

NCUA LETTER TO CREDIT UNIONS

**NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314**

DATE: May 2008 LETTER NO.: 08-CU-13

TO: Federally Insured Credit Unions

SUBJ: Environmental Liability: Risk Management Guidance

**ENCL: (1) Appendix A – Guidance for an Environmental Risk
Management Program
(2) Appendix B – List of Resources**

Dear Board of Directors:

The purpose of this letter is to inform all federally insured credit unions of potential liability to your members, and possibly to the credit union, when environmental contamination is discovered on real property financed by the credit union. While environmental liability can occur with any real estate secured loan, it is generally more likely to occur with non-residential real estate (i.e., commercial use properties). All credit unions granting real estate secured loans need to be aware of this issue and credit unions granting member business loans secured by real estate should establish policies and procedures to help ensure liability in this regard is minimized.

The need and extent of environmental risk education and risk management will vary depending on the types of loans granted and the likelihood of an environmental hazard existing in the credit union's trade area. Federal laws provide defenses against the potential liability of having to pay for cleaning up a contaminated site for members as owners of real property and for a credit union in cases where foreclosure becomes necessary. If a member or credit union cannot invoke an established defense, the potential fines and costs for cleanup of a property could be substantial.¹ With the continued growth of residential and member business real estate secured loans in the credit union industry, it is important that we consider environmental liability as an element of risk in the

¹ The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), of 1980 and subsequent amendments establish fines and costs for particular environmental hazards, including daily and aggregate maximum amounts. CERCLA is just one federal environmental protection law to consider. There are other federal environmental laws, such as the Resource Compensation and Recovery Act, which can apply depending on the type of environmental hazard present. There may also be liability under state environmental laws.

lending process. I encourage you to use this letter to assist in informing staff of environmental risk considerations, including ways to mitigate risk.

If you have any questions or concerns, please contact your NCUA Regional Office or State Supervisory Authority.

Sincerely,

JoAnn Johnson
Chairman

Enclosures

APPENDIX A

GUIDANCE FOR AN ENVIRONMENTAL RISK MANAGEMENT PROGRAM

BACKGROUND

Congress enacted the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), in 1980 that gave the United States Environmental Protection Agency (EPA) the authority to respond to human health and environmental hazards posed by hazardous substances at sites. Subsequently, Congress passed the Small Business Liability Relief and Brownfields Revitalization Act to help move brownfield sites² back into circulation by offering CERCLA liability protection to owners that satisfy specific provisions, including environmental due diligence requirements. The EPA issued its All Appropriate Inquiries (AAI) Rule effective November 1, 2006, which establishes the due diligence standards and practices related to assessing the prior ownership and uses of a property. Performing AAI is one of several requirements that must be met in order for a property owner to avoid liability under CERCLA.

SCOPE

Environmental liability can occur with any real estate secured loan, but it is more commonly found with loans secured by commercial use properties. Liability under CERCLA generally does not apply to residential real estate secured loans. The scope of the AAI Rule does not include property purchased by a non-governmental entity or non-commercial entity for residential use where an onsite inspection and title search reveal no basis for further investigation. CERCLA states that in those cases, the title search and site inspection will satisfy the requirements of AAI.

While meeting the requirements of the AAI Rule can help to provide protection from CERCLA related liability, this protection does not apply to other federal environmental statutes, and, depending on state law, state environmental statutes.

CERCLA provides liability exemptions for credit unions (i.e., secured lender) if certain conditions are met.³ The secured lender exemption within CERCLA is not conditioned upon a credit union undertaking AAI prior to issuing a mortgage or

² With certain legal exclusions and additions, the term 'brownfield site' means real property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant.

³ CERCLA, chapter 103, subchapter I, Section 9601(20)(E), establishes exclusions from related liability for lenders.

prior to the property being purchased by a member. Requiring a member to perform AAI prior to granting a real estate secured loan could provide added liability protection for the member, which in turn could better protect the credit union, as associated costs for environmental liability could lead to member default and contamination would likely cause a decline in collateral value.

ENVIRONMENTAL RISK MANAGEMENT PROGRAM GUIDANCE

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors in evaluating real estate transactions and making loans secured by real estate. The need to perform more extensive due diligence prior to granting such loans predominately applies to those loans secured by commercial use properties. Credit unions should consider implementing an environmental risk management program, as applicable, to address related risks.

The board of directors should review and approve the program and, if warranted, designate a senior officer knowledgeable in environmental matters responsible for program implementation. The environmental risk program should be commensurate with the credit union's operations. Credit unions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk management program than credit unions that lend more to lower-risk industries or localities. For example, loans collateralized by 1- to 4-family residences normally have less exposure to environmental liability than loans to finance industrial properties.

ELEMENTS OF AN ENVIRONMENTAL RISK MANAGEMENT PROGRAM

An environmental risk management program should include staff training, policy guidelines and procedures, an environmental review or analysis during the application process, loan documentation standards, and establishment of appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

Training

The environmental risk management program should incorporate training sufficient to ensure that the program is implemented and followed within the credit union, and the appropriate personnel have the knowledge and experience to determine and evaluate potential environmental concerns that might affect the credit union. Whenever the complexity of the environmental issue is beyond the expertise of credit union staff, the credit union should consult legal counsel, environmental consultants, or other qualified experts.

