Mortgage Lenders and the Institutionalization and Normalization of Environmental Risk Analysis

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Real Estate Markets, Uncertainty, Environmental Risk, and the Real Estate Appraiser

Buyers and sellers of real estate, whether a personal residence, an income-producing investment, or a property used in a trade or business, understand intuitively that owning real estate involves accepting risks. For example, home buyers accept risks related to such things as the condition of building systems that are hidden behind walls or floors, the friendliness of their neighbors, the quality of the local school system, or the future state of the marketplace when it comes time to sell the property.

As appraisers, we too know that owning real estate, or lending on it, is accompanied by willing acceptance of some types of risks. Although the level of risk can be reduced by laws or regulations requiring disclosure of specific types of information—and by customary "due diligence" by typical buyers, sellers, or lenders in a marketplace—acceptance of some risk is inherent in the process of real estate acquisition and lending. Acceptance of some risk is a fundamental and normal component of the typical marketplace of buyers, sellers, and lenders who are reasonable, knowledgeable, and willing.

One of our functions as real estate appraisers and analysts is to determine, from the marketplace itself, what level of risk the marketplace is willing to accept. Appraisers, in the normal course of their work, become experienced in the identification and evaluation of what risks the marketplace is willing to accept. Market prices paid for similar properties with similar degrees of risk lead us to our market value conclusions, and, in the case of income producing properties, we further evaluate risks based upon the accepted rates of return for properties carrying similar levels of risk.

The history of the American real estate marketplace over the last 100 years is a story of constant change and innovation. New types of property concepts, new types of regulations, new types of uses for real estate, and new types of ways to own and finance real estate are constantly being added to the factors that the marketplace must incorporate into the transactional process. Change creates uncertainty, and every time there is uncertainty some level of risk is introduced that must be analyzed and dealt with by the marketplace. With time, the market becomes comfortable with the new uncertainty and any early impact on price due to its novelty diminishes.

The environmental awakening of the 1970s was just such a fundamental change, creating considerable uncertainty in the real estate marketplace. New information about the toxic effects of some types of chemicals and the extent of these chemicals in the environment, as well as new laws and regulations limiting emissions and imposing cleanup responsibilities, had to be assimilated into the real estate marketplace.

Over the past 15 years or so, the American real estate marketplace has become increasingly comfortable evaluating and handling environmental risks. This is due to a variety of factors, including the development of the technical and scientific expertise to identify the presence and extent of contamination, the creation of a remediation industry and cost-effective cleanup techniques, the clarification of legal responsibilities, and the infusion into the mar-

ketplace of the information and techniques necessary to evaluate those risks and quantify them into hard dollars and cents.

Consider, for example, the evolution of environmental science as a profession. Twenty-five years ago, environmental science was not a common university curriculum. Today, it is a well-recognized science field with a clear career path. Many environmental professionals—whether employed by a government agency, a lending institution, or an independent consulting office preparing environmental reports—have master's degrees in science. An increasing number of these technical professionals have been involved in the environmental field for 10 to 20 years or more. Today's environmental profession and industry utilize reliable techniques and cost-effective procedures to detect environmental contamination and to implement reasonable cleanup.

Lenders and the Internal Institutionalization of Environmental Risk Analysis

As the marketplace has evolved, all of the players in the marketplace have grown in their sophistication in understanding and evaluating environmental risks. This is especially true of the lending community, one of the most critical players. The attitude of the lending community toward environmental risk has changed dramatically over the past 25 years.

Mortgage lenders have incorporated techniques for evaluating environmental risks into their mortgage lending, business lending, trust, and real estate acquisition and disposition processes. The impetus for this has come from several sources, including:

- case law such as the *Fleet Factors* case[1] that initially made mortgage lenders potentially responsible for cleanup and other liabilities associated with classification as "potentially responsible parties" (PRPs) unless they could successfully invoke the "innocent purchaser" defense by having utilized good commercial due diligence practice before making a mortgage loan;
- guidance comments from lending industry regulators that "encourages" lenders to add environmental professionals to their staffs and to adopt acceptable procedures to gauge environmental risks before making some types of decisions;[2] and
- the natural inclination of lenders to develop systematic and efficient ways to handle risks associated with real estate lending and ownership.

An astute lender recognizes that all real estate and business transactions involve acceptance of some risk. To competently lend, a lender must first identify the risk, then identify the extent of the risk, and finally identify ways of managing the risk. Lenders can take on the risk themselves or to transfer some or all of the risk to another entity—by requiring or securing environmental insurance, for example. Some larger banks with a risk management culture have responded by hiring environmental professionals to provide professional guidance to the loan committee on environmental issues and risks.

