

# Convergence of Appraisal and Environmental Functions within Financial Institutions

**Derek Ezovski**

**Outsourced Risk Management Solutions LLC &  
Environmental Bankers Association**

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# Agenda

1. Current Trends
2. Regulatory Changes to the Environmental Due Diligence process
3. Residential Issues
4. Commercial Issues
5. How Appraisals and Environmental Converge
6. Environmental Bankers Association Overview
7. Q & A

# Appraiser Poll

## Question:

Are environmental issues typically not looked at because of ignorance or apathy?

## Response:

*We don't know and we don't care...*

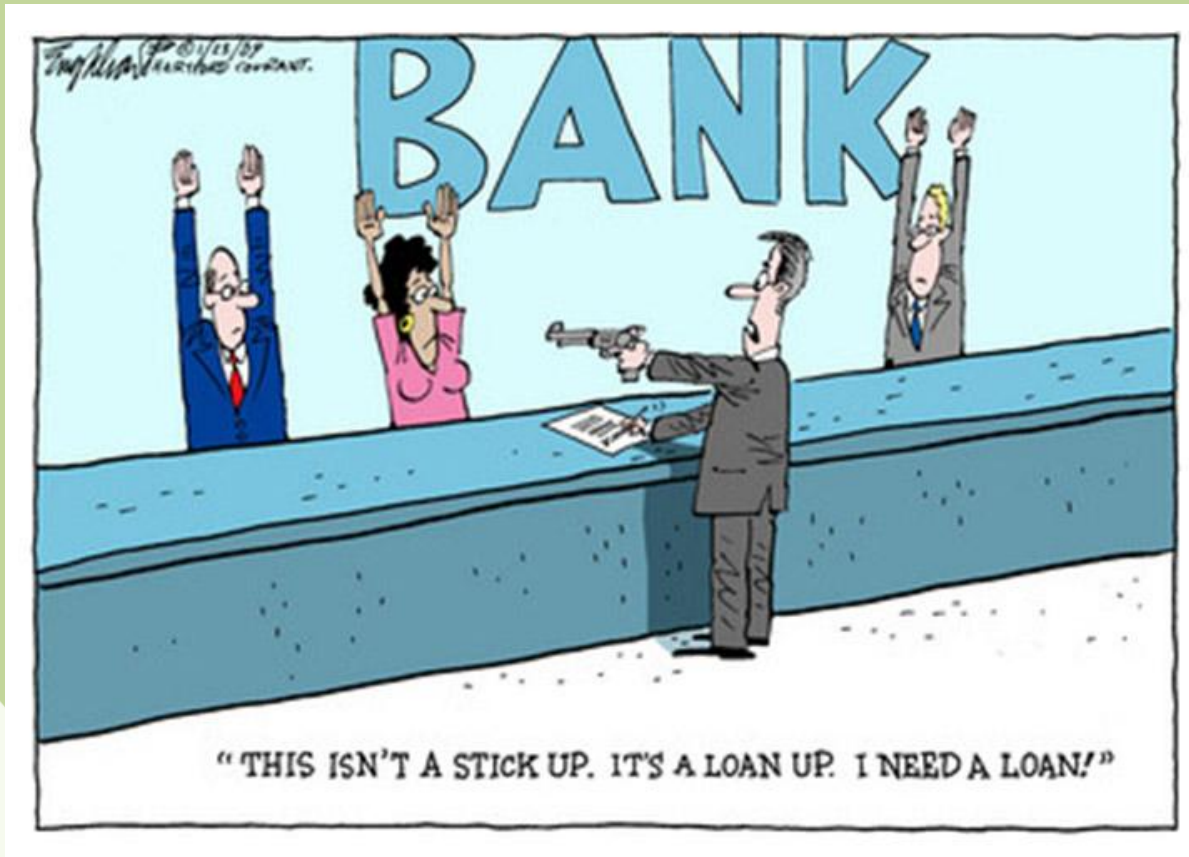
# Current Trends in Lending

- Intense pressure from regulators
- Falling asset values/foreclosures
- Need to shore up their balance sheets
- Distressed Assets
- Lenders updating environmental/appraisal policies to conduct:
  - More due diligence...on a greater % of loans

