Common Sense Initiative
Access to Capital "Charrette"
Washington, D.C.

January 16, 1997

BACKGROUND

In the Fall of 1995, the Common Sense Initiative (CSI) Metal Finishing Subcommittee began the Access to Capital project. The initial goal of this project was to explore the barriers small metal finishers face in obtaining capital and to explore some innovative methods of financing environmental improvements. Throughout our conversations with metal finishers and other stakeholders, we have learned that metal finishing job shops have a difficult time obtaining capital for pollution prevention investments, capital improvements, or remediating existing contamination on-site. Further research has shown that these problems, while acute for metal finishers, are not isolated to this industry.

At the request of the Common Sense Initiative Council, we convened this meeting with members of industries dominated by small businesses (metal finishing, printing, printed wire board manufacturing), insurers, lenders, government agencies, and other interested stakeholders in order to:

- accurately define the specific obstacles (and methods for overcoming them) that these industries face in obtaining capital, especially for environmental investments;
- explore the potential benefits and availability of various "environmental" insurance policies;
- determine the appropriate role for EPA, the federal government, and the public/private sectors in general in facilitating industry's ability to improve their environmental performance through greater access to capital.

What is a *charrette*?

A charrette is an intensive information exchange workshop that seeks to develop solutions to specific issues or problem areas. Charrettes were initially used by architects and city planners (participants) who had reached an impasse and who required a meeting with a third party (panelists) to help them identify the cause of their conflict and to suggest methods for overcoming it.

PARTICIPANTS

Diane Cameron	Natural Resources Defense Council, CSI Metal Finishing Subcommittee
Stu McMichel	Custom Print, CSI Council, CSI Printing
Bob McBride	A.C. Plating, Vice President NAMF
Michael Kerr	The Institute for Interconnecting and Packaging Electronic Circuits (IPC) (Printed wire board industry)

PANELISTS

Ziona Austrian	Environmental Finance Center (Region 6)
Sloan Coleman	US Small Business Administration
Michael Curley	Environmental Finance Advisory Board
Scott Dosick	US EPA, OPPE, CSI Metal Finishing
Robert Hallenbeck	Environmental Compliance Services (Environmental Insurance)
Bill McElroy	Zurich American (Environmental Insurance)
Bruce McKenney	Industrial Economics, Inc.
Randy Muller	Bank of America (Chicago)
Richard Plewa	Comerica Bank (Michigan)

MODERATORS

Jack Greer	Maryland Environmental Finance Center
Beth Hickey	Maryland Environmental Finance Center

MEETING SUMMARY

CHARRETTE PARTICIPANTS FRAME THEIR ACCESS TO CAPITAL ISSUES

Industry participants presented their Access to Capital issues. Of the three sectors present, metal finishers have the greatest difficulty accessing capital. Printers and printed wire board manufacturers suggested that they may have less of a problem obtaining financing because they tend to have a lower risk of contaminated property and may have better cash flow.

According to Bob McBride of the National Association of Metal Finishers, his industry believes that the financial community treats them as “lepers.” In large part, the industry’s inability to obtain loans can be attributed to lenders' fears that assets taken as collateral will lose value due to past and/or future contamination. Metal finishers use a variety of hazardous materials (i.e., metals, acids, and solvents) in the plating process that could contaminate property and equipment.

Michael Kerr made the case that printed wire board manufacturers are not platers, even though electroplating is a portion of their operations. He believes that when his industry does have problems accessing capital, it is due to lenders over-estimating the environmental risks present at PWB facilities.

Stu McMichel of the printing sector stated that despite massive investments in toxic use reduction at his facility, lenders and insurers have not rewarded his risk reduction with either better access to environmental loans or decreased insurance premiums.

All three sectors complained that their equipment is undervalued as collateral by lenders, either because lenders perceive greater contamination than exists or misestimate the resale value. Diane Cameron discussed the subject of technology verification -- a protocol for verifying the efficacy and costs of operating various equipment (i.e., "does the equipment do what the seller says it will do"). Technology verification would provide information on equipment performance that could improve how equipment is valued on the open market. This could help lenders value equipment more accurately and provide a sounder basis for industry to purchase equipment.

