169

Evangelical Christian Credit Union
955 West Imperial Highway
P.O. Box 2400
Brea, CA 92822-2400
800.634.3228 714.671.5700
www.eccu.org

MARK G. HOLBROOK
President / CEO

June 20, 2005

Mary Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: ECCU's Comments on Part 723 Member Business Loans

Dear Ms. Rupp:

Evangelical Christian Credit Union ("ECCU") appreciates this opportunity comment on the Agency's proposed revisions to the Member Business Lending Rule. As the largest originator of member business loans in the credit union industry, we are writing to share our experience and our comments on the Agency's proposal to amend the definition "net worth" and of "construction and development loans" as they pertain to the Member Business Loan Rule.

While we have no qualms about the Board's desire to amend the definition of "net worth" to mirror the definition set forth in the PCA Rule, we do object to the imposition of quarter-end as the only applicable time to determine a credit union's net worth for purposes of the Member Business Loan Rule. Credit unions should be permitted to take advantage of any increases in net worth (or suffer the consequences of any decreases in net worth) as they occur, rather than arbitrarily locking in the credit union's net worth valuation as of quarter end.

While we believe that it is appropriate to extend the definition of "construction and development loans" to include construction and development loans of properties already owned, ECCU respectfully requests that the Board reconsider the broad scope of the proposed definition. We believe that such a broad definition would have a detrimental impact on the ability of many credit unions to make competitive and attractive construction and development loan products readily available to its members.

As proposed, the expanded definition of construction and development loans appears to include any purchase money loan where the borrower <u>intends</u> to acquire the property for the purpose of <u>improving</u> it as a commercial property. We believe that in expanding the definition, the NCUA is unnecessarily broadening the scope of the rule to include those loans that actually possess very little speculative risk.

170

In considering the scope of the definition, we are concerned about exactly what the Agency may mean in the use of the terms "improving" and "improvement," and how the terms could be interpreted by field examiners. From our experience, there are very few commercial properties that are immediately ready for use, "as is" by the buyer, without the need or desire for any kind of improvements, including cosmetic upgrades, repair, or maintenance, either immediately or sometime in the future. Without any qualification of the word "improve," (or derivative terms thereof) regardless of the nature, cost, or effect of the "improvement," the entire acquisition loan will have to be classified as a construction and development loan – not just the amount actually expended upon the "improvement."

Additionally, we are concerned about how the Agency and its field examiners may construe the term "intend." Without further clarification, the new definition would appear to require the classification of a loan as a construction and development loan if the borrower merely indicates to us that they intend to (someday) improve or develop the acquired or already-owned property, regardless of the proposed timing of the improvements, and regardless of whether the improvements are to be financed using the same property as collateral, by the credit union, by a third party, or through the borrower's own financial resources. In our experience, the mere intent of a borrower to develop or improve the property at some future date does not increase the risk of a loan made on unimproved land.

If "intent" becomes a triggering factor, the new definition will appear to apply to loans that many in the credit union industry have traditionally not considered as a construction and development loan. For example, many businesses regularly obtain operational lines of credit, secured by the equity in their property. These lines of credit are to assist them manage the day-to-day operational needs, and are often times used by many to fund minor improvements, such as maintenance and repair to the property. Such use would then require the credit union to treat the entire line of credit as a construction and development loan, including imposing the cost and inconvenience of written inspections by qualified personnel, and setting up a pre-approved draw schedule.

By using "intent" as the defining factor, coupled with the broad purpose of "improvement," this changed definition has the potential to encompass a significant portion of our loan portfolio.

These concerns with the broad scope of the proposed definition are not insignificant, as they directly affect (a) whether the 25% equity requirement applies to the particular loan; (b) whether the loan is to be counted against the maximum aggregate construction and development loan caps (currently 15% of net worth unless a variance applies); and (c) whether an on-site, written inspection by qualified personnel will be required, along with a pre-approved draw schedule.