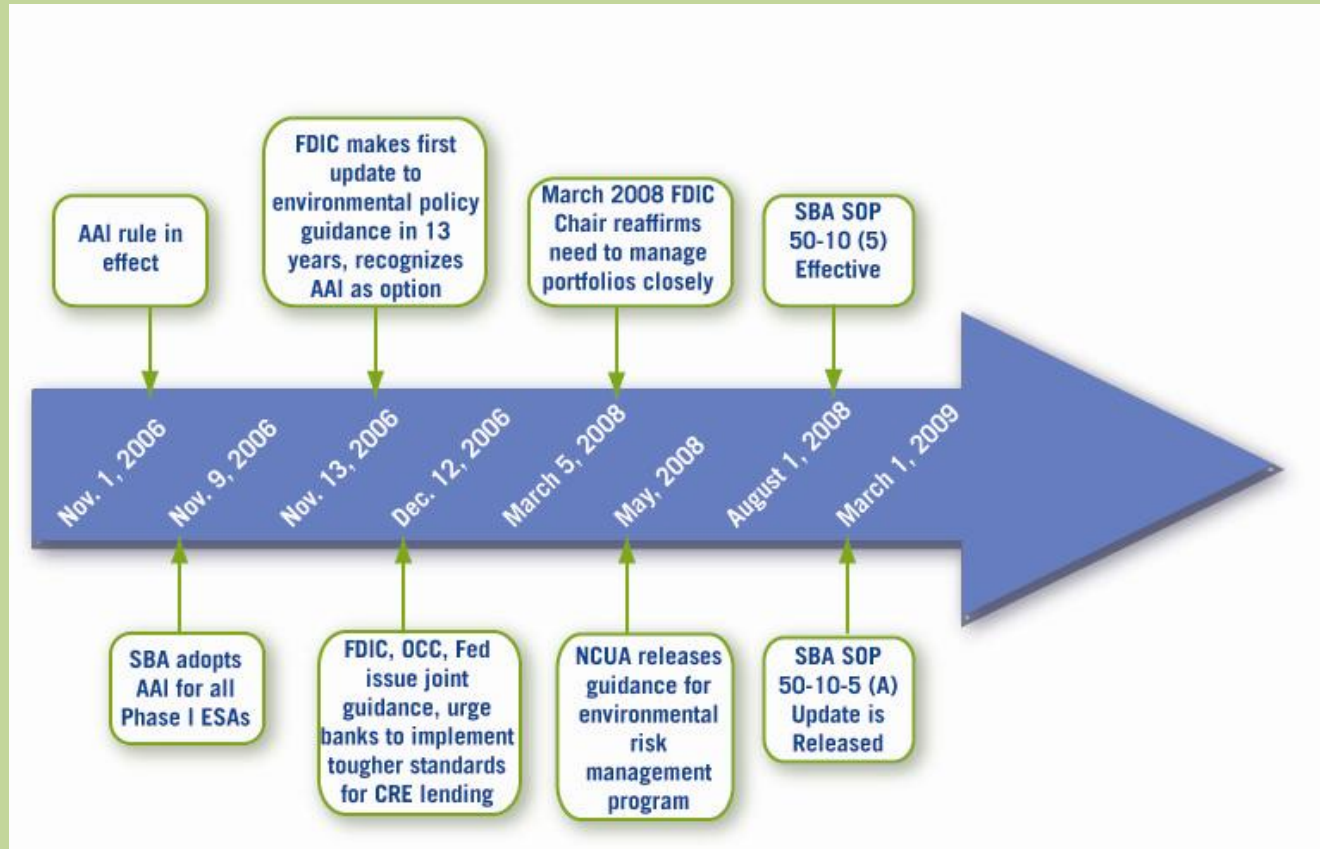
# Current Status of Banking

- 90 banks and savings institutions have failed in 2010, most of which had unusually high commercial-mortgage exposure.
- Foresight Analytics in Oakland, Calif., estimates the U.S. banking sector could suffer as much as \$250 billion in commercial real-estate losses in this downturn and that more than 700 banks could fail.
- 63% of lenders that had an examination last year were asked about their environmental policy.

# State of the Market



# Recent Regulation Changes on the Environmental Front



# Banking Issues

- Credit & Trust Risk
- Collateral Devaluation
- Direct Liability, Loan origination to foreclosure
- Reputational Risk (Brand and Image)
- Operational & Enterprise Risk
- Market & Interest Rate Risk
- Restructurings and Foreclosures
- Sustainable Development & Finance

# EPA's All Appropriate Inquiry (AAI) / ASTM 1527-05 Summary

# EPA's All Appropriate Inquiries (AAI) Rule

- For the first time, there was a federal statutory authority saying what is needed for a Phase I environmental site assessment (not just an ASTM standard)
- Created by EPA under Brownfields Amendments to CERCLA in 2002.
- Biggest impact of AAI on lenders were the changes to FDIC guidelines - but there are other impacts of AAI including...

