Office of Regulatory Activities

Thrift Bulletin

**Handbook: Thrift Activities**
**Subjects: Lending Risk Assessment**

**Section: 210**
**TB 16**

TB 16 Rescinded 1/22/09 with the issuance of RB 37-30

February 6, 1989

# Environmental Risk and Liability

*Summary:* This Bulletin addresses the potential risks and liabilities that thrift institutions can incur as a result of adverse environmental factors. It also contains guidelines for the development of policies of reasonable due diligence to protect institutions against financial risks created by such factors.

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*Thrift Bulletin 16*

Introduction

Environmentally related hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its mortgage or commercial loans and real estate investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems or oil and gas wells.

Thrift problems with pollution and hazardous waste contamination have grown as Federal, state and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for cleaning up the environment. Thrifts must be aware of and concerned with regulations that impose cleanup liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Potential Risks And Liabilities To Institutions

There are at least eight basic categories of risk that an association can face as a result of environmentally contaminated property. These include:

1. The risk that the collateral for a real estate loan or property to be acquired may be drastically reduced in value after discovery of the existence of hazardous waste contamination.

2. The risk that the borrower cannot repay the loan if the borrower must also pay for the cost of cleaning up the contaminated property. The cost for cleanup in many cases can be significant and may exceed the institution's encumbrance on the property.

3. The risk that a mortgage loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up hazardous waste contamination may have priority over a lender's mortgage.

4. The risk that a lender may be liable to the extent of any credit extended to any debtor who has operated property containing hazardous wastes, has generated such waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous waste.

5. The risk that the thrift may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property or becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the disposal of toxic or hazardous waste.

6. The risk that a lender may not be able to pursue its foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could lead to charging off the loan balance.

7. The risk that the borrower does not maintain collateral or property with an environmental risk potential in an environmentally sound manner.

8. The risk that, aside from the statutory liabilities that can be imposed for toxic waste contamina-

tion, there is also potential liability for personal injury or property damage.

To address these potential risks and liabilities, thrifts should develop internal underwriting and risk management procedures and require their mortgages, guarantees, indemnity contracts, and other loan documents to protect themselves against potential environmental hazards and to maintain the value of their loans and real estate investments.

Purpose Of Environmental Risk Policy

The most expeditious means by which a thrift institution may commence protective action against potential environmental risks and liabilities is to develop and implement a written environmental risk policy. Such a policy will serve several critical purposes. It will:

1. establish a level of due diligence in all real estate transactions;

2. establish a means of identifying excessive environmental risk in properties being considered as collateral or for acquisition, or in properties being analyzed prior to foreclosure, or to meet standards set by buyers in the secondary market;

3. minimize environmental contamination of the borrower's property through the life of the loan by alerting institution staff to a potential problem property and providing for collateral monitoring and periodic property inspections throughout the loan term.

4. establish guidelines for a satisfactory inquiry into the uses of property and for other protective actions as needed to qualify for the "innocent landowner"[1] defense in the event that it acquires, through foreclosure or otherwise, a contaminated property that it could not have reasonably known to be contaminated; and

5. support the institution's adherence to the principles of safety and soundness.

Environmental Risk Policy Components

The following are essential components in an institution's environmental risk policy:

1. A stated assessment of potential environmental problems and liabilities. (i.e., an acknowledgement of the risks cited under "Potential Risks and Liabilities to Institutions" (pgs. 1 & 2) and a declaration that a policy of due diligence is adopted to protect the institution from such risks.)

2. A requirement that loan applicants provide information on environmental matters pertaining to their business and facilities. Institutions should develop a form covering specific questions to which applicants respond. The questions should request information concerning past, present or proposed uses of the proposed collateral, potential hazards, insurance availability for the property as it pertains to environmental matters, and contacts by any Federal, state or local government agencies concerning environmental matters that must be resolved in order to obtain business and environmental permits.

3. A requirement that an acquiring institution, in a purchase or participation loan, ensure that adequate due diligence regarding environmental risk matters has been met by the lead lender and a requirement that all loans sold to Freddie Mac or Fannie Mae meet with the environmental due diligence standards imposed by those agencies.

4. A requirement that all loan requests, in which the proposed real property collateral has a higher environmental risk potential than other types of real property, have a Phase I Environmental Risk Report (See Appendix) prepared for the institution prior to approval of the loan.

Most one-to-four family residential properties will not need a Phase I Environmental Risk Report. If cursory property inspections or records research, however, disclose a high potential for environmental risk, then Phase I reports are likely necessary.

