



NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

March 19, 1991

Cheryl N. Ray, Loan Manager
England Federal Credit Union
P.O. Box 12490
Alexandria, Louisiana 71375-2490

Re: Member Business Loans (Your March 6, 1991 Letter)

Dear Ms. Ray:

You requested clarification of the meaning of the phrase, "one other such dwelling owned by the member" in Section 701.21(h)(1)(i)(A)(3) of NCUA's Rules and Regulations, 12 C.F.R. §701.21(h)(1)(i)(A)(3) ("exception (i)(A)(3)"). That phrase is not specifically defined. However, the meaning of the exception was discussed in the preamble to the rule (52 F.R. 12366, April 16, 1987). In the preamble, the NCUA Board stated that the three exceptions listed in Section 701.21(h)(1)(i)(A):

will permit a member to have a total of three fully secured loans (primary residence, secondary residence and one other) that would not otherwise be subject to Section 701.21(h). This change should accommodate those instances where a member purchases a new primary residence and does not sell his prior residence but, instead, rents it to a family member or other person. In many cases, the motivation to maintain the old residence is not investment oriented but rather to provide a home for a family member.

Although a former residence later rented out is the only example specifically discussed in the preamble, it is merely an illustration, and not the only type of property that falls

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within exception (i)(A)(3). Moreover, while the preamble suggests that investment oriented property does not fall within exception (i)(A)(3), the rule itself is not so narrow.

We have previously interpreted exception (i)(A)(3) in two letters, copies of which are enclosed. Although our responses were based upon the specific facts presented, the letters may further your understanding of the exception.

Please be advised that on January 24, 1991, the NCUA Board issued a proposed revision of Section 701.21(h), which would eliminate the current rule's exceptions for one to four family dwellings owned by the member. 56 F.R. 2723. We are enclosing a copy of the proposed rule for your information. We anticipate that the Board will issue a second proposed revision of Section 701.21(h) within the next few months, and that the newer version will also eliminate exception (i)(A)(3).

Sincerely,



Hattie M. Ulan
Associate General Counsel

Enclosures

GC/MRS:sg
SSIC 3500
91-0305



NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

December 6, 1990

Clara Temporal
Program & Resource Director
Hawaii Credit Union League
1654 South King Street
Honolulu, Hawaii 96826-2097

Re: Section 701.21(f) of NCUA's Rules and
Regulations (Your October 22, 1990, Letter)

Dear Ms. Temporal:

You have asked whether a member may receive a 20-year loan from an FCU for general maintenance on an 8-unit apartment building under Section 701.21(f) of NCUA's Rules and Regulations. The answer is no.

BACKGROUND

The member owns an 8-unit apartment building which is also his primary residence. One of the apartments is occupied by the member's son. The member receives rental income on the other six units. The member wishes to receive a loan from the FCU with a maturity in excess of 12 years to do general maintenance on the building. The FCU would like to grant this loan under its home equity line-of-credit program. There is no mortgage on the building so this would be a nonpurchase first mortgage loan.

ANALYSIS

Section 701.21(f) states in part that:

Notwithstanding the general 12-year maturity limit on loans to members, a Federal credit union may make loans with maturities of up to 20 years in the case of a second

* Vol. I, C, 20 Commercial Loans

mortgage loan (or a nonpurchase money first mortgage loan in the case of a residence on which there is no existing first mortgage) if the loan is secured by a residential dwelling which is the residence of the member-borrower

Section 701.21(g), which governs mortgage loans of up to 40 years, limits such mortgages to 1-to-4 family dwellings. Section 701.21(f) (the 20 year authority) does not have such a limit; however such loans must be made on a member's residence. Furthermore, 20-year loans are not limited to the member's principal residence and can be made on second or third homes (e.g., vacation homes) that are used by the member as long as the statutory requirements of Section 107(5)(A)(ii) of the FCU Act are met. We also note that a line of credit can be secured by a residence (home equity) and is not subject to any maturity limit. However, if a loan meets the business loan definition, it is subject to different limitations.

Member business loans are defined in section 701.21(h)(1)(i) as:

. . . any loan, line of credit, or letter of credit, the proceeds of which will be used for a commercial, corporate, business or agricultural purpose

Section 701.21(h)(1)(i)(A) excludes from the definition of a member business loan a loan or loans fully secured by a lien on a 1-to-4 family dwelling that is: (1) the member's primary residence; or (2) the member's secondary residence; or (3) one other such dwelling owned by the member. Since the apartment building is an 8 unit dwelling, it does not come within the above cited exception to the business loan rule. Exclusions found in Section 701.21(h)(1)(i)(B) through (D) are not applicable in this situation.