# Key Changes to Phase I ESAs under AAI

1. Defined qualifications for environmental professionals (EPs);
2. Emphasized responsibilities of the “user” (person seeking liability protection);
3. New levels of Phase I research for consultant;
4. Shorter shelf life for Phase I reports.

# Impact of AAI: Who Qualifies as an Environmental Professional?

<b>Professional/Educational Qualifications</b>	<b>Relevant Experience</b>
Professional engineer or professional geologist license/registration	3 years
Federal or state license/certification to perform environmental inquiries	3 years
B.A./B.S. degree or higher in any science or engineering field	5 years
No B.A./B.S. degree	10 years

# “New” FDIC Guidance

- FDIC updated its Guidelines in November 2006.
- Other regulatory agencies also updated their guidelines:
  - NCUA (effective May 2008)
  - OCC
  - OTS
  - Federal Reserve
- FDIC’s guidance set the standard; FDIC is regarded as a leader in terms of environmental requirements.
- FFIEC implemented environmental policy training/education for examiners across all agencies (October 2007, May and June 2008)
- A majority of banks have reconsidered and revised their environmental policies.

# FDIC Focus

- FDIC emphasizes process and consistency.
- Ensures proper document management and records retention;
- Document due diligence;
- Track changes to policy and consistent application of policy.
- Banks must avoid “participating in management” of the business and thereby assuming liability under CERCLA.
- Many attorneys recommend a Phase I ESA in the event of foreclosure.

# The SBA also updated its environmental process.

- The changes took effect August 1, 2008 and have been updated twice since.
- Went from 1000 pages to 400 pages.
- Especially important for institutions with preferred status who do SBA underwriting.

# Significant *new* SBA Environmental Due Diligence Items

- 2 levels of Environmental Due Diligence
  - AAI Phase I - for high risk properties
  - Records Search with Risk Assessment” - low risk
    - Includes a search of the government databases identified for AAI;
    - A search of historical use records, and;
    - *A risk assessment by an environmental professional determining whether the site is “High”, “Elevated” or “Low” risk*
- List of NAICS Codes of Environmentally Sensitive Conditions
- New Gas Station/Dry Cleaner Requirements

# Impact of Bank Size/Resources

## Regional & National Lenders

- Resources in place to understand environmental issues on the property
  - Screen for lower-risk loans
  - Have staff/internal resources to manage environmental risk

## Community Banks

- No on-staff environmental expertise (typically)
- Not as sophisticated with regard to environmental issues or due diligence options available
- Often rely only on environmental questionnaires and/or proceed without accurate knowledge of environmental condition of property
- Rely on external guidance to dictate their practice

# Types of Due Diligence

- Environmental questionnaire
- Desktop due diligence
- Transaction Screens
- Environmental insurance
- Phase I Environmental Site Assessments
- Phase II, III, Remediation, etc.

# Tiered Due Diligence

- 61% of lenders stated they had added more levels of due diligence over the past 2 years.
- 51% of lenders said they would adopt the SBA policy for their traditional loans as well.

# Policy Matrix Becoming Common

	<b>Minimum Due Diligence Requirements</b>		
<b>Real Estate Loan Type</b>	<b>&lt;\$250K</b>	<b>\$250K &lt; \$1M</b>	<b>&gt;\$1M</b>
<b>Low Risk Loan - new</b>	Questionnaire/Desktop	Desktop/Transaction Screen	Phase I
<b>High Risk* Loans - new</b>	Phase I/Transaction Screen	Phase I/Transaction Screen	Phase I
<b>Renewals -Low Risk</b>	Questionnaire/Desktop	Questionnaire/Desktop	Questionnaire/Desktop
<b>Renewals -High Risk</b>	Questionnaire/Desktop	Questionnaire/Desktop	Desktop/Transaction Screen
<b>Multi-Family</b>	Questionnaire/Desktop	Desktop/Transaction Screen	Desktop/Transaction Screen
<b>Outdated Phase I</b>	Questionnaire/Desktop	Questionnaire/Desktop	Desktop/Phase I update

# Common Residential Issues

- Lead Based Paint
- Asbestos
- Radon
- Mold
- Neighboring properties
- Stormwater Runoff (for incomplete C&D)
- Heating Oil Tanks
- Meth Labs (emerging)

# CRE - The Next Bubble?



# Common Commercial Issues

- UST's
- Spills
- Storage/disposal of Hazardous Waste
- Superfund
- Vapor Intrusion
- Transfer Act (in CT only)
- Gas Stations
- Dry Cleaners
- Mold, lead, asbestos, etc.
- Stormwater

# Environmental Issues In Real Estate Valuation

–Contamination

–Green/Sustainability

# Environmental & Appraisals

## Types of Contamination

### – Building Contamination

- E.g., asbestos, lead paint, radon, formaldehyde
  - Encapsulate, Enclosure, Removal

### – Soil & Groundwater Contamination

- E.g., hydrocarbons, solvents
  - Phase I (initial review) through III (remediation)

# Environmental & Appraisals

Stigma – Adverse public perception  
regarding a property

e.g., environmental contamination, grisly crime

# Environmental & Appraisals

## Green/Sustainability

- A development that meets the needs of the present without compromising the ability of future generations to meet own needs
- Goal - merge the priorities of economic prosperity, environmental quality and social equity.