BANKS CLAIM -- WE'RE LENDING TO ALL OF YOUR SECTORS!

The two representatives of the lending industry indicated that both of their banks have lent to all three sectors and do not reject loans outright simply because there is a potential for environmental liabilities. In their opinion, many small businesses may have trouble accessing capital because they rely on local community banks for financing. These smaller banks often do not have the resources to invest in developing expertise at evaluating environmental risks. If they are unable to measure environmental risks, they are unlikely to loan to small businesses in polluting industries. The representatives of the two larger banks suggested that this dynamic has led to the misperception that small businesses in polluting industries cannot obtain financing.

However, the lenders also noted that small loans tend to be less profitable than large loans because of the relatively higher transaction costs of processing small loans. Moreover, even though large lenders may be experienced at evaluating environmental risks, there are still costs involved in evaluating the environmental risks of the prospective borrower. If the size of the loan is small, and the evaluation of environmental risks requires a considerable effort, the transaction costs of the loan could outweigh its profitability.

ENVIRONMENTAL INSURANCE -- IT'S A BUYERS MARKET

According to both of the insurance charrette panelists, there is a glut of environmental insurance products on the market. These products include policies which could provide lenders coverage in the event that borrower's collateral becomes impaired by contamination. Bill McElroy pointed out that the insurance industry "doesn't make money by not insuring environmental risk. We're over-supplying right now." However, there are still questions as to the coverage and affordability of these policies for small companies.

Some firms may be unwilling to pay higher interest rates on a loan to cover environmental insurance costs, even if paying this "risk surcharge" would improve access to capital. Coverage and affordability issues need to be further explored by industry representatives and insurers to determine if cost-effective policies exist or can be developed to control environmental risk and thereby improve access to capital.

WILL GREATER ACCESS TO CAPITAL SLOW DOWN THE TREND OF INDUSTRY CONSOLIDATION?

A number of panelists wondered if improving access to capital might have the unintended affect of allowing "dirtier" firms to stay in business longer than they would otherwise. Without financing help, some older, higher polluting firms might exit the industry. In general, their capacity would be replaced by newer, cleaner production capacity.

In response, some panelists noted that older, dirtier firms often do not exit the industry because they fear incurring remediation costs for environmental liabilities. These firms might opt to exit the industry if they could finance the transition. Panelists suggested that greater access to capital could have three effects: (1) make site transition more possible for those firms that would like to exit the industry responsibly (a positive effect); (2) make it possible for some dirtier firms to continue operating longer than they would otherwise (a negative effect); and (3) provide an opportunity for some polluting firms to improve their environmental performance and stay in business (a positive effect).

Panelists agreed that exit strategies, like the Environmentally Responsible Transition recommendation that came out of the CSI Metal Finishing Subcommittee, could help older, dirtier firms transition out of business or to a new owner. Furthermore, panelists felt that CSI enforcement targeting projects could work to reduce the likelihood that firms purposely flaunting or disregarding applicable laws and regulations could continue operating, even with greater access to capital. They also felt that any Access to Capital program should only be targeted at companies seeking to improve their environmental performance.

EPIPHANIES & OPINIONS

- Each industry trade association should determine its sector's need for improved access to capital, and the demand for tools that help provide it.

- Many banks used to serve the financial needs of specific industrial sectors (e.g. Chemical Bank). In this way, banks had a better understanding of the lending risks for certain sectors. Small business sectors could consider developing alliances with one or two large lenders that are experienced in assessing environmental risks. Larger banks are not as resource-constrained as small, community lenders. Therefore, they are better equipped to develop in-house expertise in sector-specific environmental risk assessment. If industry could offer a high volume of loans to a lender, it would lower the transaction costs for the bank. Therefore, even small loans for businesses with environmental risks could be attractive to the lender.

  It should be noted that banks want to maintain a diversified lending portfolio, which suggests that specializing in lending to a particular industry may not be wise. However, because of their high volume and diversity of loans, large banks should not have a problem specializing in loans to an industry.