The loan will be classified as a business loan if it meets the above cited definitional criteria. The use of the proceeds of the loan determines whether or not the loan comes within the purview of the rule. Under your fact scenario,

Clara Temporal

December 6, 1990

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the proceeds will be used primarily to maintain the entire commercial property; thus the loan is for commercial purposes and should be classified as a member business loan with a maturity limited to 12 years. All other requirements of the business loan rule (Section 701.21(h)) must be complied with. If the loan were to be used only for improvement to the member's living unit (his residence), it would not be subject to the business lending rule.

One last note. You stated in your letter that a 1-4 family dwelling could also derive rental income without being classified as a business loan under certain circumstances. A loan may be exempt from the business loan rule pursuant to Section 701.21(h)(i)(A), as noted above. However the Section 701.21(h)(i)(A) exemption is limited to 1-4 family dwellings. By its terms the exemption can not be applied to an 8 unit dwelling.

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Associate General Counsel

GC/MM:sg
SSIC 3501
90-1103



NATIONAL CREDIT UNION ADMINISTRATION
Washington, DC 20436

August 17, 1987

Office of General Counsel

GC/JT: g
4650

Mr. Ed Muehlenberg
Vice President - Legislation
Wisconsin Credit Union League
10025 W. Greenfield Ave.
West Allis, Wisconsin 53214

Dear Mr. Muehlenberg:

This is in response to your letter of June 10, 1987, in which you raised several questions with respect to Section 701.21(h) (member business loans) of the NCUA Rules and Regulations.

You note in your letter that Section 701.21(h) (1) (i) (A) excludes from the definition of member business loan a loan or loans fully secured by a lien on a 1 to 4 family dwelling that is: (1) the member's primary residence; or (2) the member's secondary residence; or (3) one other such dwelling owned by the member. You asked whether "property out in the country with acreage" would qualify under one of the Section 701.21(h) (1) (i) (A) exclusions. You provided the following fact patterns with respect to this question: (1) a former farm active in dairying or cash cropping; (2) a member that raises and houses horses as a hobby; (3) a member who pastures beef cattle for grazing purposes; (4) a member who rents excess land to others who farm in the area; and (5) a member who purchases property with the intent to return it to a natural state.

We would begin by noting that a member business loan is generally defined in Section 701.21(h) (1) (i) as any loan which will be used for a commercial, corporate, business, or agricultural purpose. Applying this definition to the examples you have provided leads us to the following. It would appear that your example (2), where a member obtains a real estate loan secured by property on which the member will raise horses as a hobby, is not a business loan within this definition. It is unclear as to whether the activity described in example (5) constitutes a business and, therefore, falls within the definition of business loan.

As to your remaining examples, we direct your attention to the definition of 1 to 4 family dwelling. The term "1 to 4 family dwelling" has been defined as a conventional home, condominium

Mr. Ed Muehlenberg

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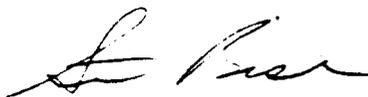
unit or cooperative unit. (See, 48 Fed. Reg. 52475, November 18, 1983). While it is not clear from the fact patterns you presented us, we assume that in each example there is a 1 to 4 family dwelling on the property. If not, the property is not within the Section 701.21(h)(1)(i)(A) exclusions. To the extent the property surrounding the dwelling is used for business purposes, as would appear to be the case in examples (1), (3), and (4), the property would not be within the Section 701.21(h)(1)(i)(A) exclusions.

You stated in your letter that the types of loans described by your fact patterns should be excluded from the business loan rule because they "will not create income to base any loan repayment upon." Although that may be the case, the source of the funds to repay the loan is not relevant in determining whether a given loan will be within the member business loan rule. Rather, it is the use of the proceeds of the loan that is determinative of whether or not the loan comes within the coverage of the rule.

Your final question pertained to Section 701.21(h)(3). Under this Section, a Federal credit union is prohibited from making member business loans to several individuals, including any member of the board of directors who is compensated as such. This provision is made applicable to federally-insured state credit unions by Section 741.3. You stated that, in Wisconsin, a director cannot be compensated for services performed as a director, but if the director is also an employee of the credit union, e.g., a loan officer, he could receive compensation for this service. You were concerned that a volunteer director who is also a compensated employee of the credit union would be prohibited by Section 701.21(h)(3) from obtaining member business loans. You need not be concerned. The prohibition applies only where the director is compensated for services he performs as a director. While you state that Wisconsin does not permit this type of compensation, there are states that do, making the prohibition necessary. Also, under Section 112 of the FCU Act, one board officer may be compensated as such. However, to the extent that the individual (director) performs services as an employee of the credit union and receives compensation only for such services, he/she would not be prohibited from obtaining a business loan from the credit union.

