

# Lenders' Tolerance for Environmental Risks

*A survey of bankers and environmental experts finds consensus along the risk continuum.*



BY JOE DERHAKE

IN THE ENVIRONMENTAL risk market, who are the market makers? In the world of real estate, the most influential market makers are lenders. Lenders define risks that can be financed and those that must be mitigated. Lenders drive voluntary cleanups of properties and act as de facto regulators.

Sixty of the nation's most prominent environmental risk managers, bankers, and consultants recently took part in a survey designed to find out how they evaluate environmental risk associated with real estate. The survey, conducted by Partner Engineering and Science, a national engineering, environmental, and LEED consulting

firm, attempted to find participants' tolerance levels. For example, at what stage does a consultant recommend a Phase II Environmental Site Assessment (ESA) based on the findings of a Phase I ESA? What facts would represent enough risk for a lender to reject a loan without further assessment of the perceived risk, or accept the risk with a no-further-action recommendation and loan approval? In other words, where are the lines drawn?

Lenders and risk managers use Phase I ESAs to identify and evaluate environmental risk associated with real estate. The standard practice for ESAs is ASTM 1527, which focuses the environmental assessor on past and present

uses of the property. The assessor collects facts derived from a site visit, regulatory research, and historical use research and judges whether the information gathered represents a risk or, to use the terminology of ASTM 1527, a *recognized environmental condition* (REC).

Most risk managers would agree that the use of acetone in a nail salon is of minimal environmental concern but that extensive use of chlorinated solvents in an industrial setting is an REC. Between these extremes is the risk continuum. In the survey, environmental professionals, bankers, and risk managers were asked to consider seven risk cases. Three were current uses: a dry cleaner, a gas station, and an auto repair shop. Four were historical uses: a gas station, an industrial printer, an oil-well site, and a heating oil tank at an apartment building. Multiple questions were asked about each case. In the three current cases, duration of use was a variable.

The survey was targeted originally at members of the Environmental Bankers Association, many of whom also are RMA members. Risk managers from seven of the top 10 U.S. banks and several large European banks, insurance lenders, and environmental attorneys also participated. Professionals from 18 environmental consulting firms, most of them national or super-regional, took part. Collectively, these professionals greatly influence risk standards in the real estate market.

### Survey Results

Dry cleaner, gas station, and auto repair facilities clearly are environmentally sensitive uses, and the risk increases with the length of use. For these three sensitive uses, survey respondents were asked if the case facts called for an REC after two, four, eight, 12, and 20 years.

- Dry cleaners were treated conservatively by respondents. More than half considered two years of use to constitute an REC. Eight years of use was classified as an REC by almost everyone.
- The gas station in question is a modern facility with double-wall tanks and a leak-monitoring system. Clearly the new fuel storage and dispensing systems are vastly superior to the old steel systems, but at what age do the new stations warrant REC status? A minority of respondents considered the station to be an REC at two and four years, but a majority considered it an REC at eight years of operation.
- The auto repair facility has hydraulic lifts, a clarifier, and drums of waste oil. The response for auto repair was similar to that for the gas station, but slightly less conservative. Most respondents were unconcerned by short durations, but at eight years most said the auto repair facility qualified as an REC.

The remaining four cases offer historical property uses that raise environmental concerns. In each case, the use in

question was long past and the property had been redeveloped. Risk managers were asked whether the facts of the long-ago historical use warranted an REC now.

- *Use of a property by an industrial printer in the 1960s and 1970s.* The case offered no affirmative proof of solvent use, although solvent use and solvent-based inks were common during that period. Despite the absence of proof, 81% of respondents considered these facts to merit an REC designation now.
- *A gas station active in the 1960s and 1970s.* Almost all respondents considered this to merit an REC designation now. Subsequent questions explored respondents' thoughts if a regulator had issued a case closure letter for the site. The results of this case are discussed later in the article.
- *An oil-well site redeveloped into an office building.* The oil wells, one of which was directly under the building, were closed and abandoned in the 1950s and limited documentation exists. Some 82% of respondents considered these facts to merit an REC designation now, and 78% considered the facts to represent a potential vapor-intrusion condition (as defined by the 2008 Vapor Intrusion Standard ASTM E2600-08).
- *An old heating-oil tank under an apartment building.* The case presented a 500-gallon tank that was used from the 1920s through the 1960s. The tank was abandoned and filled with concrete; no testing was performed. Some 65% of respondents believed these facts merited an REC now. This was the only question on which lender responses differed significantly from those of consultants. Only 44% of lenders considered the 500-gallon heating oil tank to be an REC, while 83% of the consultants considered it an REC. When the question was modified by enlarging the tank to 5,000 gallons, both consultants and bankers were more conservative—100% of consultants and 62% of lenders believed the larger tank to be an REC.