- It may be possible to use Capital Access Programs (like Michigan's) and other pooled loan funds to target specific industries and specific investments. EPA and/or SBA could provide credit enhancements to extend the reach of the programs to support environmental investments, if such firms are currently frozen out.

- An industry trade association-based insurance pool could be used to characterize and control industry-specific environmental risks.

- The loan securitization process groups similar loans together into a single unit, and then sells shares of this mix to investors. Securitization spreads risks, allows for the use of non-bank capital, and could help facilitate the flow of capital to small businesses in these industries.

- A trade association (like NAMF) could start an environmental loan fund using seed money from SBA/EPA. The advantage of such a program is the detailed industry knowledge that the trade association possesses. However, there are anti-trust and proprietary financial information issues which would have to be explored.

POTENTIAL RECOMMENDATIONS

■ **Develop Alliances With Large Commercial Lenders**

i. Steer credit-worthy firms (i.e. those with adequate collateral) to larger banks.

ii. Create alliances between industry and one or two larger banks who have (or can develop) specialized knowledge about the industry.

iii. Explore the relationship between loans and environmental insurance.

iv. Identify and/or develop insurance policies that the loan applicants or lenders could purchase. The lender's cost of insurance premiums could be passed on to loan applicants via higher interest rates.

■ **Use Existing Public/Private Partnerships; Develop New Ones As Needed**

i.

Examine State Capital Access Programs (CAP) and determine their ability to increase the flow of capital to these industries for environmental investments.

ii. If existing CAPs are not addressing environmental financing needs, research the possibility of developing an industry-specific CAP or SBA program.

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Trade Association Risk Pooling

i. Determine the demand for environmental insurance in general. (Insurance comprises about 1% to 4% of a metal finisher's total costs. How much more would small platers be willing to pay to internalize environmental risk?)

ii. Analyze captive insurance companies developed by other industries.

iii. Analyze the prospects for developing an association-sponsored captive insurance company.

- **Loan Securitization**

i. Research the applications of securitization for small business loans.

ii. Analyze other sectors' use of this approach, if any.

iii. Develop a plan for applying loan securitization to the metal finishing sector to improve access to capital for both on-going operations and site-transition.

- **SBA/Trade Association-Sponsored ACCESS TO CAPITAL Program**

i. SBA (or other entity) provides a grant to a trade association.

ii. The trade association utilizes the grant to purchase a CD (or other deposit account) from a lender to serve as collateral.

iii. The lender makes a loan to the trade association in the amount of the CD.

iv. The trade association creates a captive loan operation for the industry.

v. Loans are made to platers for environmental investments

vi. The trade association and EPA develop a simple, one-page application.

vii. Loans are made at 2-5% above prime in order to dissuade firms that are capable of accessing conventional loans. A portion of the surcharge can be used to accumulate a loan-loss reserve and possibly to pay the public sector back for a portion of the grant.

viii. The program should be targeted to a single sector, such as metal finishing.

NEXT STEPS

The Environmental Finance Advisory Board, established like CSI under the Federal Advisory Committee Act (FACA), sent representatives to the Access to Capital Charrette for the express purpose of providing recommendations to the Administrator on what steps could be taken to resolve small business Access to Capital issues. CSI and the EFAB will be working together to make a joint presentation to the CSI Council at an upcoming meeting. Near-term activities to move the Access to Capital project forward include:

- Review of the charrette recommendations by the CSI Access to Capital workgroup and development of a plan to take the charrette recommendations to the CSI Council. This review will also involve each sector reporting to their Subcommittee on the charrette's findings and soliciting feedback and guidance.

- Establish independent contacts between industry trade associations, lending institutions, and insurers. Representatives of all three industries have indicated that they have already initiated such contacts in order to set the stage for implementing some of the recommendations.

- Provide analytical support to facilitate industry follow-up on recommendations that are most relevant to their needs. The EPA team, working with the metal finishing sector, has already initiated this process.

If you would like further information about the background or current status of this project, please contact Scott Dosick at:

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