Surveys Show Changing Lender Attitudes Over Time

During the late 1980s and early 1990s, lender attitudes about making loans on contaminated properties evolved quickly. Spurred on by a number of policy and regulatory initiatives, lenders gradually developed techniques and procedures for incorporating environmental risk analysis into their lending decisions. Adding to the pressure was a movement by state and federal lawmakers to clarify the situations in which mortgage lenders would be characterized as "innocent purchasers" who could avoid potential liability for the costs of environmental remediation.[3] The resulting change in lender attitudes toward lending on properties affected by environmental risks has been documented in surveys conducted by appraisers.

Patricia and John Healy, Jr., MAI, reported in *The Appraisal Journal* in 1992 the results of their 1990 fourth quarter survey of major lenders on issues related to environmental risk. The purpose of the survey was "to quantify lenders' perceptions of environmental risks and the degree to which these perceptions affect underwriting policy."[4] They contacted 57 institutions, including the 25 largest banks and a number of international banks. The survey was relatively short and to the point, comprising only eight questions, two of them vaguely worded que-

1. *United States v. Fleet Factors Corp.,* 724 F.Supp. 955 (S.D. Ga. 1988), 901 F.2d 1550, *reh'g denied, en banc,* 911 F.2d 742 (11th Cir. 1990).
2. Among the agencies issuing such "guidance" notes were the OTS in 1989, Fannie Mae/Freddie Mac in 1991, the Federal Reserve in 1991, and the FDIC and OCC in 1992.
3. See, for example, Thomas R. Kearns, "Environmental Audits: Real Estate's Newest Transaction Safeguards," *The Appraisal Journal* (July 1991): 348–352.
4. Patricia R. Healy and John J. Healy, Jr., MAI, "Lenders' Perspectives on Environmental Issues," *The Appraisal Journal* (July 1992): 394–398, at 398.

ries about which environmental problems these lenders believed were most significant.[5]

The Healys' most significant questions involved bankers' attitudes about lending on contaminated property, previously contaminated property, or property adjacent to contaminated property, as well as their question concerning underwriting standards on properties affected by environmental risk.

More than 84% of the bankers said they would have no problem lending on a previously contaminated property after remediation. About 50% of the national banks said they made loans on properties that were in the process of being remediated. But fewer than 40% would consider making a loan on a property contiguous to a contaminated parcel. As to properties that had once been contaminated but were subsequently remediated, almost 50% of the bankers interviewed did not believe there was any loss in market value, 37% of the bankers were not sure if there was a loss in market value, and 19% perceived a "stigma" effect on market value as a result of the previous contamination.

The bankers in the Healys' survey considered various types of underwriting techniques when contamination was a concern. About 66% said they would require additional indemnification—60% would require some form of personal guarantee—while 46% would consider adjusting the loan-to-value ratio, and 21% would consider an interest rate adjustment.

Another appraisal firm that surveyed lenders about the same time as the Healys found an increasing concern about environmental issues among the lenders surveyed in the late 1980s, but decreasing concern about these issues in the early 1990s. Mundy & Associates found that the percentage of surveyed lenders with formal policies about contaminated properties increased from 41% in 1987 to 88% in 1991, and to 90% in 1992.[6] But at the same time, this survey found that while 42% of the lenders surveyed in 1991 believed that environmental problems would continue to increase, only 27.5% of survey respondents in 1992 shared that belief.

The Mundy & Associates 1991 survey found that despite the bankers' belief that environmental issues had become more acute during the 1980s, the vast majority of banks were ready and willing to consider making loans on property with known or suspected contamination. About 88% of the respondents to the 1991 survey said loans on property with known or suspected contamination were only occasionally, rarely, or never declined solely due to the contamination. Only 12% said such loan applications were often declined.

Changing Lender Attitudes as Evidenced by Revised Internal Loan Policy Procedures

Lenders have gradually reduced the amount of environmental review necessary before making many types of lending and transactional decisions, further evidence that lenders perceive that the environmental risks associated with many types of properties are decreasing. In the 1980s and early 1990s, many lenders required full Phase I environmental site assessments before making most types of real estate lending decisions.[7] Today, most national and regional banks use *risk-based criteria* to decide if a full Phase I site assessment is necessary. The criteria are based on property type and loan amount. For example, the threshold for a Phase I assessment may be set on a specific loan amount; many banks set this at a million dollars. (For a shopping center, this threshold may be set somewhat higher.) Transactions that do not trigger a Phase I assessment may be subject to "ASTM transactional screens."[8] As banks frequently use less rigorous rubrics when first reviewing most loan, trust, and acquisition decisions, there