We trust this has been of assistance.

Sincerely,



STEVEN R. BISKER
Assistant General Counsel

JT:sg

RULES & REGULATIONS

January 18, 1991

NATIONAL CREDIT UNION ADMINISTRATION

12 C.F.R. PART 701

Organization and Operation of Federal Credit Unions

AGENCY: National Credit Union Administration (NCUA)

ACTION: Notice of Proposed Rulemaking

SUMMARY: The NCUA Board is proposing to revise Section 701.21(h) (Member Business Loans) of its Rules and Regulations. The proposal results from NCUA's policy to periodically review each of its regulations. This proposal will clarify certain portions of the existing regulation and amend or add other provisions.

DATE: Comments must be received on or before (60 days after publication in the Federal Register). (*March 25*)

ADDRESS: Send comments to Becky Baker, Secretary of the Board, National Credit Union Administration, 1776 G Street, NW, Washington, D.C. 20456.

FOR FURTHER INFORMATION CONTACT: D. Michael Riley, Director, David Marquis, Deputy Director or Timothy P. Hornbrook, Director, Department of Supervision, Office of Examination and Insurance, NCUA, at the above address, or telephone: (202) 682-9640.

SUPPLEMENTARY INFORMATION:**A. Background**

The NCUA Board adopted final rules regulating member business loans effective July 1, 1987. NCUA began collecting data on member business loans with the Call Report for June 1986. At that time, federally insured credit unions held less than \$800 million in commercial loans. In 4 year's time, that amount has grown by about 78 percent to approximately \$1.4 billion in commercial loans (see Exhibit A). This represents .7 percent of the total assets of all credit unions. About 7 percent of federally insured credit unions (895) are currently engaged in some form of business lending to their members.

Although business loans account for less than 1 percent of total assets in aggregate, this percentage is much higher for those credit unions actively engaged in granting such loans. See Exhibit B for a distribution of credit unions granting member business loans by CAMEL rating. As indicated in Exhibit C, credit unions granting member business loans have, on average, 3.7 percent of assets committed to member business loans. This is over five times the national average of member business loans granted by federally insured credit unions. As a result, credit union exposure is significant among those credit unions involved in this activity.

Member business lending has exposed both credit unions and the National Credit Union Share Insurance Fund (NCUSIF) to significant losses over the past 4 years. In a cursory review of the five largest failures in each region during fiscal year 1990, commercial lending was a factor in 16 of the 30 cases. These 16 cases caused losses in excess of \$100 million. When combined with ineffective management and other contributing factors, commercial lending can and does result in significant losses. Clearly, the volume of losses attributable to member business loans is extraordinarily high in proportion to the total of all credit union lending.

The adequacy of reserves appears to be a significant factor to successful operations. Among well-operated credit unions offering member business loans, less than 6 percent had commercial loans in excess of reserves (less Allowance for Loan Losses). On the other hand, more than 25 percent of less well-operated credit unions had member business loans in excess of reserves. Exhibit D illustrates this relationship.

Member business lending requires unique skills in underwriting and administration which are different from those typically required to originate consumer loans. Success in commercial lending requires that lenders retain experts with commercial lending expertise. In view of the staffing and administrative expense involved, few lenders are capable of servicing all types of commercial loans, in addition to consumer loans. For the most part, credit unions offering commercial loans do so on an extremely limited basis. Few credit unions are able to establish commercial loan departments due to an insufficient volume of loans to support the related expenses. As a result of inadequate staffing and inexperience, poor underwriting and servicing have led to unusually high losses in this area.

In view of the small number of credit unions offering member business loans and the relatively high risk involved, it is not reasonable to expect all federally insured credit unions to indirectly share this risk through exposure to losses to the NCUSIF. Accordingly, the NCUA Board is proposing to impose additional requirements on credit unions involved with business lending. These additional requirements are determined to be necessary in order to assure that credit unions which grant member business loans apply safe and sound lending practices

appropriate to this type of activity. Although these requirements do not prohibit commercial loans, they do seek to clarify certain areas of the existing regulation and strengthen other provisions. The NCUA Board believes that credit unions were formed primarily as consumer lenders and that member business loans be made available to finance the incidental needs of members - not to engage in wholesale, high-risk commercial lending.

