Financial Institutions (FI) face a myriad of environmental exposures. Not only must they be mindful of environmental contamination when they consider a location for a branch or operations facility, they must also conduct extensive due diligence when considering a loan or investment that is either financing a piece of real estate or is secured by one.

In this Alert, we spotlight the potential impact of these exposures on an FI’s ability to conduct business and present risk management solutions, including a review of Environmental coverages available in today’s market.

Willis has long been a leader and innovator in the area of Environmental insurance. Our national Environmental Practice is prepared to assist our FI clients as they attempt to evaluate and quantify the impact of these risks on their business transactions. Rick Secchia, the author of this Alert, is a senior member of our Environmental team.

As you read this issue, please keep in mind that environmental impact is a critical issue in the insuring of certain terrorism-related risks, including nuclear, chemical and biological pollution. There are solutions available today that can help you proactively address the full range of environmental risks.

As always, we sincerely appreciate the opportunity to serve you. Please contact me, Rick or your local Client Advocate with questions about these important issues.

– John Bayeux, FI Industry Practice Leader

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. Insurance-based solutions are a critical part of an overall strategy to manage these risks.

Multiple Exposures

Pollution-related exposures arise from a variety of circumstances:

• **Direct 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. In the course of facility maintenance, large commercial office complexes may handle a variety of hazardous materials that can result in various types of pollution. Liabilities may also exist due to legacy contamination problems from past industrial use of a property.

• **Equity Positions in Businesses and Real Estate**
  Potential exposures from such 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 funding of cleanups, reduce asset values or make future transfer or sale extremely difficult.
A Loan Portfolio
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. Even a single default or contamination problem in a firm’s portfolio can compromise overall returns.

Performing Investment Banking and Transactional Services
Contamination problems can create a variety of obstacles to any transaction involving the purchase or sale of properties and businesses. Ineffective management of these problems can negatively impact the services provided by financial institutions in support of such transactions by introducing unexpected costs, heightening risk and uncertainty, and outright blocking otherwise attractive deals.

Potentially Serious Consequences

Direct Losses from Cleanup and Damages Payments
Most asset managers are well aware of the severe financial losses that can arise from pollution events. These direct costs include legal defense, cleanup to satisfy regulatory requirements and payments to injured third parties. Often, these costs can rise suddenly and without warning to many times the initial estimates.

Indirect Losses Such as Business Interruption
Pollution events can trigger a variety of consequential losses. For example, contamination can render facilities unusable, causing business interruption losses. Also, failure to perform full and appropriate financial disclosure of environmental liabilities can create additional liabilities resulting from shareholder litigation.

Devalued Equity or Loan Portfolios
The potential magnitude of the cost of addressing even a single contamination event can impact the overall value of large asset holdings or the transferability of individual assets.

Impeded or Blocked Investment Banking Transactions
Attractive business opportunities can be lost due to an inability to assess and contain environmental risk. Often buyers and sellers will have widely divergent valuations of the same environmental problem.

Weakness of Traditional Risk Controls
Many established methods used by financial institutions to prevent or contain environmental risks have fundamental deficiencies and offer incomplete solutions:

Over-Reliance on Due Diligence
Some real estate asset or loan managers rely exclusively on environmental due diligence efforts to screen out pollution problems from their portfolios. This is only partially effective because of the unavoidable errors associated with preparing due diligence reports and the potential severity of even a single loss event within a portfolio.

Incremental Spending Approaches
Known contamination problems are often addressed through a seemingly endless series of investigations and corrective measures that do not take advantage of performance-based contracts or insurance. Instead, they are performed by contractors who assume no risk and have no incentive to expedite final resolution.

Transaction Complications
Several approaches (other than Environmental insurance) — each with inherent weaknesses — are often employed to enable a property sale or M&A transaction. Even if they succeed, these approaches can negatively impact the long-term success of the transaction and may leave unwanted assets — and their accompanying liabilities — lingering on balance sheets.
Effective Risk Management Solutions

Environmental insurance, when used in coordination with other risk management techniques, can:
- Provide blanket coverage for exposures from owned properties
- Protect equity investments from pollution-related losses
- Protect against loan defaults caused by pollution problems
- Facilitate mergers & acquisitions (M&A), investment banking or real estate transactions

More specifically, insurance can:
- Offer protection from future environmental liabilities, e.g., currently unknown but existing contamination that is not discovered until a future time, as well as pollution incidents that occur in the future
- Minimize the impact of known contamination problems on total expenditures, financial disclosure and potential acquisition or divestiture of property and businesses

Insurance should not be used as a substitute for proper environmental due diligence; however, when used to supplement such reviews, the right insurance can offer site owners or lenders protection against problem situations that are overlooked.

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). They can be designed to protect the underlying venture itself or protect lenders from defaults caused by pollution events. Coverage scope can include payments for cleanup costs, bodily injury and property damage, legal defense and even business interruption.

Also available are insurance products that can cap known liabilities such as remediation costs. They provide funds for unanticipated cost overruns that might result from a variety of factors including discovery of additional contamination, underestimation of project costs or changes in regulatory requirements. Such insurance is increasingly used in M&A or real estate transactions in which a third party is brought in to assume cleanup liabilities for a single fixed cost. A growing market of engineering service providers will accept management of these risks and, if desired, assume ownership of contaminated assets. The capability of these firms to accept such liabilities is enabled by a structured insurance program that provides long-term financial assurance and security. Such approaches allow sellers to transfer contaminated assets to buyers without either party retaining or assuming any cleanup obligations.

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