

Lender Attitudes Toward Source and Nonsource Impaired Property Mortgages

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The results of a number of general surveys of lender policies and attitudes concerning environmentally impaired property have been published over the past several years.¹ In general, those surveys indicate that lenders have adopted policies addressing the environmental condition of a property. They also indicate that lenders tend to avoid lending when such property is to be used as collateral or to lend at incrementally higher premiums or at terms, and conditions that increase the borrower's costs as way of offsetting lender perceptions of higher risks.

A sample of mortgage lenders were surveyed on specific circumstances involving a source and a nonsource property. A source property is defined as the property on which a release of a hazardous substance occurred. Therefore, the owner of a source property is assumed to have liability under the *Comprehensive Environmental Response, Compensation and Liability Act* (CERCLA). A nonsource property is one that has been contaminated by a release of a hazardous substance on another property having no ownership or operating relationship to the subject. The sampling was conducted in two market areas, south Florida and Chicago.

The results of the sampling indicated that lenders were not *a priori* adverse to mortgage lending on either the source or the nonsource property at unimpaired market terms and conditions, given the situations that were described to them in the sampling. This result is somewhat at odds with what one might expect from earlier, more general published surveys of lender attitudes. Part of the apparent difference may be attributed to the normal respondent reactions to a general inquiry versus a specific case on which to base answers.

SAMPLING DESCRIPTION

Both samplings were conducted in an identical manner. Lenders were selected based on the premise that the lender was in the market area of the subject property and had a designated member of the Appraisal Institute on staff, or a designated member in the area knew of the lender's activities. Each lender was contacted to identify within its organization the individual most capable of providing experienced lending officer responses, given the type of property involved. That individual was then contacted by an appraiser with expertise in obtaining lender data and underwent several specific screening criteria. To prevent bias, the interviewer was not the person who constructed the questionnaire and was not acquainted with the respondent.

The screening criteria were number of years of experience in commercial and/or industrial property mortgage origination, and specific experience in environmentally impaired properties. If the individual did not have at least five years of experience lending to commercial and/or industrial properties and experience dealing with environmentally impaired properties, the interview was terminated.

As an additional qualification criterion, the individual was questioned about the lender's policy on environmental screening of property before granting a mortgage and was asked to provide an outline of the policy. If the lender did not have a written or an unwritten policy, or the individual could not provide a policy outline, the interview was terminated.

1. See Bill Mundy, "The Impact of Hazardous Material on Real Property Value," *The Appraisal Journal* (April 1992): 155-162; "Stigma and Value," *The Appraisal Journal* (January 1992): 7-13; "The Impact of Hazardous and Toxic Material on Property Value: Revisited," *The Appraisal Journal* (October 1992): 463-471; and John J. Healy and Patricia R. Healy, "Lenders' Perspectives on Environmental Issues," *The Appraisal Journal* (July 1992): 394-398.

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Case Descriptions

Once the screening procedure was cleared, a specific case was described to the individual. The following descriptions of the cases were read to the respondent:

Source property case description

"The subject property is a small (12,000-square-foot) industrial building approximately 20 years old in reasonable condition for its age. It is of masonry and steel frame construction with approximately 1,000 square feet of office space included within the building and located in an industrial park containing similar buildings with a high occupancy rate. An appraisal performed by a well-respected, experienced MAI concluded that the market value of the subject was \$475,000, assuming the building is ready for occupancy. According to the appraisal report, estimated gross annual rental income would be \$51,570 with an estimated net annual income of \$46,323 in 1991. Assume that all of the information is the same today as in 1991."

Nonsource property case description

"The property is a neighborhood shopping center with a strong positive cash flow more than sufficient to cover debt service, and an ownership that has successfully managed both the subject property and several similar properties for more than ten years. The property is held in a partnership and the net worth of the partners is in excess of ten times the amount requested. Individual guarantees by the partners are available.

"The subject property was appraised in 1990 and the value opinion was \$3.15 million. For purposes of this analysis, the 1990 value is assumed to be the current market value subject to confirmation by an appraisal. The existing loan has been successfully serviced since origination, but carries a higher than current market rate. The owners, therefore, feel it is desirable to obtain a replacement loan at contemporary rates. They are requesting a loan with a loan-to-value ratio of 70%,

seven-year term, 15-year amortization with a balloon payment."