5. Question 2 stated "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 storage tanks. b. unencapsulated asbestos. c. encapsulated asbestos. d. groundwater contamination. e. a tenant who stored toxic materials." This question did not clearly establish the basis for the worry—personal concern on the part of the survey respondent? Institutional concern, and, if so, how established? Societal concern? Concern in terms of difficulties to clean up, or concern in terms of lending decisions? Question 3 was similarly ambiguous: "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?" Again, the meaning of "concern to your institution" was not defined for the survey respondent. Of great concern because the institution had made loans on properties in the past with that type of environmental problem? Concern because it is the most serious problem facing the country? Concern because the institution does not have the expertise to evaluate the risks associated with lending on a property so affected?

6. Victoria Adams and Bill Mundy, MAI, "Attitudes and Policies of Lending Institutions Toward Environmental Impairment," *Environmental Watch* (6:4, 1993). *Environmental Watch* is a discontinued publication of The Appraisal Institute.

7. See, for example, Albert R. Wilson, "The Environmental Opinion: Basis for an Impaired Value Opinion," *The Appraisal Journal* (July 1994): 410–423. The American Society for Testing and Materials (ASTM), founded in 1898, is the largest voluntary consensus standards developing organization in the world. It provides the standards for both Phase I and Phase II audits. See *Standard Guide for Environmental Site Assessments: Phase 1 Environmental Assessment Process* (ASTM order number E1527-00) and *Standard Guide for Environmental Site Assessments: Phase 2 Environmental Assessment Process* (ASTM order number E1903-97). ASTM's web site is www.ASTM.org.

8. ASTM's Standard Practice for Environmental Site Assessments: Transactional Screen Process (Standard No. E1528) requires the 28-question "transaction screen" and an on-site inspection. Industry-wide, this is commonly called an "ASTM transaction screen," while the plain term "transaction screen" refers only to the 28-question computer printout.

are now in effect two levels of less-detailed review and risk analysis that are frequently used by lenders before a full Phase I environmental assessment is triggered.

Scaling back of the due diligence process is evidence of the increasing comfort of the lending community in evaluating environmental risks. Lenders have evolved due diligence techniques that have shorter turn-around times and are less expensive—about $800 for an ASTM screen, and only $200 for a typical non-ASTM-compliant screen—a sure indication that they feel more comfortable with risk analysis, and that the perceived risks attached to many types of properties have decreased dramatically. Lenders today feel much more comfortable with their ability to analyze and manage environmental risks at a much lower cost.

The Environmental Bankers Association and the External Institutionalization of Environmental Risk Analysis

Another telltale sign that the environmental industry has matured in its evaluation of environmental risk is the development of a national organization of lending professionals involved in environmental risk analysis. The Environmental Bankers Association (EBA) is a non-profit group that represents the financial services industry, including banks, insurers, and asset management firms.[9] Its membership comprises lending institutions, insurers, environmental engineers, consultants, and attorneys. The EBA was established to heighten sensitivity to environmental risk issues, and to highlight the need for environmental risk management and due diligence policies and procedures in financial institutions. The membership includes environmental officers employed in some of the largest financial institutions in the nation.

Founded in 1994 with a membership of about 25 banks, the EBA today has a roster of 38 regional banks. Its main functions are to:

- keep members informed about new developments in environmental policy, banking policy, legislative and regulatory trends, and other emerging environmental issues on both a state and national level;
- provide input about new benchmarks for environmental due diligence procedures and risk-based decision making for appropriate levels of environmental inquiry to financial transactions;
- periodically update information on environmental insurance programs and ways to utilize insurance to quantify the cost of environmental risks;[10]
- interface with banking and environmental regulatory officials;
- provide industry training and round table discussions at twice-yearly conferences; and
- conduct periodic surveys of EBA members about their procedures for handling environmental risks.