Examples of properties that should have a Phase I Environmental Risk Report include:

a. Proposed construction properties (other than a proposed individual one-to-four family residential property).

b. Industrial properties and properties on industrially zoned land.

c. Properties located close to industrial areas.

d. Properties that include or are close to an existing or former gas station site.

e. Commercial properties that include an automotive repair facility or a dry cleaning es-

[1] An exemption from liability for an innocent landowner who acquires property unaware of the presence of hazardous material. The landowner must not have conducted, permitted or contributed to the release of hazardous substances and must have had, after appropriate inquiry, no knowledge of the pollution at the time the property was acquired.

tablishment where the work is done on the premises.

f. Properties adjacent to railroad tracks or underground pipelines (excluding one-to-four family residential properties).

g. Properties that have served as or are close to a refuse or waste disposal site.

h. Properties where the past uses or the surrounding uses include the storage of or usage of hazardous or toxic substances (e.g., pesticides).

i. Properties suspected of containing asbestos material that is or may be friable (easily crumbled or crushed into powder and capable of being absorbed into the environment).

j. Properties where the emanation of radon gas from the soil may result in detrimental health effects to building occupants. (Institutions may need to consult with qualified environmental firms regarding the seriousness of radon problems in specific areas.)

k. Residential properties where there are known hazardous conditions on or in the property's immediate vicinity: where Superfund sites[2] exist within a one mile radius; where the site is in close proximity to oil and gas production; where there is asbestos within the building structure; where the site is a corner lot property (and is known to have been previously used as a gas station locale); or where the historic use of the property prior to its residential zoning is cause for concern.

The designation by the institution's board of directors or senior management of one or more qualified staff persons as the association's "designated environmental risk analyst(s)". These staff members should receive special training through courses or seminars in reviewing and interpreting environmental risk reports for the institution, and should assist in the development of the institution's environmental risk policy.

6. Criteria for the selection and retention of a roster of qualified environmental experts retained for risk analysis reports. The association should confirm that the organization or individual has appropriate education, training and experience. The consultant should not be affiliated with the buyer or seller of the property nor with a firm engaged in any business that might present a conflict of interest.

7. A requirement that it will be the loan officer's responsibility (after consultation with the designated environmental risk analyst) to order the Phase I Environmental Risk Report on the subject property as needed. Guidelines regarding environmental risk reports follow:

   a. The association must be the client on the environmental risk report. This provision will maximize the likelihood that the institution will receive an objective report that discloses all of the pertinent facts.

   b. The institution should only use environmental risk auditors from its approved roster.

   c. The loan officer, with assistance from the institution's designated environmental risk analyst, should have the responsibility to review the outside environmental audit reports and judge the conclusions of the report after consulting with any environmental risk resources considered necessary. Final acceptance of environmental risk reports and decisions concerning the information in the report should be made by the institution's senior management.

8. A requirement that appraisal reports fully disclose the findings and take into consideration any environmental risk factors and remediation costs identified in environmental risk reports.

9. A requirement that any potential environmental problems noted in an environmental risk report be considered by the institution's required approval authority and senior management before the loan is approved or the property is purchased.

10. Criteria for determining the circumstances in which loan requests may be declined due to environmental factors. Some reasons for declining loans based on environmental factors are:

    a. The structure is built over a sanitary landfill or other solid, hazardous or municipal waste disposal site.

    b. There are materials containing friable asbestos or substantial

[2] Sites identified by the Environmental Protection Agency (EPA) from which hazardous substance releases occurred or from which releases could occur (e.g., abandoned hazardous waste dumps and chemical spills). The EPA is authorized to undertake removal or remedial actions at such sites.

amounts of non-friable asbestos that cannot be safely encapsulated or removed or will not be routinely inspected and maintained by the borrower.

c. There is evidence of spills, soil or groundwater contamination on or around the loan applicant's properties.

d. There is documented soil or groundwater contamination on the subject property and:

i. physical constraints posed by the site specific geology, geohydrology or subsurface structure render corrective actions technically impossible; or

ii. constraints render treatment processes or disposal options prohibitively expensive, i.e., beyond the financial capabilities of the current owner; or

iii. environmental hazards or potential hazards exceed the value of the land or the requested loan amount; or

iv. potentially responsible parties are unwilling or financially incapable of instituting corrective actions on neighboring properties.

e. There is laboratory analysis of soil and groundwater samples that indicates they exceed action levels established by government agencies.

f. There is polychlorinated biphenyls (PCB) contamination where:

i. physical constraints posed by the site specific geology, geohydrology or subsurface structure render corrective actions technically impossible; or

constraints render treatment processes or disposal options prohibitively expensive (i.e., beyond the financial capabilities of the current owner)

g. There are [illegible] above acceptable standards that can only be corrected through large capital improvements or extensive ongoing maintenance programs that are beyond the financial or technical capability of the borrower.

h. There are conditions that represent violations of applicable local, state or Federal environmental or public health statutes and laws.

i. The properties are currently the subject of environmental or public health litigation or administrative action from private parties or public officials.

