How Environmental Issues Affect the Appraisal Process and Practical Case Studies of Real Life

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AI Connect
July 26, 2016
• CRE Trends
• Technical Updates (ASTM)
• Regulatory Updates (OCC)
• Lender Trends
• Mike to discuss the overall lender process
• Case Studies
My Background

- Environmental Engineer/MBA
- Formerly worked for Fleet Bank, Marsh, EDR
- Most of my career (20+ years) has been as a risk management advisor to “non-environmental” professionals (lending, insurance, risk management)
- Uniquely qualified to work on these issues.
Current Trends in Lending/Financing of Commercial Real Estate

- Pressure from regulators
- Updated ASTM Standards for Phase I’s & Transaction Screens
- OCC Guidelines & CRE Warning
- SBA Lending
- Lenders updating environmental/appraisal policies
- More levels/forms of due diligence than ever before on more loans
- The CRE market is busy and lending guidelines might be relaxing again…
Figure 8: CRE debt maturities by lender type

At least $1.7 trillion of CRE debt will mature between 2012 and 2016. Trepp LLC estimates that nearly 29.0 percent of these loans are underwater, which continues to pose a risk to a broader CRE recovery.

Source: Trepp LLC, August 2012
US Commercial Property Prices

Moody’s/RCA CPPI
Overseas Investment in US Commercial Real Estate
$ Billion Annual

Source: JLL; Real Capital Analytics
Question:

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

Response:

We don’t know and we don’t care…
Borrowers’/Loan Officers’ Reaction when you tell them they need to do environmental...
The Reaction when they find out there are Environmental Problems…
What the process can feel like…
Why do Environmental Due Diligence on Commercial Real Estate?

• Minimize Risk(s)
  ▪ Allows lenders to understand the potential environmental liability that may exist
  ▪ Allows lenders to stay abreast of continually changing environmental issues

• Protection from environmental Liability

• *Business Risk is primary reason for lenders to do Environmental Due Diligence*
Phase I Highlights/Updates
• “Good and customary practice” for conducting a Phase I ESA

• Goal of a Phase I – to identify if any Recognized Environmental Conditions exist at a property.

• Should provide protection under the “All Appropriate Inquiries” (AAI) Rule

• Should be the standard of care for Phase I reports.
Redefined Historical Recognized Environmental Condition

• Past releases addressed to unrestricted residential use
• Must consider current regulatory framework (rules change)
• HRECs are not RECs

Created new Controlled Recognized Environmental Condition term

• Past releases addressed to non-residential standard, subject to some type of control
• CRECs are RECs and **must be included in the conclusions section of the report**
Vapor Migration

- E1527 had been silent on vapor
- EPA recommended the task group not ignore the vapor pathway
- 2013 revision acknowledges the vapor pathway in “migration” definition
Vapor Intrusion
The Trouble with Dry Cleaners
Non-Scope Issues

- Warning Asbestos
- Do not disturb
- Lead Based Paint
- Keep Out
- Protected Wetlands
- Danger Radon Gas
Non-Scope Issues

- **Lead Based Paint**
  - O&M Plans? Do them or not?
  - Renovations/Demolition – this is when this becomes very important

- **Radon**
  - Zone Maps used to determine sampling requirements (these are outdated!)
  - Sampling required for residential properties (Freddie, SBA, HUD)

- **Mold**
  - Identify potential mold conditions
  - Recommend Moisture Management Plan

- **PCBs**
  - Identify equipment which may contain PCB contaminated fluids
  - PCB in caulk?
  - Recommend PCB O & M Plan if no confirmation from utility provider regarding PCB content of transformers
Shelf Life of Phase I

- Per EPA, the clock starts on date of acquisition
  - 180 days prior = report valid
  - 1 year prior—EP must conduct or update specific components to within 180 days
  - More than 1 year prior, every AAI step must be conducted or updated to reflect current conditions and property-specific information

- **NOTE:** that SBA will consider appeals when the Phase I is slightly dated, but is followed by a current Phase II
Different Perspectives on Phase I