NET ZERO HOUSE

LEED PLATINUM

801 17<sup>TH</sup>, NW, DC



# Environmental & Appraisals

## Green/Sustainability - Valuation Issues

- Initial Costs are typically higher
- Benefits both direct & indirect
  - Direct
    - Reduced operating expenses
    - Reduced maintenance costs
    - Increased occupancy rates
    - Decreased tenant turnover
    - *Possible* increased rental rates
  - Indirect
    - Appeal to tenants' social conscience/image
- Is it too new to measure value premium???

# APPRAISER'S GENERAL ASSUMPTION

...The appraisers have no knowledge of the existence of [hazardous substances] on or in the property unless otherwise stated. The appraisers, however, are not qualified to test such substances or conditions...the value estimated is predicated on the assumption that there is no such condition on or in the property or in such proximity thereto that it would cause a loss of value. No responsibility is assumed for any such conditions, nor for any expertise or engineering knowledge required to discover them.

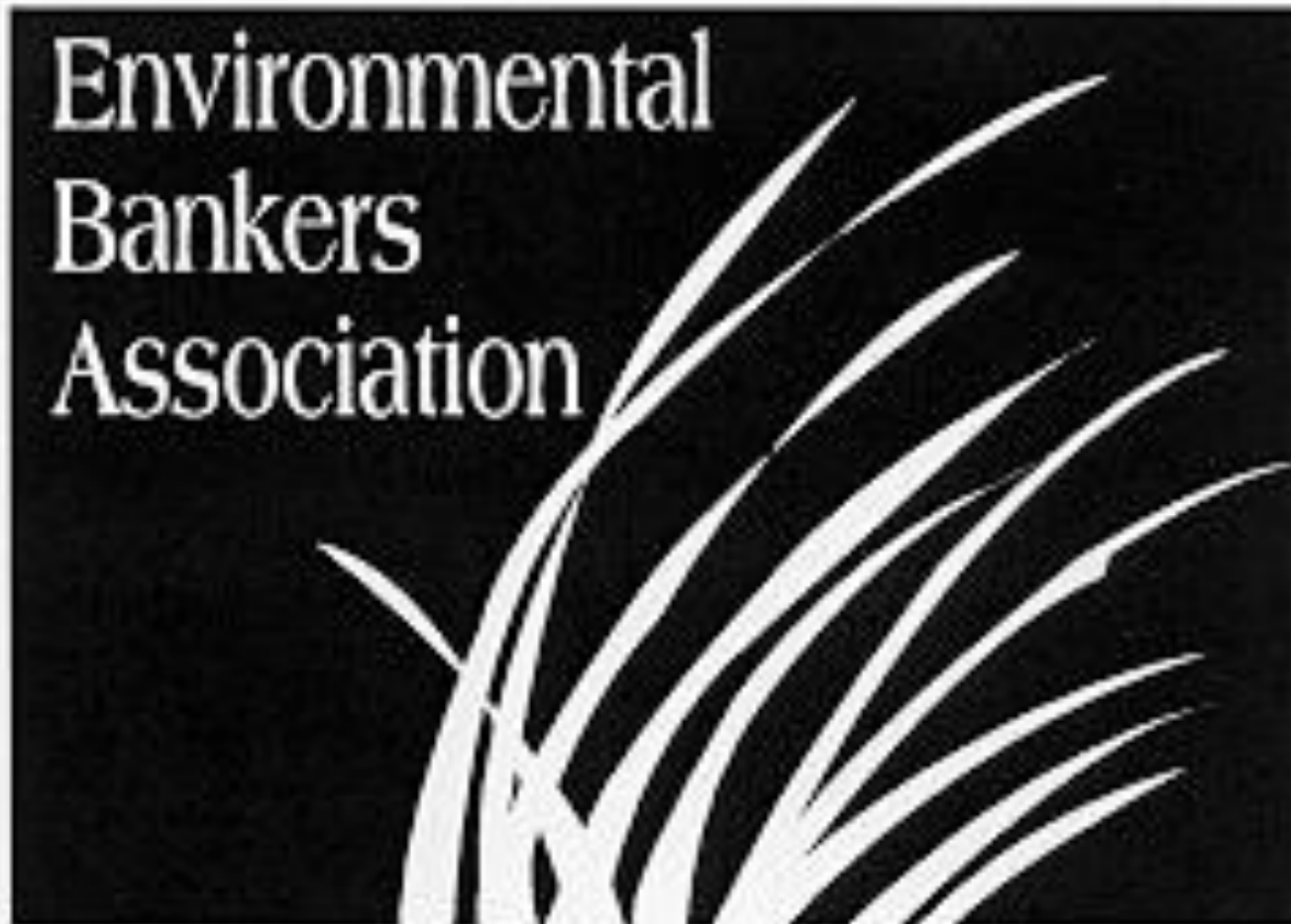
- **USPAP Advisory Opinion 9 (Appraisals of Real Property That May Be Impacted by Environmental Contamination)**
- Appraisals of contaminated properties, or properties suspected of being contaminated, are sometimes developed using either a hypothetical condition or an extraordinary assumption that the property is free of the contamination. While this is acceptable practice under certain conditions and for certain intended uses, there are assignments that require an appraisal of the “as is” condition of the property, with full consideration of the effects of environmental contamination. In these assignments, the appraiser is asked to analyze the effects of known environmental contamination on the value of the subject property.
- **Valuation Issues -As Impaired**
- **Highest and Best Use Issues:** The appraisal of properties that may be impaired by environmental contamination usually involves extensive highest and best use analysis. ....the appraiser must consider relevant factors in developing an opinion of highest and best use of the property in its impaired condition. The valuation of impaired property considers limitations due to contamination, its remediation and any legal use restrictions associated with the cleanup of the contamination source. ...In addition, excessive environmental risk and stigma may deter site development or redevelopment and thereby limit the highest and best use until the property’s environmental risk is reduced to levels acceptable to the relevant market participants.

