Due Diligence: An Environmental Risk Manager’s Perspective

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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