ENVIRONMENTAL INSURANCE AND FINANCIAL INSTITUTIONS

The success of any financial institution is contingent, in large part, on the effective management of risk. Pollution-related exposures – often significant and just as often under-managed – can impact the financial strength of a firm, the returns generated by lending and investment activities and the quality of services provided to clients.

What can be done? The answer is a comprehensive environmental risk management plan and risk financing strategy. But first, financial institutions must understand the exposures they face.

KEY FINANCIAL INSTITUTION EXPOSURES

EQUITY POSITIONS IN BUSINESSES AND REAL ESTATE

Potential exposures from investments can be as varied as the assets in the portfolio. Environmental problems arising from either previously unknown historic contamination or future incidents can require expensive cleanup activity, reduce asset values and make future transfer or sale extremely difficult.

LENDING ACTIVITIES

Problems with loan portfolios can materialize in two ways: 1) when environmental problems cause borrowers to default on their loans and 2) when a borrower defaults for another reason and the lender forecloses on an environmentally distressed property.

INVESTMENT BANKING AND TRANSACTIONAL SERVICES

Environmental liabilities can create a variety of obstacles to any transaction involving the purchase or sale of properties and businesses. Ineffective management of these problems can introduce unexpected costs, heighten risk and uncertainty, and often block otherwise attractive deals.

OWNERSHIP AND OPERATION OF BUILDINGS AND PROPERTIES

A financial institution's portfolio of owned real estate used for retail branches or administration can present potentially significant environmental exposures, including mold-related indoor air quality issues and vapor intrusion from contamination beneath buildings. Additional liabilities may also emerge from legacy contamination problems associated with past industrial use of a property.

The potential consequences can include:

- **Direct losses.** Legal defense costs add up quickly; so can unexpected cleanup expenses and damage payments to third parties.
- **Indirect losses.** Pollution events can trigger a variety of consequential losses; for example, contamination can render facilities unusable, causing business interruption losses, loss in rental income and costs associated with relocation.

- **Devalued equity positions** or **impeded investment banking transactions.** Environmental liabilities can dramatically impact the overall value of large asset holdings or the transferability of individual assets.

REAL SOLUTIONS

When used in coordination with other risk management techniques, Environmental insurance provides parent companies and their directors and officers with blanket coverage for environmental liabilities emanating from lending activities, equity investments, joint venture enterprises or subsidiary operations.

Environmental insurance products can be used to:

- Protect against loan defaults caused by pollution problems
- Protect lenders from direct liability emanating from owned properties or foreclosure properties
- Facilitate mergers/acquisitions, investment banking or real estate transactions
- Protect equity investors from long-tail environmental liability exposures after completion
- Replace indemnities and/or warranties and help ensure a clean exit for equity providers
- Provide security in the event of concerns about buyer or seller credit-worthiness
- Quantify and cap actual or potential remediation liabilities or environmental obligations

Some of the new, more flexible products available in the marketplace do not require the individual scheduling of locations, disposal sites, transportation exposures or contracting operations. Like other pollution policies, there are many optional enhancements – such as pollution impacts of terrorist acts related to nuclear, biological, chemical or radiological agents (NBCR).

Coverage can be designed to transfer unknown historical contamination risks and/or insure against losses associated with future operational pollution risks – in some cases for up to 10 years. Policies can be worded so that they are fully transferable and often jointly insure various parties (e.g., acquirer and lender). Coverage scope can include payments for cleanup costs, bodily injury and property damage, legal defense and even business interruption.

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AN EXPENSIVE EXAMPLE

A California appeals court found a national bank liable for environmental problems at nine oil wells, even though the bank held only mineral rights. The bank acquired an interest in the mineral rights when it merged with another entity. When the lessee of the property on which the wells were located later declared bankruptcy, the California Division of Oil and Gas ordered the bank to plug the wells, remove debris and clean up the site.

The court concluded that the bank had a responsibility to manage the restoration of the abandoned wells based on its "independent status as the owner." Furthermore, the court found that public policy favored the assignment of cleanup responsibility to the bank because of the state's interest in remediation of sites. The cleanup costs exceeded $2.5 million.