# Summary

- Market pressures have reinforced long-term trend to increased due diligence.
- Regulators enforcing risk management due to a perceived over-concentration of risk regarding commercial real estate.
- Overall Credit Risk Management is more critical than ever
- Environmental and appraisals are both pieces of the puzzle

## Contact Information:

**Derek Ezovski**  
**860.838.5388**  
**dezovski@orms.com**



# How it all started ...

- Lender liability issues in the early 1990s
- Environmental regulations
- Bankers wanted a place to share best practices and to learn additional skills

# Environmental Risk Management Stages for Financial Institutions

- Risk Identification
- Risk Appraisal/  
Evaluation
- Risk Control
- Risk Transfer/  
Financing
- Risk Monitoring
  - Life Cycle of Loan

# Environmental Risk Management Issues

- Bank Risk Tolerance
- Business Environmental Risk
- Distressed Assets & Restructurings
- Loan modifications/renewals
- Workouts, Foreclosure/Bankruptcy
- Climate Change Risk
- Bank Failures

# Committees

- Risk Management
- Technical
- ASTM and Legal issues
- Trust Activities
- Global Issues
- Membership & Business Development
- Programs and Communications
- Policy
- Finance
- Appraisal??

# Work Products

- Benchmarking
- Participation in Conferences
- Training
- Technical Support/Tip Sheets
- Publications
- Industry Leader
  - Surveys

# Benefits

- Networking/Social Media
- Local and Global Forums
- Resources- repository for reports, policies
- Training/Education
- Conferences/Meetings
- Publications
- Surveys
- Webinars

# Collaboration

- Bank Regulators & Trade Associations
- Export credit agencies
- Environmental and other Agencies
- Rating agencies
- Standard Setting Organizations

# Training

- Environmental credit risk management
- Sustainable Financing (green buildings)
- Brownfield Redevelopment
- Sustainable development/carbon risk underwriting
- Management issues
- 2 Conferences per Year

# EBA Web Site

- Directory (Resources and Career Center)
- Registration and payment
- Articles & Tip sheets
- News & Articles
- Members Only Section
- BankNotes & Alerts



# BankNotes

- Cover Story-Philosophical Message
- Legislation / Regulations
- Case Law - International, National, Regional
- Banking Buzz, Commercial Real Estate and Insurance and Risk Management
- International Activities
- Articles of Interest / Member News
- Committee Presentations
- Members in the News

# What Next ?

- How do you want to be involved?
- How to join?
- Attend a meeting?
- Attend a Committee conference call or webinar?

Environmental Bankers Association

510 King Street, Suite 410

Alexandria, VA 22314

703-549-0977

[tacytelego@envirobank.org](mailto:tacytelego@envirobank.org)