After the case description had been read, the respondent was given an opportunity to clarify his or her understanding of the information. The questions asked by the respondent were recorded along with the interviewer's response to the questions. The interviewer had been briefed on the most likely questions and was required to provide responses within his understanding of the case.

The respondent was then asked specific questions about his or her organization's willingness to lend on the subject property, given the case description, and—in the source property case—the probable terms of any mortgage financing available. These responses were recorded in terms of recourse versus nonrecourse loan types, loan-to-value ratios, amortization schedules, call dates, interest rates, and likely closing costs.

The respondent was then informed that certain environmental conditions existed on the property and was given the following information:

Source property environmental condition

"An environmental issue of concern has been revealed by an American Society for Testing and Materials (ASTM) Phase I Environmental Site Assessment and additional data. As a result of the conditions identified, a competent, experienced environmental consultant has reviewed the available records. The following is a summary of findings and opinions:

"A review of the governing agency records indicates that the tenant of the property at the time the *Resource Conservation and Recovery Act* (RCRA) was first in effect had filed a request for RCRA Part A and Part B permits. Those permits were granted on an interim basis by the governing agencies.

"After an investigation and post-issuance review, the governing agencies notified the tenant to formally request a withdrawal of the permits because the tenant neither stored hazardous material nor generated hazardous waste. Thus, the permits should not have been issued as the tenant was not an RCRA facility. The governing agency asked

the tenant to send the appropriate paperwork withdrawing the RCRA permits. Because the tenant moved and went out of business, the administrative step for withdrawal of the permits was not completed. Accordingly, the permits are still present on the records.

"Small quantities of several common industrial substances were also identified in the soils on the subject property. These substances are of unknown origin. It is the considered opinion of the environmental expert that the substances will not require remediation due to low concentrations and lack of threat to human health and/or the environment. A requirement by the governing agencies to remediate the solvents is unlikely. The governing agency staff is aware of the situation and has expressed no interest in pursuing the matter."

Nonsource property environmental condition

"The environmental issue of concern has been revealed by an ASTM Phase I Environmental Site Assessment and additional data. It is summarized as follows:

"Adjacent to the subject property is a major brand gasoline station with underground storage tanks. Leaks and spills are likely to have occurred on the station property. The property owner and the operator have jointly undertaken investigative work that outlined the extent of the problem. Further, they have acknowledged responsibility for any leaks or spills originating on their property. Based on available information, it appears that some of the refined petroleum products entered the groundwater and migrated under the subject. The subject and surrounding properties do not use the groundwater, having full municipal water and sewer services.

"There are not now and have never been as far as can be determined any underground storage tanks on the subject. Remediation of

the groundwater underlying the subject will be wholly financed by the station owner and operator, who have sufficient financial resources to complete the work. The remediation activities should not disturb the subject's use, occupancy, or revenues. There is no evidence of any impact on the subject property's buildings nor is any expected."

The respondent was then given an opportunity to clarify his or her understanding of the environmental condition on the same basis as before. Having answered the respondent's questions about the case, the interviewer then asked the identical mortgage lending questions regarding the availability of funds for this situation and the terms and conditions associated with those funds, given the environmental description.

SAMPLING RESULTS

Table 1 indicates the respondents' average number of years of experience and loan-to-value ratios. The ranges of other responses are also shown. Note that the nonsource property sampling was conducted before the United States Environmental Protection Agency (EPA) issued its "EPA Policy Toward Owners of Property Containing Contaminated Aquifers" on May 25, 1995. This policy should improve the lending environment for the nonsource property case. The policy was summarized as follows:

As part of the Agency's Administrative Reform and Brownfields Initiatives, EPA is issuing a new policy toward certain owners of property to which hazardous substances have migrated in an aquifer from a source outside the property. Based on EPA's interpretation of CERCLA, the Agency will not pursue such property owners to perform cleanups or for reimbursement of response costs and will consider *de minimis* settlements with such owners where necessary to protect them from third-party contribution suits.²

ANALYSIS OF RESULTS

One of the first points to keep in mind is that the results of the sampling may be biased in the sense that lenders appear to be more wary of commercial property than of indus-

2. Environmental Protection Agency, "EPA Policy Toward Owners of Property Containing Contaminated Aquifers," *Environmental Due Diligence Guide* (1996): 501:1425 et seq.