B. Section by Section Analysis

Section 701.21(h)(1)(i) - This section has been modified to include within the definition of "member business loan" any loan, line of credit or letter of credit where the source of repayment is derived, in whole or in part, from income produced by a commercial, corporate, business or agricultural enterprise.

This modification recognizes those circumstances where business related income is the source of repayment for personal or consumer purposes. The existing regulation does not cover this circumstance. Since much of the risk involved with member business loans is related to the source of repayment, as well as the purpose of the loan, the proposed change will require the additional analysis necessary to properly evaluate these credits. Where business related income is relied upon as a source of repayment, the viability and soundness of the underlying business enterprise is a critical factor in determining whether or not to lend. This modification also emphasizes this Agency's view that member business loans be based on the creditworthiness of borrowers and not the value of collateral.

Section 701.21(h)(1)(i)(A) - The existing section has been deleted from the proposed regulation. This change was made to remove the exception from the general definition for loans secured by a 1 to 4 family dwelling. The existing rule excluded from the definition of "member business loan", all loans secured by a 1 to 4 family dwelling which was the principal residence, secondary residence or one other residence of the member. The NCUA Board proposes to remove these exclusions from the definition. Loans for business purposes or financed by the proceeds of a business enterprise are fundamentally different products from consumer loans. The risks and assumptions required to analyze member business loans generally exist without regard to the type of collateral. As a result, the NCUA Board believes that these loans should be subject to the special underwriting and other requirements of this section.

Section 701.21(h)(1)(i)(B) - This section has been redesignated as Section 701.21(h)(1)(i)(A). No other changes to this section.

Section 701.21(h)(1)(i)(C) - This section has been redesignated as Section 701.21(h)(1)(i)(B). In addition, this section was modified to reduce from \$25,000 to \$10,000 the minimum aggregate

loan amount which may be excluded from the definition of a member business loan.

The NCUA Board proposes to lower the limit to \$10,000 to recognize the inherent risks of member business loans and to require the additional analysis required by this section to a larger population of loans. Experience has shown that member business loans present similar types of risk without regard to the amount of the loan. Notwithstanding the above, the NCUA Board believes that some reasonable limit is necessary in order to avoid undue delays in processing relatively small, incidental credits.

The NCUA Board continues to believe that credit unions should perform the appropriate analysis for all business loans, even if less than \$10,000. While smaller business loans are not included within the definition of member business loan, this does not relieve the board of directors of the responsibility to perform the appropriate steps to underwrite, administer and secure these loans consistent with safe and sound lending policies.

Section 701.21.(h)(1)(ii) - This section was amended to remove the Allowance for Loan Losses account from the definition of "reserves". This definition is used in determining the maximum amount of member business loans available to one member and in aggregate. The Allowance for Loan Losses account is established as an estimate of the potential losses in existing credit union loan portfolios. As specifically designated reserves, it is the view of the NCUA Board that it is inappropriate to allow any portion of this account to be used as a basis to grant additional, high-risk loans.

Section 701.21(h)(1)(iii) - The term "associated member" has been clarified slightly. This clarification includes changing the term "common ownership" to "shared ownership" since the word "common" may connote a legal distinction unintended in the regulation. The term "with the borrower" is added to clarify that the interest of the associated member is pertinent only as determined in context of the interest of the borrower-member.

Section 701.21(h)(2) - This section was clarified to state that other sections of the NCUA Rules and Regulations may also be applicable to member business loans in addition to this section. No change to existing policy is intended.

Section 701.21(h)(2)(i)(C) - This section clarifies a reference to other sections of this regulation. This is a technical clarification in order to accurately cross-reference other proposed changes to this general Section (701.21(h)).

Section 701.21(h)(2)(i)(E) - This section clarifies a reference to another section of this regulation. This is a technical clarification in order to accurately cross-reference other proposed changes to this general Section (701.21(h)).

Section 701.21(h)(2)(i)(H) - This section was amended to clarify the documentation requirements for member business loans. ~~This proposal clarifies that the board of directors is responsible for determining the documentation required to support each request for a member business loan.~~ This proposal limits the discretion of the board of directors to allow exceptions to the general documentation requirements to those circumstances where "such documentation requirements are not generally available". A review of member business loans granted by credit unions indicates that documentation is not always complete and that the board of directors have not enforced such requirements consistently. Analysis and documentation of member business loans is critical in evaluating creditworthiness of borrowers. Accordingly, the NCUA Board believes it is appropriate to obtain such documentation in all cases, provided such information is generally available.

The proposed rule eliminates the "trend and structure analysis" as this term is not generally understood and is redundant with other provisions. Finally, the term "ratio analysis of cash flows" is changed to "cash flow analysis" in order to be more consistent with generally understood terminology in this field.

