

LENDERS' PERSPECTIVES ON ENVIRONMENTAL ISSUES

Environmental contamination does not necessarily discourage real estate lending.

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In the fourth quarter of 1990, The Hanford/Healy Companies (HHC) conducted a survey of major real estate lenders. The purpose of the survey was to quantify lenders' perceptions of environmental risks and the degree to which these perceptions affect underwriting policy. Individuals from 57 institutions were interviewed, including the largest 25 banks in the country,¹ the largest 15 banks in California,² and the largest five foreign bank branches in the United States.

It should be noted that more than one person from some of the larger institutions were interviewed, namely, a lending/credit officer and an officer from the appraisal/environmental services area. The survey percentages reported in this article consequently do not always reflect the number of institutions contacted. Survey percentages also vary because some lenders did not have an opinion about a specific survey question or felt that more than one response was appropriate or individuals from the same institution had differing opinions.

The survey consisted of eight questions, each of which had multiple parts (see Exhibit I).

Questions 1 through 3 of the survey addressed the lenders' relative concern about specific environmental issues, such as underground storage tanks and unencapsulated asbestos. Questions 4 and 5 addressed environmental audits and the use of outside environmental consultants. Question 6 linked environmental issues to the appraisal process, while the last two questions focused on underwriting standards.

The results of the survey were compiled in an indepth report. As it would be impossible to duplicate all of the results herein, this article highlights some of the more significant responses to the survey questions.

Groundwater Contamination: The Greatest Concern

Of all banks responding, 41% believed groundwater contamination was the greatest concern among five specified environmental issues: underground tanks, unencapsulated asbestos, encapsulated asbestos, groundwater contamination and toxic inventories (Table 1). Unencapsulated asbestos was a distant second, with 14% of the banks ranking it as their primary environmental concern. Not one bank categorized groundwater contamination as the least

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EXHIBIT I

Hanford/Healy Companies' Environmental Risk Survey Questions

1. Would your institution lend on a property knowing it:
 - a. Had underground storage tanks.
 - b. Contained unencapsulated asbestos.
 - c. Contained encapsulated asbestos.
 - d. Was surrounded by contiguous parcels with environmental problems.
 - e. Had tenants that might use toxic materials.
 - f. Previously had some contaminations but has been cleaned up.
2. On a 1 to 5 scale, rank the following environmental issues according to their concern, with 1 being the least worrisome and 5 being the most worrisome:
 - a. Underground tanks.
 - b. Unencapsulated asbestos.
 - c. Encapsulated asbestos.
 - d. Groundwater contamination.
 - e. A tenant who stored toxic materials.
3. Regarding the above environmental issues:
 - a. Which issue is the greatest concern to your institution?
 - b. Which issue is the least concern to your institution?
4. In regard to environmental audits:
 - a. When is a Phase I audit required?
 - b. Does the lender or borrower order, deliver and pay for the Phase I audit?
 - c. If the borrower orders a Phase I audit, must the environmental consultant be approved by the lender?
 - d. If the lender orders the audit, which banking area issues the order and who is responsible for the interpretation of the audit?
 - e. Do you have any loans on property where an environmental cleanup is being conducted—other than property containing asbestos?
 - f. If so, did your institution lend the money for the cleanup?
5. Does your institution hire outside consultants to aid in review of environmental audits?
 - a. What types of consultants?
 - b. When are they retained (under what circumstances)?
 - c. Do you hire different consultants depending on the nature of the environmental problem?
6. With regard to appraisals:
 - a. If the presence of contamination has been proved, do you ask appraisers to consider the known contamination in the appraisal process?
 - b. Who is responsible for informing the appraisers of the contamination?
 - c. In your opinion, have appraisals of previously contaminated properties that have been cleaned up reflect any loss in value?
7. Are the following underwriting standards on loans adjusted when a property has a potential or an actual environmental problem?
 - a. Loan to value ratio.
 - b. Borrower indemnification.
 - c. Personal liability.
 - d. Interest rates.
8. Have your underwriting standards been changed since the Fleet Factor court decision?

disturbing issue. In fact, when rating the five specified environmental issues on a scale of 1 (least worrisome) to 5 (most worrisome), 87% of the banks believed groundwater contamination rated 4 or above.

Conversely, 46% of the banks believed that encapsulated asbestos was the least worrisome *vis-à-vis* the other environmental issues. On the 1 to 5 scale of risk, 71% of the banks rated encapsulated asbestos at 3 or below.

Less than 40% of the banks would consider lending on a property located contiguous to a parcel that was environmentally contaminated (Table 2). Not one of the foreign banks was interested in lending

to such a borrower, and only 22% of the California banks would consider lending on a property with this risk.

While 61% of the banks said they would lend on a property with an underground storage tank (Table 2), approximately 66% gave the caveat that the property must pass a Phase I environmental analysis and be on an ongoing monitoring program. (As an aside, 81% of the national banks stated they would lend on property with underground tanks.)

