

Know the Power of Pollution Protection

When lenders require environmental insurance, help clients understand why

By **Debra Hausser**, assistant vice president and product-line manager, Zurich North America Commercial

THE INCREASING NUMBER OF defaults and foreclosures on commercial real estate loans can leave lenders holding environmentally impaired properties. When foreclosing on commercial properties with environmental contamination, lenders not only lose the unpaid loan balance along with interest and fees, but they also face the costs of cleaning up the property as well as having to deal with potential third-party bodily-injury and property-damage claims.

Typically, lenders have retained the risk of environmental loss. They often attempt to mitigate that risk through tools such as Phase I environmental site assessments, transaction screens, environmental questionnaires, and environmental escrows or indemnities from borrowers.

These tools, however, often are time-consuming and can delay or stop a deal completely. Also, if a site assessment fails to detect existing contamination or if new contamination occurs during the loan term, these tools offer little protection for the lender. Ultimately, using these tools also can lead to increased expenses and potentially lower profit margins for a lender.

As a result, many lenders look for solutions to better mitigate their risks and increase efficiencies when faced with environmentally challenged properties. Environmental insurance can be a cost-effective and cost-efficient solution to such challenges.

In recent years, mortgage lenders have increasingly required environmental insurance for individual loan transactions, new-loan portfolios and commercial mortgage-backed-securitization deals. Brokers who understand why lenders might require environmental

insurance of their borrowers, as well as how it typically works, can best advise their clients on these matters.

Taking a portfolio approach

Lenders may require environmental insurance on an individual transaction when they need a quick turnaround, when there is an environmental concern on the subject property or on adjacent properties, or as a substitute for an environmental indemnity or escrow from the borrower. In fact, environmental insurance often costs less than the amount borrowers would have to put into an indemnity or escrow.

Lenders also may choose to make this insurance part of their environmental-due-diligence procedures. This practice is described as a portfolio approach.

In a portfolio-program scenario, lenders often accept environmental insurance in lieu of a new Phase I environmental site assessment for all or most of their commercial real estate loans.

In these cases, lenders set up a warehouse policy to use environmental insurance on most of their new commercial mortgage loans. They may do this when they are looking to transfer their environmental liabilities to an insurance carrier; to expedite the loan-underwriting process; to reduce costs, which could provide them a competitive advantage; and to protect their assets.

The lender sets up a portfolio program by submitting an application to the insurer, which then develops a price matrix indicating the cost to insure loans that qualify under the portfolio policy. Each loan is then underwritten with information that the loan officer and borrower provide on a disclosure form, which third-party sources then validate.

Some companies have automated the loan-underwriting process to streamline the information exchanged between the lender and the underwriter. Some use Web-based application-processing systems that can provide faster turnarounds, with straightforward loans approved in minutes. These systems also can allow lenders to process or check the status of their loans online at any time.

Loans are reconciled monthly, and borrowers pay a fee when the loan closes. Premiums are typically collected as part of the loan's closing costs.

Property types that can be included in portfolio programs include apartments, offices, retail, warehouse, vacant land and light industrial. Excluded property types generally include heavy industrial, manufacturing operations, large-quantity Resource Conservation and Recovery Act generators and properties with known environmental contamination above acceptable regulatory standards. Coverage for higher-risk properties may be available on a separate policy tailored to that particular deal.

Program benefits

Environmental insurance has benefits to lenders and borrowers. In particular, implementing a portfolio program often is a quick and cost-effective alternative to lenders' traditional environmental-due-diligence procedures. The loan-review process typically takes days rather than weeks, and the cost of environmental insurance is typically less than the cost of a Phase I environmental-site-assessment report.

Portfolio programs provide lenders with a risk-transfer mechanism for environmental liabilities. They also provide payment for covered loss should there be a discovery of a pollution event during the policy period rather than simply identifying potential pollution events at a specific point in time.

These programs also provide collateral-value protection by compensating the lender financially if there is a default and if a pollution event is discovered during the policy period.

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Debra Hausser is assistant vice president and product-line manager for Zurich North America Commercial's lender-environmental-liability programs, headquartered in Denver. She develops, markets and manages innovative risk-transfer products for financial institutions. Hausser received a bachelor's degree in finance from the University of Colorado at Boulder and has obtained a chartered-property-casualty-underwriter designation. Reach her at (303) 224-4071 or debra.hausser@zurichna.com.

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By enabling lower processing fees and faster turnaround times on loans, these programs can give lenders a competitive advantage while also saving borrowers time and money.

Collateral protection

The most commonly used lender-policy form available in the marketplace typically is called the "lesser of" policy. The lesser-of lender policy provides the lender with collateral-value-protection coverage by paying the lesser of the outstanding loan balance or the estimated cleanup costs if a borrower defaults on a mortgage agreement and if a pollution event is discovered on the property during the policy period.

The policy also covers first-party cleanup, which protects the lender on foreclosed or real estate owned property, and third-party liability for bodily-injury and property-damage claims, including defense costs. Further, the policy provides coverage for historical unknown con-

tamination, as well as for new contamination discovered during the policy period.

Coverage for each loan insured in the portfolio policy usually is for the term to maturity of each loan and evidenced by a covered-location endorsement.

Securitization programs target lenders that pool existing loans to submit and sell to the secondary bond market; this typically includes financial institutions that operate on Wall Street. Loss of collateral value from pollution and other environmental conditions on commercial real estate is a major concern for all parties involved, especially trustees and bondholders.

Using lender environmental-insurance policies can help stabilize bond performance by protecting the loan's collateral value in the event of a loan default and discovery of a pollution event during the policy period. Historically, rating agencies have required new Phase I envi-

ronmental-site-assessment reports as part of the underwriting process. Some insurers, however, have worked with the rating agencies and with B-piece buyers to accept environmental insurance in lieu of a new Phase I report.

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With so many challenges in today's market, mortgage brokers and lenders are forced to rethink how they will do business going forward. Many are implementing new processes to make their operations more efficient.

Environmental insurance is one tool that can allow them to streamline their loan-underwriting processes, transfer environmental risk, and gain a competitive advantage with lower processing fees and faster turnaround times on their loans. When this insurance is required, brokers also should be ready to tell clients why. 