Section 701.21(h)(2)(ii) - This section was added in order to require certain minimum policies with respect to loan-to-value (LTV) ratios, collateral interest, personal liability of principals and experience requirements for credit union personnel involved in making member business loans.

The proposal would limit credit unions to financing no more than 80 percent of the value of the security. ~~This change reflects the higher risk involved in granting such loans.~~ Lenders which finance loans with high loan-to-value ratios take on most of the increased risk. Risk of failure to the member/borrower is minimal under such favorable financing terms and may actually encourage risk taking by borrowers. In view of the high failure rate of small business enterprises, the potential risk is significant. Accordingly, staff believes that requiring member/borrowers to retain a substantial equity interest in the property or business enterprise will impose additional discipline on borrowers and correspondingly reduce risk to credit unions.

The proposal would limit collateral used as security for member-business loans to first security interests. ~~Numerous losses at federally insured credit unions were caused by failing to secure a superior lien position to protect the credit union from loss.~~ The potential impact on liquidity and risk of deterioration in collateral value by accepting secondary security interests is significant.

Staff also proposes to require the personal liability and guarantees of the principals on all member business loans. ~~Use of corporate and other forms of business ownership has encouraged risk taking by small entrepreneurs.~~ Such forms of

ownership are often used as a means of avoiding personal liability on business losses. Requiring the personal liability and guarantees will impose additional responsibilities on member/borrowers at least commensurate with those taken by the lender. The NCUA Board believes that this requirement will discourage speculative and high risk ventures and their risk to credit unions.

Finally, this section proposes to require that personnel involved in underwriting and administering member business loans have, at a minimum, 2 years direct experience with the type of business, collateral and amount of credit. Member business loans require special expertise in virtually all phases of origination and administration. This includes, but is not limited to, underwriting, credit analysis, collections, documentation and file maintenance. Significant losses have occurred because boards of directors have failed to recognize and adjust to the special requirements of commercial lending. This inexperience and naivete has, in some cases, resulted in poorly structured and administered credits to marginal borrowers. Most of these problems could have been avoided had the credit union been better informed and prepared through use of qualified personnel.

Section 701.21(h)(2)(iii)(A) - This new section replaces the existing Section 701.21(h)(2)(ii) and proposes to lower the maximum member business loan to any one borrower from 20 percent of reserves to 10 percent. Concentrations of credit to one borrower present a significant risk. A problem with a single borrower is the potential to jeopardize the safety and soundness of the credit union under the existing 20 percent limit. By lowering the maximum loan to one borrower, the proposal will reduce concentrations of credit and their attendant risks.

In addition, it is proposed that any security interest in primary and secondary residences be included in the calculation of the loans to one borrower limit. This provision, although included in the original proposed rule in 1987, was eliminated from the final rule. Interest in residences are often excluded from the bankruptcy estate under state laws. Accordingly, the rationale for excluding residences from the loan limit calculation is unclear. As collateral value, a residence may have little or no value under a foreclosure action on a member business loan. As a result, the NCUA Board proposes that interest in residences not be excluded from the calculation of the loans to one borrower limit.

Section 701.21(h)(4)(ii) of the existing regulation is restated within proposed Section 701.21(h)(2)(iii)(A).

Section 701.21(h)(2)(iii)(B) - This section has been added to restrict member business loans to no more than 100 percent of credit union reserves. In view of the extraordinary level of losses and potential exposure, the NCUA Board proposes that an aggregate limit for member business loans be established. Based

on June 30, 1990 data, 144 of the 895 federally insured credit unions granting member business loans would be affected by this revision. Of those 144 credit unions affected, 112 are rated a CAMEL 3, 4 or 5 and, as a result, are of supervisory concern. In many cases, commercial loans are a major factor in the problems facing these credit unions. This aggregate limit is intended to be inclusive of loans granted for construction, development and speculative projects. Credit unions needing a higher limit may apply as provided in Section 701.21(h)(2)(iii)(C).

Section 701.21(h)(2)(iii)(C) - This revised section clarifies an existing portion of Section 701.21(h)(2)(ii) to indicate that credit unions seeking an exception to the regulatory limits on member business loans explain members' needs and the ability of the credit union to manage this activity. No change is intended as this reflects current policy and practice.