Seller Phase I

Buyer Phase I
Lenders’ Needs vs. Owners’ Needs

• **Lenders**
  - Not typically buying the property (not do they want to)
  - Can have varying levels of risk tolerance
  - Their scopes can be specialized
  - Might be ok taking on some risk

• **Owners/Users**
  - Typically need more definitive answers
  - They are ultimately responsible
  - CT and NJ – Transfer Act and ISRA
Regulators vs. Lenders
Challenges that Appraisers Face

- Pressure on bank appraisal/environmental departments
- Cost to cure calculations
- Not all appraisers are competent to assess environmental impacts (might have to call one in)
- Bidding process – appraisers would need to know this upfront because the as-is impaired is a different kind of assignment
- Potential project delay/cost increase
"Oh yeah?! Well, I just invented regulations for the wheel!"
Bank Regulator Flashes Warning Light Over Commercial Real Estate

by Rachel Evans
	@rachaelevans_ny
Highlights of OCC CRE Concerns

• Sending a “flashing yellow” signal;

• Concerns include:
  ▪ Easing of Underwriting Standards
  ▪ Increased CRE Exposures
  ▪ Rapid Growth of Marketplace lenders
  ▪ Expanded Third Party relationships

• Growth in CRE (400 of 1400 banks are up)

• Sound Risk Management is the focus

• Gateway cities are where the easing of underwriting seems the most common

• OCC feels that we are late in the lending cycle and effective risk management is critical
2 levels of Environmental Due Diligence for SBA

1. **Phase I** – for high risk properties
   - If property type/use matches the list of NAICS codes for Environmentally Sensitive Conditions

2. **Records Search with Risk Assessment** – low risk properties
   - Includes a search of the government databases (compliant with 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*
     - New Gas Station/Dry Cleaner Requirements
### Sample SBA Policy Matrix

<table>
<thead>
<tr>
<th>Real Estate Loan Type</th>
<th>Minimum Due Diligence Requirements</th>
<th>&lt;$150K</th>
<th>$150K &lt; $5MM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Risk Loans</td>
<td>Questionnaire</td>
<td>RSRA/TSA</td>
<td></td>
</tr>
<tr>
<td>High Risk* Loans – NAICS Codes</td>
<td>Phase I</td>
<td>Phase I</td>
<td></td>
</tr>
<tr>
<td>Gas Station</td>
<td>Phase I + Evidence of UST Compliance</td>
<td>Phase I + Evidence of UST Compliance</td>
<td></td>
</tr>
<tr>
<td>Dry Cleaners</td>
<td>Phase I</td>
<td>Phase I</td>
<td></td>
</tr>
<tr>
<td>Dry Cleaner (older than 5 years old)</td>
<td>Phase I and Phase II</td>
<td>Phase I and Phase II</td>
<td></td>
</tr>
<tr>
<td>Special Use Facilities (i.e. Daycare)</td>
<td>More specific requirements (i.e. Lead Paint Testing, Lead in Drinking Water, etc)</td>
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<td></td>
</tr>
</tbody>
</table>
Dry Cleaners

DROn YOUR PANTS HERE
AND YOU WILL RECEIVE
PROMPT ATTENTION
Impact of Lender 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
  - However, often very are in silos from appraisal

Credit Unions/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 practices
Environmental Due Diligence Options

- Environmental questionnaire (EQ)
- Desktop due diligence
- Transaction Screen Assessment (TSA)
- Phase I Environmental Site Assessments
- Phase II, III, Remediation, etc.
- Storm water Issues
- Sustainability/Green Issues
- *Environmental Insurance*
- Others
Environmental Due Diligence Products

- **Environmental Questionnaire**
  - Should be required unless this process was or will be duplicated during the Transaction Screen or Phase I ESA process
  - Must be completed by a knowledgeable party
    - Typically the borrower, seller, or Relationship Manager in coordination with a knowledgeable party

- **Environmental Screening Report/ EnviroFlash**
  - Can be subscription based or transactional. Ideally, will include an evaluation by an environmental professional.
  - It has limitations, not always easy to figure out how to mitigate findings?
Environmental Due Diligence Products

- Desktop Review
  - A review of current environmental records, along with historical information similar to the information used in a Phase I.
  - Questionnaire

- Transaction Screen
  - Follows ASTM E1528-14 (updated from 2006)

- Phase I ESA
  - Follows ASTM E1527-13 (updated from 2005)
Phase II / Limited Phase II

What is a Phase II?