11. Procedures for reviewing collateral before completion of foreclosure procedures or acceptance of a deed in lieu of foreclosure. The procedures may include, but should not be limited to:

a. A review of the existing loan file (including site inspection, leases, reports and completion of an environmental checklist).

b. A review of the loan documents and any subsequent modifications.

c. A determination as to whether any guarantees or indemnities were obtained on the loan.

d. A determination as to whether the borrower has any environmental impairment insurance or other applicable insurance that could be utilized for an environmental hazard claim.

e. A review of the current tenants and real property uses.

f. Document of a Phase I Environmental Risk Report if conditions suggest it is neces-

12. An acknowledgement of the importance of coordination and cooperation among the institution's loan origination department, its loan servicing department, its designated environmental risk analyst, its legal counsel, and its appraisers, to carry out the environmental risk policy and to enlist the help of environmental specialists and applicable government agencies in this endeavor.

RESCINDED

Darrel W. Dochow

*— Darrel W. Dochow, Executive Director*

# Attachment to TB 16—Description Of Environmental Risk Reports



The following is a brief description of the various types of environmental risk reports that institutions may need to employ.

1. A Phase I Environmental Risk Report is a qualitative assessment of the property. A typical Phase I Report includes, but is not limited to:

   a. A historical review of the use and improvements made to the subject site.

   b. A review of building, zoning, planning, sewer, water, fire, environmental and other department records that would have information on or have an interest in the property and neighboring sites.

   c. A review of the Department of Health Services, Solid Waste Management Board, Regional Water Quality Control Board, Air Quality Management District, and other Boards or Agencies records and files whose actions may affect the subject property and neighboring properties.

   d. An investigation of the subject property and neighboring properties with regard to the Environmental Protection Agency's National Priority List or Comprehensive Environmental Response Compensation and Liability Information System (CERCLIS) list and similar state lists.

   e. An inspection of the site and all improvements with particular attention to the use of hazardous materials in the structures or operating equipment.

   f. A verification as to whether present or past owners or tenants have stored, created or discharged hazardous materials or waste, and review of whether appropriate procedures, safeguards, permits and notices are in place.

   g. An analysis of old aerial photographs to determine the construction or destruction of buildings and the existence of ponds and disposal areas on the property over time.

   h. Interviews with neighbors to determine prior uses of the subject property (if appropriate and only if deemed acceptable by the parties involved in the transaction). Confidentiality must be recognized.

   i. A review of building records and a visual inspection of the building(s) to determine if asbestos-containing building materials may be present.

   j. A review of scientific literature to determine the potential existence of radon in the soil.

   k. A written report summarizing the findings.

2. Phase II Environmental Risk Report

A Phase II Report is performed if "red flags" are apparent to the lender or if they are disclosed during the Phase I investigation. This report consists of all Phase I activities plus combinations of the following field tests and activities.

   a. Testing of underground storage tanks for content and integrity.

   b. Soil gas analysis to identify the potential for petroleum hydrocarbons and volatile organic compounds such as industrial solvents and dry cleaning chemicals.

   c. Bulk soil sampling.

   d. Groundwater sampling if groundwater may be impacted by land activities.

   e. Limited surface water sampling if there is a pond, lagoon or stream on the property.

   f. A comprehensive review of the regional and local geology to determine the pathways leaked chemicals would follow in the event of a spill or leak.

   g. A list of individual groundwater wells or subsurface water bodies that may be affected by a spill or leak.

   h. A comprehensive inspection of the building for asbestos-containing building materials. This should include collecting and analyzing samples of the building material for friable asbestos. It is strongly recommended that inspections be performed by EPA-certified inspectors and analyses be completed according to EPA guidelines.

   i. If no listed hazardous materials or waste are found, an appropriate verification should be provided.

   j. A written report summarizing the finding.

3. Phase III Environmental Risk Report

A Phase III Environmental Risk Report is much more detailed and consists of all of the Phase I and Phase II activities in addition to involved soils, water and air quality analyses. As in a Phase I and Phase II Report, a Phase III Report also includes a written report summarizing the findings of the investigation.

Based upon the Phase I, Phase II or Phase III report results, subsequent steps regarding further assessment, corrective action or preventative programs should be submitted. This should include gross cost estimates for correcting any discovered contamination

Institutions should not hesitate to contact environmental firms and question the principal investigator for the project regarding observations, conclusions and recommendations made in the environmental assessment reports.