Section 701.21(h)(2)(iii)(D) - This new section has been added to limit member business loans to no more than 60 months in maturity. With few exceptions, business loans are generally short-term credits. Long-term lending in this area exposes lenders to additional, unanticipated risks which are largely unmeasurable. These risks are associated with national and local economic cycles, industry trends and similar factors. In view of the inability to accurately forecast or plan for such events, credit union activity in this area should be limited to a shorter, measurable time period. It is anticipated that the limit of 60 months in the proposed rule will accommodate most member business loans on the books of credit unions today.

Section 701.21(h)(2)(iv) - This section is the same as existing Section 701.21(h)(2)(iii) and is merely renumbered.

Section 701.21(h)(3) - This new section was added to include additional requirements in the area of loans to finance construction, development and speculative real estate lending projects. A disproportionate amount of losses incurred by credit unions in member business loans have been in the area of construction, development and speculative real estate lending. This type of commercial lending is considered to be the riskiest segment of this market. This type of lending is predicated on the premise that the proposed venture will be completed on schedule, within cost estimates and will be successful as a business enterprise. None of these factors are assured. The risk of failure is one borne by the lender.

The proposed rule imposes additional restrictions on this type of lending activity in an effort to reduce the potential risk to an acceptable limit. The proposal limits the aggregate of such loans to 15 percent of reserves. This lower limit will reduce the overall exposure to the credit union. This limit is included within the proposed aggregate limit for all member business loans of 100 percent of reserves as provided in Section 701.21(h)(2)(iii)(B).

In addition, the proposed rule requires borrowers to retain at least a 35 percent equity interest in the project. This provision will help insure that borrowers, as well as lenders, retain a vested interest in the success of each project.

Finally, the proposed rule imposes project management requirements to insure that funds are disbursed according to a preapproved draw schedule following on-site inspections by independent, qualified personnel. NCUA's review of past problems in this area indicates that many losses occur due to inadequate management of the project following loan approval. In some cases, draw schedules were never developed or approved, and funds were disbursed at the request of borrowers without on-site inspections. The proposed rule requires a preapproved draw schedule specific enough to determine the timing of disbursements in accordance with the completion of various stages of development. In addition, credit unions will be required to obtain the services of qualified personnel to perform on-site inspections. Such personnel should be independent of the lending, underwriting and approval process, but need not be outside consultants.

Section 701.21(h)(4) - This proposed section has been renumbered from the existing Section 701.21(h)(3).

Section 701.21(h)(4)(i) - This proposed section has been clarified to eliminate any confusion in meaning. No change is intended from the existing provision.

Section 701.21(h)(4)(ii) - This section was renumbered and clarified to explain that the term "equity kickers" refers to business arrangements also known as "joint ventures". In addition, the word sales is added to note, under such arrangements, income is sometimes tied to the ultimate sale of the project, as well as business profit. No change in meaning is intended.

Section 701.21(h)(5) - This section was added to clarify that credit unions engaged in making member business loans must separately identify such loans in the records of the credit union and report as such on the financial and statistical reports required by the National Credit Union Administration. Credit unions are already required to separately itemize member business loans on the semiannual call reports (financial and statistical reports). The proposed rule expands the scope of recordkeeping and reporting requirements to include all member business loans without regard to the amount, security or whether the credit is fully insured or guaranteed by, or under a purchase commitment by any government agency or political subdivision. This section was added to provide accurate data to monitor the activity and potential impact of member business loans on credit unions and the NCUSIF.

Section 701.21(h)(6) - This section replaces existing Section 701.21(h)(4) and was modified to remove obsolete references to

the effective date of this section and to establish a new effective date for the new provisions established in this proposed rule change. Federally insured credit unions may meet this requirement by either: (1) fully meeting the requirements of Section 701.21(h), or (2) providing a plan, subject to the approval of the respective regional director, establishing a proposed time table for fully meeting the requirements of Section 701.21(h).

Part 741 Requirements for Insurance, Section 741.3 Minimum Loan Policy Requirements - Although no change is proposed to this section, state regulatory authorities and federally insured state-chartered credit unions are advised that exemptions previously obtained by states under the existing regulation are no longer valid to the extent that existing state regulations are not substantially equivalent to the final regulations adopted by the NCUA Board. Such states must reapply for exemption as provided in this section.

C. Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board certifies that the proposed rule, if made final, will not have a significant impact on a substantial number of small credit unions because the rule only applies to the federally insured credit unions which make member business loans. Less than 35 federally insured credit unions with assets of less than \$2 million grant member business loans. Accordingly, the NCUA Board has determined that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

This proposed rule makes no substantive changes to collection requirements, therefore, it need not be sent to the Office of Management and Budget for approval.