Since 1995, the EBA has undertaken two surveys of its members. The first survey was conducted in 1995 and had 30 questions, some with a number of subsections. It was sent to member financial institutions, and 32 responded. All respondents had net asset values in excess of $1 billion.[11] The second, conducted over the course of 1999 and 2000, had 35 questions (again some had a number of subsections), and 25 member banks responded.[12] Both surveys addressed many of the same questions, though the second survey was more extensive. The first survey was designed to address "Environmental Due Diligence policy and procedures for real estate property taken, or considered for collateral, ownership and fiduciary assets."[13] According to the EBA, the second survey conducted in 1999/2000 was designed to "provide insights about trends relative to how environmental policies are being employed, how the due diligence process is evolving, what are the average cost and time frames for conducting due diligence, and what additional risk management tools are being used, such as environmental insurance for real estate transactions."[14]

9. The Environmental Bankers Association has an administrative staff of two. It can be contacted at *www.envirobank.org* and is headquartered in Alexandria, Virginia.
10. Based on comments of the bankers who attended the EBA's conference in Santa Fe, New Mexico, in February 2001, many of them now view environmental insurance as the ultimate way to quantify environmental risk and stigma in hard dollars and cents and to transfer that risk from the property itself to an insurance carrier. For more information on environmental insurance programs and their relevance to the appraisal process, see Richard J. Roddewig, MAI, "Using the Cost of Environmental Insurance to Measure Contaminated Property Stigma," *The Appraisal Journal* (July 1997): 304–308.
11. Eight of the responding banks had net assets between $1 billion and $10 billion, while six had net assets in excess of $100 billion. The remaining 18 had net assets between $10 billion and $100 billion.
12. Two banks had more than one representative return a survey form, so the 1999/2000 had 27 total responses.
13. Environmental Bankers Association, Inc., *January, 1995 Environmental Due Diligence Survey:* 1.
14. Environmental Bankers Association, Inc., *1999/2000 Environmental Due Diligence Survey:* 1.

A comparison of the results of the two surveys provides a number of important insights about the real estate lending industry and its increasing ability to institutionalize environmental risk evaluation and management procedures. Among them are the following:

- There is a growing trend toward written environmental review policies adopted on a corporate-wide basis. In 1995, for example, 93% of the surveyed institutions responding had written environmental policies addressing real estate secured lending/credit risks, a figure that rose to 100% by 1999/2000. In 1995, only 29% had a single corporate-wide environmental policy, while 60% reported such a policy in the 1999/2000 survey.
- Lenders are increasingly appointing full-time environmental risk managers or environmental policy managers to designated internal departments or groups responsible for implementation and overview of environmental due diligence. These professionals are increasingly likely to be trained environmental professionals (65% in 1995 compared to 80% in 1999/2000) rather than "converted" bankers (48% in 1995 compared to 20% in 1999/2000), and are increasingly likely to be located in either their credit policy, real estate, or appraisal areas of business.
- Lenders are becoming more likely to provide internal environmental risk training programs (90% in 1995, increasing to 96% in 1999/2000).
- Lenders seem to be more skilled at quickly differentiating between potentially risky environmental situations without automatically requiring environmental due diligence. In 1995, for example, 93% of the respondents required environmental due diligence before purchasing a facility or a property, but only 76% required this in 1999/2000. In 1995, 92% of the respondents said they required environmental due diligence prior to acceptance of a trust asset/account, compared to only 56% in 1999/2000.
- While member institutions continue to establish thresholds for requiring environmental due diligence, the threshold seems to be getting lower. For example, in 1995, 79% of the respondents reported that they did not require environmental due diligence when lending on one- to four-unit residential properties. In 1999/2000, only 56% automatically exempted such properties. In 1995, 14% automatically exempted properties valued under $100,000 and 53% automatically exempted properties under $250,000, but by 1999/2000, the percentages were 28% and 24%, respectively.
- Institutions are generally employing a wider variety of environmental due diligence procedures. The percentage of respondents using each of the eight types of due diligence procedures listed in the 1995 survey increased dramatically in five of the eight categories specified again in 1999/2000.[15]
- The costs and completion times associated with inspections, screenings, and Phase I environmental site assessments are decreasing, and it is the borrower who now tends to order the work (40% in 1995, compared to 60% in 1999/2000).

The 1999/2000 EBA survey included a number of new questions. Many of these dealt with issues related to environmental insurance, an increasingly popular tool for lenders to quantify the costs associated with environmental risks. In 1995, only 6% of the respondents indicated that they used "environmental impairment/transaction insurance" as a due diligence technique. By 1999/2000, "forty percent (40%) of the respondents said that they used environmental insurance for real estate secured lending and 32% for commercial and/or industrial transactions..."[16] A number of the banks were using environmental insurance as a substitute for guarantor or borrower environmental indemnities, and the two most prevalent types of insurance policies and coverage were secured creditor policies (48% of respondents) and "cost cap/stop loss coverage" (36% of respondents).

Conclusion

Implications for Appraisers in the Evolution of Lender Attitudes About Environmental Risk

This internal and external institutionalization of environmental risk analysis by lenders has a num-

15. The only exceptions were "environmental inspections" (81% in 1995 and 72% in 1999/2000), environmental compliance audits (50% in 1995 and 48% in 1999/2000), and environmental site assessments (100% in both surveys).

