

Structuring a Lending Environmental Risk Management Policy

Regulators require that a lending institution have an environmental risk management policy and that they then follow it. Regulators do not prescribe the nature of the policy. Each institution must then consider the policy carefully in that it affects both the quality of the bank's assets as well as its marketing plan. The policy is an exercise in balance.

Marketing Effort

Some higher quality borrowers will drive the environmental risk management practice by doing their own Phase I environmental site assessment as well as any advisable follow-up activities. Unfortunately, in Michigan, most borrowers, including purchasers, do not understand environmental law and do not care to perform any environmental risk management. This is especially true in the case of a refinance. In a refinance, the borrower has nothing at all to gain and faces at a minimum, the loss of funds required to perform due diligence. In the worst case scenario, the bank may, as a result of environmental due diligence, deny the loan but leave the borrower in a situation where he is legally required to report contamination and clean it up.

Loan officers generally have a negative attitude toward environmental due diligence. The fees involved and the time involved make selling a loan to a borrower much more difficult. In the best scenario, after three weeks and high fees, the loan can be made. In a common scenario, however, after three weeks and irritating fees, the closing date has to be postponed because the consultant has found a "potential" issue that will require another month and thousands of dollars to investigate.

Another irritation to loan officers is that there is no uniform lending policy among lenders. A loan officer may lose an otherwise attractive loan because he is required by policy to charge for environmental due diligence, but another bank has no such requirement.

It is imperative, therefore, that the marketing effect of the environmental risk management policy be taken into consideration.

Credit

In Michigan, the appraisers generally do not take environmental conditions into consideration. However, the value of the collateral property is contingent upon its

environmental condition. Whether the loan is supported by value of property is not known until some environmental due diligence is completed.

Some institutions have such a large loan loss reserve that they can skip environmental due diligence for lower value loans. Upon foreclosure, they will fund, out of pocket, their own environmental due diligence with the understanding that failure to do so would make them liable for site cleanup if they take title. However, if contamination is found, they can walk away from the property with negligible impact to the bank.

The lending institution must consider the size of the loss that they can accommodate for failure to perform environmental due diligence at the origin of a loan.

Another consideration in creation of the policy is the nature of the collateral property. It is clear that a site that routinely handles chemicals is suspect and will likely always require due diligence prior to a loan.

Most institutions therefore structure a due diligence approach on a sliding scale, taking into consideration the size of the loan and the nature of the property.

Procedures

Once minimum parameters are set on the loan amount and type of property that require due diligence, guidance is required on who will perform due diligence. Will it be the loan officers, an in-house environmental risk manager, an out-sourced environmental risk manager, any consultant, a consultant on a pre-screened bank list or whomever the borrower decides? Each approach has pros and cons.

1. Lenders. Most lenders are better employed seeking loans rather than performing environmental screens, however, some institutions follow this approach for due diligence up to the level of a Phase I environmental site assessment. If the lenders are to perform due diligence, they need comprehensive training on the necessary science, laws and regulations as well as some on the job practical training. It would be wise to have them certified in-house when deemed tested and deemed competent.
2. In-house environmental risk managers. Many institutions have one or many in-house environmental experts who may be engineers or environmental attorneys. These professionals perform the due diligence for the bank but generally do not perform anything beyond a Phase I environmental site

assessment (i.e. phase II work). The advantage here is the closely controlled quality of the due diligence and perhaps lower overall cost. Note that there is an inherent conflict of interest between the bank and the borrower. In general the bank wants a very complete look at the property. The borrower, especially in a refinance, may not want any issues found. One large Michigan bank handles this conflict by not allowing the borrower to reply upon the reports – they are all performed for the benefit of the bank only. This also prohibits the borrower from suing the bank if the environmental due diligence is not performed properly.

3. Out-sourced environmental risk managers. This is the approach favored by Yeoman Group and many Michigan institutions. The loyalty of the independent risk manager is to the bank. The risk manager follows the bank policy. The final report is written for the bank, but with the bank's authorization, reliance is given the borrower (who is often the party that needs the legal protection of the report). Full reliance is given to the borrower by the risk manager with the written understanding that their sole recourse for errors is against the risk manager. One advantage to this system is that funds are only expended on an as-needed basis and are paid by the borrower. And the bank avoids having the overhead of staff that have no lending career path within the institution.
4. Any consultant. Many banks allow the loan officer to select the consultant to do the work. Is this a competent and insured consultant or the one who takes the loan officer to golf?
5. A pre-screened bank list. To avoid the problem of incompetent consultants, many banks allow applications for a list and then pre-screen the consultants for qualification. The loan officers can then select from the list. In practice, however, the bank is overwhelmed with applications and phone calls, threatened with law suits for failure to allow a consultant to be on the list, fails to update the various consultants' qualifications on a yearly basis and the whole process falls into disarray.
6. Borrower's decision. Many banks want to be open to borrowers who bring in an environmental study. How can one say, "No, this consultant is not on our list, you need to start over." One must understand however, that

environmental risk management has vast grey areas to be interpreted. A report done by the seller (not uncommon in the purchase agreement) is very different from one done for the benefit of a buyer. And buyers rarely are able to properly select consultants or judge their work. One answer is to allow the borrower to bring in any report, to have it reviewed for the bank's purposes and to make as much use of it as it deserves.

Additional Considerations

A bank's environmental risk management policy must be kept simple so that it will be read and used. A long rambling discussion of environmental law is not helpful. In addition, it must be revised annually as science and law change. It must be approved by the Board of Directors, so it is best to split a simple but definitive "policy" from more detailed procedures that do not need to be approved by the Board upon each revision. Last, it should have its basic guidance laminated and placed on the loan officer's desk so that it will be used.