Executive Order 12612

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. It states that: "Federal action limiting the policy-making discretion of the states should be taken only where constitutional authority for the action is clear and certain, and the national activity is necessitated by the presence of a problem of national scope." The issue of member business loans and their risks to federally insured credit unions are concerns of national scope. In order to enable NCUA and the NCUSIF to have an operable mechanism in place to ensure the safety and soundness of federally insured credit unions, this regulation is proposed. This regulation will apply to all federally insured credit unions. The NCUA Board believes that the protection of the National Credit Union Share Insurance Fund warrants these new restrictions and that the increased restrictions in the proposed amendments will not

unduly burden federally insured state-chartered credit unions. The NCUA Board, pursuant to Executive Order 12612, has determined that this rule may have an occasional direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. Further, the proposed amendments may supersede provisions of state law or regulation concerning member business loans which do not substantially meet the requirements of Section 701.21(h).

List of Subjects
12 C.F.R. Part 701

Credit Unions, Member Business Loans, Written Loan Policies, Conflicts of Interest

By the National Credit Union Administration Board on January 17, 1991.



Becky Baker
Secretary of the Board

For the reasons set forth in the preamble, 12 CFR Part 701 is amended as follows:

PART 701 - ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS

1. The authority citation for Part 701 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, and 1789 and P.L. 101-73. Section 701.6 is also authorized by 31 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 et seq., 42 U.S.C. 1861 and 42 U.S.C. 3601-3610.

2. In Section 701.21, paragraph (h) is revised to read as follows:

701.21 Loans to Members and Lines of Credit to Members

h) Member Business Loans

(1) Definitions.

(i) "Member business loan" means any loan, line of credit, or letter of credit, the proceeds of which will be used for a commercial, corporate, business, or agricultural purpose, or, where the source of repayment is derived in whole or in part from income produced by a commercial, corporate, business or agricultural enterprise (other than ordinary salary or employment income) except that the following shall not be considered member business loans for the purposes of this section:

(A) A loan that is fully secured by shares in the credit union or deposits in other financial institutions.

(B) A loan meeting the general definition of "member business loan" under (i) above, and made to a borrower or an associated member (as defined in (iii)), which, when added to other such loans to the borrower or associated member, is less than \$10,000.

(C) A loan, the repayment of which is fully insured or fully guaranteed by, or where there is an advance commitment to purchase in full by, any agency of the Federal Government or of a state or any of its political subdivisions.

(ii) "Reserves" means all reserves, including any undivided earnings or surplus but excluding the Allowance for Loan Losses account.

(iii) "Associated Member" means any member with a shared ownership, investment or other pecuniary interest in a business or commercial endeavor with the borrower.

(iv) "Immediate Family Member" means a spouse or other family member living in the same household.

(2) Requirements. Member business loans, as defined in Section 701.21(h)(1)(i), may be made by federal credit unions only in accordance with the applicable provisions of Section 701.21(a) through (g) above, to the extent that they are not inconsistent with this section.

(i) Written Loan Policies. The board of directors must adopt specific business loan policies and review them at least annually. The policies shall, at a minimum, address the following:

- (A) Types of business loans that will be made;
- (B) The credit union's trade area for business loans;
- (C) Maximum amount of credit union assets, in relation to reserves, that will be invested in business loans, subject to the limitations of Section 701.21(h)(2)(iii)(B) and (C);
- (D) Maximum amount of credit union assets, in relation to reserves, that will be invested in a given category or type of business loan;
- (E) Maximum amount of credit union assets, in relation to reserves, that will be loaned to any one member or group of associated members, subject to Section 701.21(h)(2)(iii)(A) below;
- (F) Qualifications and experience of personnel involved in making and administering business loans.
- (G) Analysis of the ability of the borrower to repay the loan;
- (H) Documentation supporting each request for an extension of credit or an increase in an existing loan or line of credit shall (except where the board of directors finds that such documentation requirements are not generally available for a particular type of business loan and states the reasons for those findings in the credit union's written policies) include the following: balance sheet, cash flow analysis, income and expenses, tax data; leveraging; comparison with industry averages; receipt and periodic updating of financial statements

and other documentation, including tax returns.

(I) Collateral requirements, including loan-to-value ratios; appraisal, title search and insurance requirements; steps to be taken to secure various types of collateral; and how often the value and marketability of collateral is reevaluated.

(J) Appropriate interest rates and maturities of business loans.

(K) Loan monitoring, servicing and follow-up procedures, including collection procedures.

(L) Provision for periodic disclosure to the credit union's members of the number and aggregate dollar amount of member business loans.

(M) Identification, by position, of those senior management employees prohibited by subsection (h)(3) from receiving member business loans.

