

# Due Diligence: An Environmental Risk Manager's Perspective

---

Sandra Odendahl, Senior Manager  
Environmental Risk Management  
RBC Financial Group

Presented at the  
Environmental and Property Damages Symposium  
Sponsored by the Appraisal Institute  
Toronto, April 5, 2002



# Overview

---

- About RBC Financial Group
- Environmental risk management at RBC
- How we apply due diligence
- Credit Risk
- Owned Real Estate Operations
- Case Study – No environmental policy
- Challenges

# About RBC Financial Group

---

- Founded in Halifax in 1864
- 1300 branches, 4500 bank machines, 59,000 employees, 10 million customers
- Canada, US and 28 other countries
- \$362 billion in assets
- Market Capitalisation \$31 billion
- Profits in 2001: \$2.5 billion
- "Canada's most Socially Responsible Corp"

# RBC's Commitments to the Environment

---



- I. Policy on the Environment
- II. United Nations Environment Programme (UNEP) Statement by Financial Institutions
- III. International Chamber of Commerce (ICC) Business Charter for Sustainable Development

# Environmental Risk Management at RBC

---

- Environmental Risk Management Group
  - Part of Corporate Risk Management
  - Began in 1990 to manage credit risk issues;
  - Mandate now encompasses corporate sustainability; new products; reputational risk
  - 3 full time staff
  - Develop policies and programs; expert advice
- Real Estate Operations
  - One environmental manager
  - Focus on owned and leased buildings

# When do we examine Environmental Risks?

---

- Credit Activities
  - Before advancing loans
  - During the life of the loan
  - When realising on security
- Managing Owned REO
  - Acquisitions
  - Operations
  - Property Sales

# What are the Environmental Risks?

---

- Negative impact on **value** of security
- Cost of remediation adversely affects **financial position of client** and increases credit risk
- Bank may face **legal liability** for remediation if it realises on contaminated security
- Bank may have to **forgo** realising on security due to environmental contamination
- **Reputation damage** to the bank by not meeting its environmental/social commitments
- Also: Loss of liquidity; competitive risks

# Where does Due Diligence come into it?

---

- *“The level of inquiry that is reasonable and appropriate under the circumstances”*
- Our policies must be reasonable and appropriate to mitigate the environmental risks under different circumstances



# Some Environmental Risk Factors

- Things that affect the degree of risk

---

---

- Sector (Industrial? Commercial? etc)
- Amount of credit facility
- Secured vs. unsecured by real property
- Geographic location
- Loan to Value ratio
- Borrower credit rating
- Borrower environmental track record

# Environmental Credit Risk Activities

## - Before Advancing Loans

---

1. Identify environmental risk potential
  - Client sector (Industrial, Ag, Commercial?)
  - Type of transaction (Secured? Unsecured?)
  - Amount of credit facility
2. Gather environmental information
  - client, consultant, AM, RM, and/or ERMG
3. Evaluate the risk and decide whether to proceed
4. Prepare and maintain documentation
  - clauses, reps & warranties, indemnification, etc.

# Environmental Credit Risk Activities

## - During the Life of the Loan

---

- Site Visits
- Obtain confirmation of environmental status from client
- Obtain updated environmental information
- Review Compliance Information

# Environmental Credit Risk Activities

## - Before Realising on Security

---

- *Avoid being "in charge, management or control" of a contaminated property*
- Methods of realising on security vary by Province (Foreclosure, Power of Sale, "Order Absolute", etc.)
- Lenders clearly protected from liability in Ontario via "Global Agreements" and new Brownfields legislation
- Some protection for lenders in legislation of other provinces

# Environmental Credit Risk Activities

## - Before Realising on Security (cont'd)

---

- Ontario's "Global Agreement" includes activities that lenders can carry out:
  - Environmental investigations (Phase I, II)
  - Preserve the value of the property
  - Collect rents
  - Pay bills
  - Deal with any immediate public health threats

# Policy Example:

## Environmental Policy for Commercial Mortgages

### - Before advancing loan

---

- Residential property under \$500,000
  - Environmental review at AM discretion
- Commercial mortgages under \$500,000
  - Environmental questionnaire
- Multi-residential (> 4 units); Commercial >\$500,000; Commercial pre-1980
  - Phase I ESA
- Gas Stations
  - Phase I and Phase II ESA

*Key Risks managed: value of security, credit, reputational, competitive, liquidity*

# Caveat Emptor:

Vendor doesn't have to tell you everything!