Finally, and of most significant interest, were the survey results related to previously contaminated property after successful remediation. More

TABLE 1

Issues Identified as Greatest Environmental Concerns by Financial Institutions

	Underground Tanks	Unencapsulated Asbestos	Encapsulated Asbestos	Groundwater Contamination	Toxic Inventories	All are of Equal Concern
	%	%	%	%	%	%
National Banks	11	21	0	44	8	16
California Banks	16	6	6	28	22	22
Foreign Banks	0	0	0	75	0	25
Total	12	14	2	41	12	19

Source: The Hanford/Healy Companies

TABLE 2

Environmental Issues Affecting Lending

	# Institutions Represented No.	Yes Responses %	No Responses %	Maybe Responses %
Would your institution lend on a property knowing it had...				
Underground storage tanks	54	61	28	11
Unencapsulated asbestos	56	36	48	16
Encapsulated asbestos	56	57	27	16
Contiguous contamination	55	38	40	22
Toxic inventories	55	45	35	20
Ongoing cleanup	55	40	52	8
Previous contamination	56	84	3	13
Weighted average	56	52	33	15

Source: Hanford/Healy Appraisal Company

than 84% of the banks reported that they would have no problem lending on such a project; the perceived stigma of prior contamination consequently does not appear to be significant.

Phase I Audits A Requirement

Seventy-two percent of all national banks (and 100% of all foreign banks) would require a Phase I audit on any loan secured by real property. While only 22% of the California banks would require a Phase I audit on any loan for real property, 78% would require an audit if contamination were known or likely. (There may be some bias in these responses as, on average, the exposure to contaminated properties by California banks may be limited by their overall smaller size *vis-à-vis* foreign and national banks.)

Eighty-one percent of the banks would require a Phase II audit if the Phase I work indicated that there might be some environmental concerns. The remaining banks indicated that they would not undertake further due diligence if a Phase I report was unfavorable.

The national banks were again the most progressive in granting loans on properties that were

being cleaned up (other than those that were removing asbestos). Fifty percent of the national banks reported their institutions made loans on such properties, compared with 24% of the California banks and 20% of the foreign institutions. Of those institutions that had loans on properties under remediation, 61% said that their institutions had lent the money for the cleanup of some of that property.

It appears that the borrower, not the lender, orders the Phase I audit (68% of all responses), receives the document (66%) and pays for the audit (85%). However, 80% of the banks required that the environmental consultant conducting the audit be approved by the lender, and 57% percent considered using an outside consultant to aid in the audit review. The consultant most often identified was an engineer, and the engineer most often would be involved when major environmental problems were present or when special technical expertise was required.

Appraiser's Role

If the presence of contamination was proved, 61% of the banks would instruct the appraiser to consider contamination in the appraisal process. The banks would not necessarily require the appraisal to assess

the cost of a cleanup (and its implication on the value of the property) but the appraisal should indicate the presence of such contamination in the property description and note that the appraiser did not assess the impact of the contamination on the property's value.

Almost 50% of the banks did not believe there was any loss in current value on properties that had been previously contaminated but subsequently had been cleaned up; 37% were unsure of the effect on value or had never been faced with that issue. Again, contrary to common perceptions, only 19% of the institutions perceived that there was a stigma on property that had been previously contaminated.

Underwriting Standards Adjusted

On properties with an actual or potential environmental problem, 66% of the banks would require additional indemnification from the borrower; 46% would consider adjusting the loan to value ratio; 60% of the institutions would require personal guarantees (or some personal liability). Conversely, only 21% would consider an interest rate adjustment.

The Fleet Factor case, which raised uncertainty about the exemption of a lender from liability for cleaning up environmental hazards, is considered a landmark. Nevertheless, survey respondents were divided on whether it affected underwriting standards; 47% believed the case did affect standards and 45% believed it did not. Effectively 100% of the individuals who were aware of the decision believed that, regardless of the actual impact, the court ruling had heightened the lending community's level of concern about environmental issues.

Summary

The results of the survey demonstrate a significant level of knowledge about environmental issues among lenders. Although environmental contamination does not appear to discount a bank's interest in lending on a specific property, in all cases it does require a significantly more stringent due diligence process.

As is true in most industries, active involvement in certain aspects of the business results in specialization. Clearly, some banks that are more actively involved in environmental issues have become more comfortable with environmental risk, perceived or actual, than others. Nonetheless, the survey shows that no single environmental issue would result in a blanket rejection of a loan on a contaminated property by an institution. That, in and of itself, appears to be noteworthy to us.

NOTES

1. The 25 largest banks were identified in the American Bankers Association 1991 listing of U.S. banks.
2. The 15 largest banks in California did not include banks that had previously qualified as national banks in the book of lists for San Francisco and California.