Three of the survey's most interesting findings are discussed in more detail below.

### Standard Risk Classifications

Survey respondents had a high level of agreement on risk classification. On 12 of 24 questions, the consulting community was 100% unanimous. Bankers were very close to unanimous on these questions. The following 12 risk classifications were considered as RECs by 100% of the environmental consultants:

***Clearly the new fuel storage and dispensing systems are vastly superior to the old steel systems, but at what age do the new stations warrant REC status?***

#### Dry cleaner

- › on site eight years
- › on site 15 years
- › on site 20 years

#### Modern gas station

- › on site 15 years
- › on site 20 years

#### Auto repair shop

- › on site 15 years
- › on site 20 years

#### Historical printer

- › on site in 1960s and 1970s

#### Historical gas station

- › on site in 1960s and 1970s
- › on site in 1960s and 1970s, but groundwater is very deep
- › if tanks were removed in 1980 and the site had a case closure letter from the 1980s with no actual soil testing

#### 5,000-gallon heating oil tank

- › at apartment building

These risk judgments amount to industry-standard classifications of risk. Often, risk managers who read Phase I ESAs prepared by environmental consultants hired by borrowers or provided by other parties are concerned that these unfamiliar consultants are out of touch with normal risk classifications or are managed into downplaying environmental risks. When risk managers push back, however, they are put in the uncomfortable position of challenging unfamiliar consultants.

Data from this survey offers risk managers a reference point for evaluating the classifications of risk from unfamiliar consultants. Similarly, senior staff at environmental consulting firms should be mindful of these standard risk classifications and police junior staff so that they stay within industry standards.

### Can Lithology Mitigate Risk?

The survey also asked how mitigating conditions such as depth of groundwater and protective lithology (for example, clay content of soil) influenced the perception of environmental risk. Two concerns regarding soil contamination are degradation of groundwater resources and exposure to soil contaminants that can lead to adverse health effects for future site users. Risk-based action levels can be extrapolated by determining groundwater action levels or by calculating human health risk assessments. State regulators and environmental professionals have emphasized more stringent human-health-based action levels over the past five years.

Clearly, deep groundwater and high clay content would lower the potential for groundwater contamination, but would do nothing to allay concerns about vapor intrusion

and potential exposure to future site users. Only 11% of respondents considered deep groundwater and protective lithology strong enough mitigants to reverse their classification.

### Closed Cases Could Be Reopened

The most controversial question was how to handle a gas station site closed in the 1990s. A quick summary of the case follows. The gas station had a release and went through extensive remediation. Confirmation testing was done under regulatory supervision and the site received case closure in 1996. Twelve years later, the environmental professional doing the Phase I ESA suggested that levels found in the 1996 confirmation samples would not meet today's more stringent regulations.

This scenario is becoming more common as states institute more stringent human-health-based action levels and reopen cases. Try telling a borrower who invested \$800,000 in a successful remediation project which achieved regulatory closure that more remediation is needed to meet today's standards. The borrower could argue that what was done initially should be sufficient and that it's unfair to change the rules. Some 61% of the environmental professionals surveyed agreed. Many chose to classify the scenario as a *historical recognized environmental condition* (HREC). The HREC classification was designed by ASTM for this set of facts and is generally considered a *passing* classification accompanied by a no-further-action recommendation. But a vocal 39% of professionals classified the situation as an REC. Although a minority, the presence of such a significant percentage should be a concern to risk managers. The minority viewpoint might be imposed on them during a future sale of the property.

### Lenders Are De Facto Regulators

Lenders and risk managers have become de facto regulators on environmental matters. An investor in an industrial property might be concerned that the government will require an environmental cleanup of a mess left by a past user, but a far more likely scenario is that a current or future lender will require environmental testing and possible cleanup as a condition for the loans.

To make good decisions for their portfolio, risk managers must understand not only the market for risk but also how their counterparts view risk. The complete survey and the statistical results to date are available on line at [www.partneresi.com/resources.htm](http://www.partneresi.com/resources.htm). This is an ongoing survey, so feel free to weigh in. Survey results are updated periodically. ❖



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