16. Environmental Bankers Association, Inc., *1999/2000 Environmental Due Diligence Survey:* 12.

ber of significant implications for appraisers and the appraisal community.

First, it indicates that appraisers must increasingly expect to review and understand various types of environmental issues and reports, because lenders are routinely producing such reports and analyses as part of their internal due diligence and risk-analysis procedures. Just appraisers are expected to consider the title reports produced by the potential mortgage lenders as part of our process of estimating highest and best use and market value, we may increasingly be expected to do the same with environmental reports.

Second, the surveys indicate that the lending community is increasingly comfortable and sophisticated in its analysis of environmental risk, is making loans on contaminated or remediated properties, and is far less likely today than it was in the late 1980s to have blanket policies against lending on properties affected by environmental risks. Lenders are analyzing environmental risks on a case-by-case basis and are finding fewer situations in which they will not lend or must impose penalties in the form of lower loan-to-value ratios, higher interest rates, personal guarantees, or other means to offset perceptions of the presence of environmental risks. They now have customary techniques for evaluating those risks, dealing with them, and quantifying them, increasingly through environmental insurance or other means when any significant risks are present. They, like the marketplace as a whole, have also become accustomed to accepting many kinds of environmental risk in the same manner as the other types of risks that accompany an ownership or secured creditor position in real estate.

Third, the evolving attitude of the lending community to a particular condition can often be central to understanding the actions of the "typical" buyer and seller in the marketplace and therefore, in many situations, to the impact of environmental risks on market prices and values. Lenders are in some ways an "indicator species," and the attitude of the lending community toward properties affected by environmental risk has evolved dramatically in the past 25 years. From their early-1980s position of generally refusing to loan on properties affected by environmental risk, lenders now routinely lend on such properties.

Finally, the institutionalization and normalization of environmental risk analysis by the lending community demonstrates that the marketplace is indeed dealing with environmental risks on a day-to-day basis, and that prices in the marketplace increasingly reflect reasonable and knowledgeable consideration of environmental risk. Lenders are involved in marketplace transactions because of the prevalence of mortgage financing as a customary part of the way American real estate is owned and held. Buyers and sellers of many types of properties in the United States have customarily relied on lenders to perform a due diligence function. Consider title searches and title insurance—because secured lenders require a title search before making a mortgage loan, the buyer customarily relies on that title search in analyzing title issues. There is little if any need for the buyer to duplicate the activity of the lender in scrutinizing title issues because the knowledge gathered by the lender is transmitted to the buyer and seller and is therefore appropriated by the buyer and the seller.

More and more often, the same holds for issues related to environmental risks. The mortgage lender routinely undertakes an environmental due diligence effort as part of the mortgage lending process. In many types of transactions, buyers rely on the lender's environmental due diligence as the first level of assessment of potential environmental issues. If the lender is comfortable with the environmental risks, the buyer usually concurs. If the lender determines that the price accurately reflects the presence or absence of environmental risks, then the price negotiated more likely than not represents the reasoned result of a transaction between a knowledgeable buyer and seller. In other words, the marketplace relies on the knowledge and expertise that the mortgage lending industry is increasingly bringing to the table in evaluating and dealing with environmental risks, and their potential (and actual) impacts on market prices and values.

Lenders have traditionally contributed to making the typical buyer a "knowledgeable" buyer, as that term is understood in the definition of market value used by the appraisal profession. Lenders with set environmental due diligence guidelines and trained environmental officers ensure that a "knowledgeable" person was part of the purchase process. Certainly, the presence of a lender's environmental due diligence review is not a necessary prerequisite to establishing that the marketplace has acted knowledgeably and reasonably; buyers and sellers have other sources of information on environmental issues and different opportunities for assistance and

advice. But the changing attitude of lenders helps appraisers understand how the marketplace as a whole has become more comfortable with evaluating and accepting environmental risks, and how levels of risk—and therefore potential sources of marketplace stigma—have generally been reduced over the last 15 or 20 years.

There are, of course, situations in which environmental stigma is present, and there are still other situations where mortgage lenders will refuse to lend or will require significant extra costs to the borrower. But the marketplace as a whole, including buyers and sellers individually as well as lenders, has become more knowledgeable about the proper evaluation of environmental risks and more comfortable in evaluating those risks. As a result, the prices established in today's real estate marketplace can increasingly be relied on to reflect a reasoned evaluation of environmental risks affecting real estate.

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