Cost-to-cure needed?

Yes – if the property is contaminated and/or undergoing clean-up with a cost or risk of cost to the property owner.

Must be considered within the appraisal/valuation process
A review process is very beneficial to ensure that a consistent standard is in-place and to ensure that appropriate due diligence escalations exist.

Two types of environmental reviews:

- Internal Review and Environmental Consultant Review
- Risk-based approach based on property type
Common Commercial Issues

- USTs
- Fuel Oil Tanks
- Spills
- Storage/disposal of Hazardous Waste
- Vapor Intrusion

- Gas Stations
- Dry Cleaners
- Mold, lead, asbestos, radon, etc.
- Storm water Runoff
- Superfund
Environmental Issues on CRE

August 5, 2014
"The consultant said I was wearing too many hats."
What’s the appraiser to do?

- If you see it….report it.
  - Call the client/email the client
  - Take photos and send them to the client
  - Write it up in your report/Put it in the letter of transmittal
  - Calculate diminution in value if appropriate
  - Employ a hypothetical condition or extraordinary assumption if appropriate
  - Ensure your results are credible
Summary

• Lenders have unique processes and reasons for conducting due diligence.

• 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.

• Risk Management (Credit, Collateral, Environmental, etc.) is as critical as ever to lenders.

• Environmental and appraisals are both pieces of the puzzle that are being revised under the current environment.
Best Practices/Takeaways

- Create and follow environmental policies and procedures;
- Use commitment fees from borrowers to cover the costs of the due diligence;
- At a minimum, obtain an environmental questionnaire and some form of government environmental records for each commercial transaction;
- Different types of properties require different levels of due diligence;
- **Start the process as early as possible to allow enough time for evaluation and follow-up work that may be required.**
- Work with a company or expert that has experience in this area and consider outsourcing the review process similar to other functions that are not “core-competencies” of the bank.
It’s Risk Management...
How Much and How Long??
• Tampa – January 15-18, 2017
• Northeast – June 2017
ORMS Overview

- ORMS was founded with credit unions, community and regional banks as its primary focus;
- ORMS serves as natural extension of our lender clients;
- ORMS helps lenders develop and execute environmental policies and procedures;
- ORMS helps lenders focus on the low level due diligence needs;
- ORMS helps lenders review and make decisions on existing environmental reports and information;
- ORMS helps lenders do more risk management in a cost-effective manner by outsourcing the environmental risk management process.
ORMS helps with the 5 Steps of Risk Management

- Identify Risk
- Assess Risk
- Develop Controls or Risk Strategy
- Implement policy/controls
- Evaluate policy/controls
Product and Services

- **ORMS EnviroFlash™** – current data review and opinion designed for low risk loans
- **ORMS Desktop Review (RSRA)** – current data + historical research + opinion
- **ORMS Property File Review**
- **3rd Party Reviews/Phase I Updates**
- **Assistance with selection of environmental consultants on behalf of clients**
- **Policy Development and Evaluation**
- **Training Programs**
How ORMS is Different

- ORMS doesn’t do Phase I’s/Phase II’s (although we can help you manage through the process).

- ORMS is set up to be a business advisor with our clients, not a data driven product.
  - We evaluate each situation and help select the most effective solution.

- ORMS makes sense of the issues so that you can make a informed risk-based decisions.

- ORMS provides services nationwide.
How ORMS is Different

- ORMS provides solutions/strategies to resolve environmental issues;
- We do more research:
  - Property cards
  - Internet Search
  - We utilize environmental risk management professionals
- We provide follow up help
- Our program includes data + so much more.
- WE CAN WORK WITH YOU AND YOUR BORROWERS TO HELP FIGURE OUT SOLUTIONS TO THE ISSUES
Questions??

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