June 7, 2001

Kevin M. David, Esq.
Webster First Federal Credit Union
One North Main Street
Webster, MA 01570

Re: Construction and Development Lending.

Dear Mr. David:

You have asked us to clarify how the 35% equity requirement for construction and development (C & D) loans under NCUA's member business loan rule applies in practice. 12 C.F.R. §723.3(b). You also have asked if this requirement may be waived under §723.10 of the rule. 12 C.F.R. §723.10. As discussed more fully below, C & D loan borrowers must have a minimum of 35% equity interest in the project being financed based on the value of the project at the time the loan is made. A credit union may apply for a waiver of this requirement under the waiver provisions of the rule. 12 C.F.R. §§723.10-723.13.

Member business loans pose a greater risk to credit unions and the National Credit Union Share Insurance Fund (NCUSIF) than consumer loans. Historically, member business loans have exposed credit unions and the NCUSIF to significant losses. C & D loans are among the most speculative and risky member business loans a credit union can make. Because of the increased risk associated with C & D loans, §723.3 subjects them to additional requirements. For example, §723.3(b) provides "[t]he borrower [of a construction and development loan] must have a minimum of 35% equity interest in the project being financed." Another way of stating this is that the loan-to-value (LTV) ratio for C & D loans cannot exceed 65%. The higher equity and more restrictive LTV ratio requirements serve to impose additional discipline on borrowers and reduce the credit union's risk.

There are two commonly asked questions about this provision. First, how is a borrower's equity interest measured? Second, how is the value of the financed project determined? A borrower's equity interest in a project may include down-payment money and the value of land owned by the borrower on which the project is to be built, less any liens. The borrower's equity interest is measured in relation to the value of the project. In the definition of "loan-to-value ratio" found in §723.21, the term "value" is defined as the market value of the collateral used to secure a loan. 12 C.F.R. §723.21. Market value is typically reflected in appraisals and other valuation tools available to credit unions. Because C & D projects are typically very speculative in nature, appraisals that attempt to determine the future market value of the completed project tend to be unreliable. Accordingly, NCUA believes it is more prudent to use the market value of the project at the time the loan is made. This includes the appraised value of land owned by the borrower on which the project is to be built, less any liens, plus the cost to build the project. This valuation is to be used for calculating the borrower's equity interest and the maximum permissible loan amount based on a 65% LTV ratio.

Section 723.10(c) permits credit unions to seek a waiver from the C & D loan limits in §723.3 including the 35% equity requirement. 12 C.F.R. §723.10(c). Sections 723.11, 723.12 and 723.13 provide greater detail about the waiver process. 12 C.F.R. §§723.11, 723.12 and 723.13.

Sincerely,

Sheila A. Albin
Associate General Counsel

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