---

- Ontario court dismissed allegations of fraud and misrepresentation against Petro Canada in 2000, stating that a vendor doesn't have to provide the purchaser with environmental reports vendor knew about, but had not commissioned.
- Petro Canada (PC) sold a property to an investor. PC provided investor with environmental reports that showed site was clean.
- Subsequent environmental reports for another prospective purchaser showed contamination, but PC didn't tell investor. Also didn't tell investor that there had been USTs at the site.
- **Investor did not hire his own environmental consultant**
- When investor tried to resell site, learned that it was still contaminated.

# Environmental Policy for Commercial Mortgages

## - During life of Loan

---

---

### ■ Low Environmental Risk

- Usually office buildings, strip malls, multi-unit residential, light industrial
- At renewal, client signs letter confirming environmental status

### ■ High Environmental Risk

- At renewal, client signs letter of confirmation (Years 1-3)
- New or updated ESA (more than 3 years)

*Key Risks managed: credit, value of security, reputational, liquidity*



# Environmental Policy for Commercial Mortgages

## - Before Realising on Security

---

- Phase I ESA and Market Appraisal
  - If no concerns:
    - proceed to realise on security; sell property
  - If concerns identified:
    - Obtain court order to allow access and not incur liability (not required in Ont.)
    - Phase II ESA
    - Sell, Remediate, SSRA, or Abandon

*Key Risks managed: legal, reputational*

# Owned Real Estate Operations

## - Acquisitions

---

- Acquisition of new banks includes a review of:
  1. Phase I ESAs for portfolio of branches and owned properties
  2. Environmental credit risk management policies
- Next step is integration of policies and procedures

*Key Risks managed: legal, liquidity, reputational*

# Owned Real Estate Operations

## - Manage Operations

---

- Health and Safety Issues (asbestos, mould, lead paint, IAQ, etc)
- Environmental issues (fuel tanks, refrigerants, etc)
- Real-estate-specific Corporate Ecology
  - Energy use reduction programs
  - Green Energy
  - Solid waste disposal

*Key Risks managed: legal, operational, reputational*

# Owned Real Estate Operations

## - Branch Closures

---

- Conduct a Phase I ESA
- If No Issues identified, sell as is
- If Issues Identified:
  - Phase II
  - RBC responsible?
  - Onsite vs. Offsite?
  - Free Phase?
  - Drinking water impact?
- Sell as is, clean up then sell, or hold

*Key Risks managed: legal, reputational*

# Case Study

## - What happens when there's no policy

---

- A residential mortgage in Atlantic Canada
- Property appraised at about \$60,000
- Client defaulted, bank took possession
- Discovered environmental issues
- Bank spent almost \$200,000 remediating in 2001, and it's not finished
- Net loss could approach half a million dollars
- How could this happen?

# Case Study- Residential Mortgage

## What Happened?

---

- No environmental risk policy for residential properties
- Before Advancing Loans:
  - Low value, rural properties
  - Likely “drive-by” appraisal
  - No environmental due diligence mandated

# Case Study - Residential Mortgage

## What Happened?

---

- During Life of Loan:
  - No site visits
  - No environmental information required
- When Realising on Security
  - Took possession without seeing property
  - No Environmental Site Assessment mandated

# Case Study - Residential Mortgage

## What RBC got:

---

- A C\$60,000 property with a furnace oil leak
- An order by Ministry of Envir. to clean up
- Got to clean up off-site migration at 2 neighbouring properties
- An incompetent environmental consultant hired without knowledge or approval of Corporate Environmental Risk
- Free product discovered under floor of building, after "remediation" completed
- Another year of dealing with this file!



# Case Study - Residential Mortgage

What can we do to prevent this?

---

Don't want to kill an ant with a nuclear bomb!

- Before Advancing Loans

- Check off whether heated by oil

- During life of loan

- No action for residential property

- Loan Recovery

- If oil heated; check fuel oil system before taking possession (check if heating co. could do this)
- If concerns ID'd, local staff do site visit
- No remediation without Corp. Envir. Risk advice !!
- Sell without taking possession

# Challenges

---

- Appropriate environmental policies for small residential properties?
- What should bank do if entire neighbourhood is contaminated (Port Colbourne, Brantford, etc)?
- Appropriate environmental policies for commercial real estate portfolios (REITs)?
- Who decides on cost of “stigma” and how?
- Developing brownfields