environmental risk. A low score reflects a less conservative approach to environmental due diligence and a lower risk aversion. Likewise, a higher index is reflective of a more conservative due diligence approach and a higher aversion to environmental risk. The index is based on comprehensive survey data from two separate efforts:

- EDR Insight's Quarterly State of the Property Assessment Market Survey of Environmental Professionals. Respondents include environmental due diligence consultants who work in the field with commercial real estate lenders. Inputs to the index from this survey vehicle include the percentage of environmental professionals who "completely agree" or "somewhat agree" with the statement: Commercial real estate lenders have tightened their environmental due diligence standards this quarter.
- EDR Insight's Quarterly Benchmarking Survey of Financial Institutions. Respondents include risk managers responsible for environmental due diligence at a range of institutions including community banks, regional banks, large national/international institutions, credit unions and other lenders. The index reflects the percentage of respondents who "completely agree" or "somewhat agree" with the statement: Our financial institution tightened its environmental due diligence standards this quarter.

The results are corroborated with a battery of related questions in each survey that further explore how sentiments about environmental risk in commercial real estate lending are changing in response to market conditions. EDR Insight's time-series survey data on this topic dates back to a 4Q08 baseline, and ongoing research by EDR Insight indicates that trends in the index are closely correlated with overall attitudes toward risk in commercial real estate.

Questions or comments?

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