(ii) Other Policies. The following minimum limits and policies shall also be established in writing and reviewed at least annually for loans granted under this section:

(A) Loan-to-Value (LTV) ratios which shall not exceed 80 percent;

(B) Collateral accepted as security for loans shall always represent a first security interest;

(C) Loans shall not be granted without the personal liability and guarantees of the principals (natural person members);

(D) Personnel involved in underwriting and administering business loans shall have at least 2 years of direct experience with the type of business, collateral and amount of credit being considered;

(iii) Loan limits.

(A) Loans to One Borrower. Unless a greater amount is approved by the NCUA Board, the aggregate amount of outstanding member business loans to any one member or group of associated members shall not exceed 10% of the credit union's reserves. If any portion of a member business loan is fully secured by shares in the credit union, or deposits in another financial institution, or insured or guaranteed by, or subject to an advance commitment to purchase by, any agency of the Federal Government, or of a state, or any of its political subdivisions, such portion shall not be calculated in determining the 10% limit. On or before the effective date, the federal credit union must notify the NCUA Regional Director, in writing, of any outstanding member business loans made prior to that date which exceed the 10% limit. Federal credit unions are prohibited from making any further advances beyond the 10% limit to borrowers whose aggregate business loans exceed the limit unless an exception has been approved by the regional director in accordance with Section 701.21(h)(2)(iii)(C).

(B) Aggregate Loan Limit. Business loans as defined in this section, including any construction, development and speculative loans granted as provided under Section 701.21(h)(3) of this Part, shall not exceed 100% of a credit union's reserves. On or before the effective date, the federal credit union must notify the NCUA Regional Director, in writing,

of any outstanding member business loans made prior to that date which exceed the 100% limit. Federal credit unions are prohibited from making any further advances beyond the 100% limit unless an exception has been approved by the regional director in accordance with Section 701.21(h)(2)(iii)(C).

(C) Exceptions. Credit unions seeking an exception from the limits of Section 701.21(h)(2)(iii)(A) or (B) must present the Board with, at a minimum: the higher limit sought; an explanation of the need by the members to raise the limit and ability of the credit union to manage this activity; an analysis of the credit union's prior experience making member business loans; and a copy of its business lending policy.

(D) Maturity. Member business loans shall not exceed 60 months in maturity.

(iv) Allowance for Loan Losses.

(A) The determination whether a member business loan will be classified as substandard, doubtful, or loss, for purposes of the valuation allowance for loan losses, will rely on factors not limited to the delinquency of the loan. Nondelinquent loans may be classified, depending on an evaluation of factors, including, but not limited to, the adequacy of analysis and documentation.

(B) Loans classified shall be reserved as follows:

- (1) Loss loans at 100% of outstanding amount;
- (2) Doubtful loans at 50% of outstanding amounts; and
- (3) Substandard loans at 10% of outstanding amount unless other factors (e.g., history of such loans at the credit union) indicate a greater or lesser amount is appropriate.

(3) Construction, development and speculative real estate lending.

Loans granted under this section to finance the construction or development of a commercial or residential building(s) shall be subject to the following additional provisions:

- (i) The aggregate of all such loans shall not exceed 15 percent of reserves;
- (ii) The borrower shall have a minimum of 35 percent equity interest in the project being financed;
- (iii) Funds for such projects shall be released following on-site inspections by independent, qualified personnel in accordance with a preapproved draw schedule.

(4) Prohibitions.

(i) Senior Management Employees. A federal credit union may not make member business loans to the following:

(A) Any member of the Board of Directors who is compensated as such.

(B) The credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager).

(C) Any assistant chief executive officers (e.g., Assistant President, Vice President, or Assistant Treasurer/Manager).

(D) The chief financial officer (Comptroller).

(E) Any associated member or immediate family member of (A) - (D) above.

(ii) "Equity Kickers/Joint Ventures." A federal credit union shall not grant a member business loan where a portion of the amount of income to be received by the credit union in conjunction with such loan is tied to the profit or sale of the business or commercial endeavor for which the loan is made.

(5) Recordkeeping. All loans, lines of credit, letters of credit, the proceeds of which will be used for a commercial, corporate, business, or agricultural purpose, or, where the source of repayment is derived in whole or in part from income produced by a commercial, corporate, business or agricultural enterprise (other than ordinary salary or employment income) shall be separately identified in the records of the credit union and reported as such in financial and statistical reports required by the National Credit Union Administration.

(6) Effective Date.

Section 701.21(h) is effective [30 days after publication in the Federal Register]. All member business loans made on or after that date must be in full compliance with Section 701.21(h).