TABLE 1 Summary of Sampling Responses

Data Description	Nonsource Property Responses	Source Property Responses
Number of respondents	10	5
Years of lending experience (average)	10.9	11.4
Experience with impaired properties:		
Number of properties	2,918+	229+
Number successfully placed	61%	75%
Unimpaired case:		
Willing to lend?		
Yes	8	5
No	2	0
Reason for not lending:		
Too small	2	0
Terms of lending:		
Recourse	7	4
Nonrecourse	1	1
Loan to value	NA	75%
Amortization (years)	NA	20-25
Call (years)	NA	3-5
Rate:		
Fixed	NA	7.875%-8.875%
Variable	NA	2%-3% over T-bill
Closing costs	NA	2% + appraisal fee
Impaired case:		
Willing to lend (of those willing to lend in the unimpaired case)?		
Yes	7	5
No	1	0
Reason for not lending:		
Environmental condition	1	0
Terms of lending:		
Recourse	6	4
Nonrecourse	1	1
Loan to value	NA	75%
Amortization (years)	NA	20-25
Call (years)	NA	3-5
Rate		
Fixed	NA	7.875%-8.875%
Variable	NA	2%-3% over T-bill
Closing costs	NA	2% + appraisal + environmental review costs
Additional conditions of lending:		
Cleanup performance bond	5	No
Owner guarantee of cleanup	6	No
Hold-harmless	6	No
Other	NFA	NFA

NA = Not asked in the survey.

NFA = "No further action" letter from the governing environmental agencies or a "no further action" opinion by a reputable environmental expert.

trial property. To the extent that this is an underlying phenomenon, it may be worth while to examine the nonsource property sampling absent the two respondents who were unwilling to lend because the loan was too small. All of the lenders expressed concern over the tenants of the commercial property and, in particular, were interested in whether or not a major retail anchor tenant was in place with a remaining lease term at least equal to the call date of the proposed mortgage. This issue obviously has nothing to do with the environmental condition of the property. In a similar vein, the industrial property lenders were very interested in owner occupancy and several stated that they would not lend to a property unless it was owner occupied. Again, this bias has nothing to do with the environmental condition.

Given these concerns, the results of the sampling indicate that a majority of lenders are prepared to provide mortgage financing on the same terms and conditions whether or not the property is affected by environmental conditions so long as those environmental conditions do not appear to create a financial threat to either the borrower or the lender. Put another way, the results indicate clearly that it is improper to characterize a contaminated property as "non-financeable" without careful, in-depth analysis and evaluation of the facts and circumstances of the case. While additional due diligence—with its attendant costs—may be reasonably anticipated by the borrower and those additional costs may be sufficient to decrease the property value to a minor extent (\$5,000 to \$15,000), the sampling suggests that no other incremental costs imposed by debt financing are likely.

Fee Simple? Hardly

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A discrepancy exists between the definition of "fee simple" and the prescribed methods for its valuation. Much as in the valuation of proposed buildings "as if" built and stabilized—a practice that is not allowable in every case but is acceptable when certain criteria exist¹—the key to avoiding a potentially misleading situation lies in identifying the valuation premise, clearly disclosing it in the report, and consistently applying it throughout the various methods of value used.

At the heart of the matter is terminology. Unfortunately, working with appraisal definitions can be frustrating because even the most fundamental terms often carry multiple meanings. "Market value" and "appraisal" are good examples of this. Market value has a list of definitions a mile long (A cursory review of bibliographies suggests that more *Appraisal Journal* articles have been

devoted to this definition than to any other topic.), and "appraisal" is such a sensitive term that the Appraisal Institute found it necessary to develop a supplemental standard specifically to clarify its meaning. Supplemental Standard 1 requires that the broad interpretation of the definition of "appraisal" that appeared in the Appraisal Institute's *Code of Professional Ethics* also be applied to the organization's *Standards of Professional Appraisal Practice*. This definition included any opinion of the nature, quality, value or utility of specified interests in, or aspects of, identified real estate. Furthermore, "identified real estate" was interpreted broadly by the Appraisal Institute to include even vague references in such statements as "commercial land in the downtown area."² (The Code definition of appraisal was recently changed to correspond with the definition in the *Uni-*

1. For an in-depth discussion of this issue, see The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice*, Advisory Opinion AO-17 (Washington, D.C.: The Appraisal Foundation, 1997), 145-149.

2. Appraisal Institute, *Standards of Professional Practice, Part B, Course Handbook* (Chicago, Illinois: Appraisal Institute, 1994), 1-14.

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