

Policing Environmental Policies

With regulatory changes in mind, keep an eye on lenders' environmental guidelines

By **Derek Ezovski**, managing director, property-due-diligence group, Environmental Data Resources

A DISCIPLINED DUE-DILIGENCE process helps protect a lender's bottom line. And today, having a strong due-diligence program is more important than ever.

Scrutinizing deals for potential risk in a shaky economy — particularly when an increase in bad debts is common — makes good business sense for brokers. Here's why.

Keeping pace

When it comes to financing commercial real estate, environmental contamination is one risk that can impair — or even kill — a deal. Contaminated property securing a loan transaction can expose a lending institution to direct liability for cleanup costs, as well as to probable litigation.

It also can cause buyers to default if they're forced to divert cash flow to pay for remediation, and, in the case of foreclosure, it can leave the bank with property that may be difficult to sell.

Further, environmental issues can damage a bank's and a broker's reputation, brand and image.

For these reasons, most commercial lenders have adopted a formal environmental policy to help protect themselves from unnecessary exposure. Others have revised theirs recently because of major regulatory shifts. Recent changes include the first federal guidelines for environmental due diligence, released in November 2006 — the U.S. Environmental Protection Agency's (EPA) All Appropriate Inquiry (AAI) rule — and new environmental policies issued by regulators such as the Federal Deposit Insurance Corp.

Depending on their practices and risk tolerance, lenders may need get out the red pen once again. Today's cautious market environment, along with the recent release of the U.S. Small

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Business Administration's (SBA) updated environmental policy, is further changing the way lenders approach environmental due diligence.

The SBA's new environmental protocol, for instance, is creating even more caution among lenders. Under this new protocol, for example, a qualified environmental professional must conduct an AAI- and American Society for Testing and Materials (ASTM) E 1527-05-compliant Phase I environmental site assessment for properties associated with past or current high-risk operations, regardless of loan amount. This policy revision represents a shift from former SBA protocol in which loan size was the leading determinant of whether a Phase I was required.

With these regulatory changes, environmental concerns and the current economic climate, standards for environmental due diligence in commercial real estate lending are more stringent now than they have been in recent years. As such, brokers would be wise to work with lenders that have updated their environmental policies.

Revisiting updates

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504 loans. The administration's new environmental policy is different from — and more stringent than — its previous protocol. It also includes a new level of due diligence: the records search with risk assessment.

Lenders with which you work should be ensuring that their policy aligns with all applicable laws and regulations — for example, if protection from federal cleanup liability under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) is a concern, only an AAI/ASTM E 1527-05-compliant Phase I environmental site assessment will suffice. They also should ensure that certain key elements necessary for a sound environmental-risk-management program are included in their update.

Further, every environmental policy must have:

- **Support from credit and senior management**, which must be willing to enforce the policy;
- **A definition of the document's purpose**, including the types of properties subject to the policy and who, if anyone, has the right to waive it;
- **An explanation of which due-diligence tools should be used in a given situation**. All commercial properties should receive some level of scrutiny, but not every transaction requires a Phase I environmental site assessment. Lenders' policies should include a description of the various environmental-due-diligence tools, such as Phase I environmental site assessments,

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transaction-screen assessments, records search with risk assessments, environmental database reports, site visits, questionnaires, etc. These descriptions may include tools' strengths and weaknesses, their typical costs, and the types of properties and loan amounts subject to each particular tool;

- **Clear decision thresholds for underwriters.**

The goal is to understand environmental risk and then to factor it into the overall credit analysis;

- **A definition of how often properties must be monitored over the life of the loan;** and

- **An updating schedule.** To ensure that the policy remains current, lenders must review it regularly.

Lenders also may create an approved vendor list. They should keep in mind that if protection from federal cleanup liability under CERCLA is a concern, an environmental consultant who meets the qualifications defined in the EPA's AAI rule must prepare and supervise the Phase I assessment. SBA lenders also must keep in mind that according to the agency's new policy, a qualified environmental professional must prepare the transaction-screen assessments.

To ensure that its policy aligns with the company's objectives, the lender may choose to have it reviewed by an environmental professional or attorney.



Current economic conditions and changes in regulators' environmental policies are causing lenders to beef up their environmental-due-diligence practices. Lenders that haven't updated their environmental policies recently should consider a review. And to ensure successful transactions for their clients, brokers should work with lenders that have completed such updates. 