Policies

When appropriate, loan policies and procedures should address environmental issues pertinent to the credit union's specific lending activities. For example, the loan policy may identify the types of environmental risks associated with industries and real estate in the credit union's trade area, provide guidelines for conducting an analysis of potential environmental liability, and describe procedures for the resolution of potential environmental concerns. Procedures for the resolution of environmental concerns might also be developed for credit monitoring, loan workout situations, and foreclosures.

Environmental Risk Analysis

Prior to making a loan, an initial environmental risk analysis should be conducted during the application process. Most of the information needed may be gathered by the loan officer when interviewing the loan applicant concerning his or her business activities. In addition, the loan application might be designed to request relevant environmental information, such as the present and past uses of the property and the occurrence of any contacts by federal, state or local governmental agencies about environmental matters. It may be necessary for the loan officer or other representative of a credit union to visit the site to evaluate whether there is obvious visual evidence of environmental concerns.

Structured Environmental Risk Assessment

Whenever the application, interview, or site visit indicates a possible environmental concern, a more detailed investigation by a qualified individual may be necessary. This assessment may include surveying prior owners of the property, researching past uses of the property, inspecting the site and contiguous parcels, and reviewing company records for past use or disposal of hazardous materials. A review of public records and contact with federal and state environmental protection agencies may help determine whether the member has been cited for violations concerning environmental laws or if the property has been identified on federal and state lists of real property with significant environmental contamination. The credit union's policies and procedures should reflect adequate consideration of the EPA's AAI Rule. The decision to require a member to perform a property assessment that meets the requirements of the EPA AAI Rule should be made in the context of the credit union's overall environmental risk management program and should be made on a case-by-case basis.

Monitoring

The environmental risk assessment should continue during the life of the loan by monitoring the member and the collateral for potential environmental concerns. The credit union should be aware of changes in the business activities of the member that result in a significant increased risk of environmental liability associated with the collateral. If there is a potential for environmental contamination to adversely affect the value of the collateral, management might exercise its rights under the loan to require the member to resolve the

environmental condition and take those actions that are reasonably necessary to protect the value of the real property.

Loan Documentation

Loan documents should include language to safeguard the credit union against potential environmental losses and liabilities. Such language could include requiring the member to comply with environmental laws, disclosure of information about the environmental status of the collateral, and granting the credit union the right to acquire additional information about potential hazardous contamination by inspecting the collateral for environmental concerns. The loan documents may also require that the credit union has the right to call the loan, to refuse to extend funds under a line of credit, or to foreclose if the hazardous contamination is discovered in the real property collateral. The loan documents may call for an indemnity of the credit union by the member and any loan guarantors for environmental liability associated with the collateral. Credit unions are encouraged to consult with an attorney knowledgeable in federal and state environmental laws to help ensure loan documents are properly worded to help safeguard against environmental liability.

Involvement in the Member's Business Operations

Under CERCLA and many state environmental cleanup statutes, a credit union may have an exemption from environmental liability as the holder of a security interest in real property collateral. In monitoring a loan for potential environmental concerns, and resolving those environmental situations as necessary, a credit union should evaluate whether its actions may constitute "participating in management"⁴ of the business located on the real property collateral within the meaning of CERCLA. A lender "participates in management" (and may not qualify for the exemption) if the lender "actually" participates in the management or operational affairs of a property. Merely having the capacity to influence or the unexercised right to control the property does not constitute "participating in management."

Furthermore, a lender "participates in management" if the lender, while the borrower is still in possession of the property encumbered by the security interest:

- exercises decision-making control regarding environmental compliance related to the property and, in doing so, undertakes responsibility for hazardous substance handling or disposal practices; or
- exercises control at a level similar to that of a manager of the property and, in doing so, assumes or manifests responsibility with respect to:
 - day-to-day decision-making on environmental compliance, or

⁴ CERCLA, chapter 103, subchapter I, section 9601(20)(F) defines "participation in management".

- all, or substantially all, of the operational (as opposed to financial or administrative) functions of the property other than environmental compliance.

“Participation in management” does not include such actions as:

- holding a security interest or abandoning or releasing a security interest;
- including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty or other term or condition that relates to environmental compliance;
- monitoring or enforcing the terms and conditions of the extension of credit or security interest;
- monitoring or inspecting the property;
- requiring a response action in connection with a release or threatened release of a hazardous substance;
- providing financial or other advice to the member in an effort to mitigate, prevent or cure default or diminution in the value of the property;
- restructuring the terms and conditions of the extension of credit or security interest, or exercising forbearance; or
- exercising other remedies for the breach of the extension of credit or security agreement.

If a credit union’s actions are considered to be “participation in management”, the credit union may lose its exemption from liability under CERCLA or similar state statutes.

Foreclosure

A credit union’s exposure to environmental liability may increase significantly if it takes title to real property held as collateral. A credit union should evaluate the potential costs and liability for environmental contamination in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means. Based on the type of property involved, a credit union should consider including as part of this evaluation of potential environmental costs and liability an assessment of the property that meets the requirements of the EPA AAI Rule.

APPENDIX B

List of Resources

This letter was created from information obtained from the following sources:

Federal Deposit Insurance Corporation. Financial Institution Letter FIL-98-2006, issued November 13, 2006, titled, "Environmental Liability: Updated Guidelines for An Environmental Risk Program".

<http://www.fdic.gov/news/news/financial/2006/fil06098.html>

U.S. Environmental Protection Agency (EPA). Their website has numerous links to CERCLA related information, including links to the Federal Register for the final AAI Rule, and several question and answer formatted documents clarifying key aspects of the rule. All related links can be found at:

<http://epa.gov/brownfields/regneg.htm>