Because borrowers must maintain a minimum 25% equity stake in construction and development loans, if the borrowers indicates their intent to someday improve the property, with or without using the proposed loan proceeds, the credit union would be required to treat the loan as a construction and development loan, subject to different underwriting requirements and LTV requirements, regardless of whether such enhanced scrutiny is justified. This is especially problematic where an applicant is requesting an 80% LTV loan to acquire a commercial property

171

and makes the "mistake" of telling the credit union that the applicant intends on putting in new carpeting in the building in a few months. Because of the borrower's intent, the credit union would have to inform the borrower that it would not be able to make the loan at 80% LTV and must instead apply the 25% equity requirement. Using the NCUA formula recommended in the NCUA's Legal Opinion Letter dated June 7, 2001, even when taking the cost of the improvements into account, the credit union may be forced to lend an amount less than 80% LTV of the property itself. This interpretation could apply even though the loan proceeds are to be used to purchase the property, and not for any improvements.

We are also concerned that if the borrower wanted to obtain a junior trust deed loan on the property from a third party to finance the installation of the carpet, the credit union will be required to deny the borrower permission to obtain such a loan if the additional financing would cause the member to violate the 25% equity requirement in the property. As one can see, these combined limitations would not be attractive to any borrower, and would likely cause the credit union to lose the borrower's business to a more flexible competitor. ECCU has lost a significant number of attractive construction loans to non-credit union competitors under the current regulation because of this 25% equity limitation.

Such a broad range of loans classified as construction and development loans will cause credit unions to more rapidly hit their maximum construction and development loan ceiling. While it is understandable that the NCUA would desire to minimize the risk created by a portfolio of speculative construction and development loans, again we note that not all loans for real property improvements are speculative or inherently more risky. For example, if a church wished to remodel its sanctuary, and has no prior debt and has more than sufficient cash flow to service the loan, there would seem to be very little risk in lending the church $50,000 on a property worth $200,000. Given the low risk of such a loan, there appears to be little reason to have to add this loan balance towards the construction and development loan cap. Given the low limits for construction and development loans, many credit unions will be effectively restricted from making member business loans to its borrowers for significant periods of time, until the loans are paid off.

Finally, we are concerned that the structure of the construction and development loan regulation itself results in unnecessary regulatory burden on credit unions, as it assumes the same lending risks apply to every loan involving or contemplating an "improvement" regardless of the actual dollar amount of the improvement, the percentage of the loan the improvement constitutes, the nature of the improvement, the effect of the improvement, or the experience of the lender. Requiring credit unions to treat all loans in the same manner subject to such strict limitations severely hampers our ability to provide flexible loan products that meet our members needs, without targeting the actual risks raised by making "construction and development" loans. In our experience, there is no need to place such restrictive caps on loans where the proceeds are to be used for cosmetic improvements or normal maintenance and repair, such as painting a building, replacing a roof, repaving a parking lot, or installing new carpeting. Such improvements often do not materially impact the value of a property or the inherent risk of a loan and should not be considered speculative in nature.

172

We therefore respectfully request the Agency to design the rule to more specifically target those factors that would actually increase the sort of risks contemplated. For example, in our experience, loans to members who intend to occupy the improved property for their own commercial use pose significantly less risk than loans to members who are relying upon the ultimate resale value of the property or the anticipated rental income of the developed property to fund the repayment of the loan. Again, we note that loans that are to fund maintenance, repair, or cosmetic improvements of the property do not pose the same risks as loans where the proceeds are actually used to fund structural improvements (such as the actual erection of a building or structures) that would materially impact the value of the property. In addition, loans that need to rely upon the "as-completed" value of the property to meet the LTV requirements, rather than the "as-is" (unimproved) value of the property, tend to pose differing risk levels as well. Please also keep in mind that these factors need to be considered together to determine overall the risk posed by the loan. In our experience, even where the loan is to be used to construct a building, if the costs of construction are still less than 80% of the "as is" value of the property, and the owner intends to occupy the building for its own use, such a loan would not present the same risks of a more speculative construction and development project where the owner intends to resell the building upon completion to repay the loan and recognize the owner's profit.

In addition, the Agency may wish to follow the other banking agencies' examples in establishing "guidelines" instead of "one-size-fits-all" regulations, where such guidelines outline appropriate criteria and considerations for banks to evaluate and mitigate risk commensurate with the bank's level of experience. While these banking guidelines recommend LTV limits for certain types of commercial loans, they also provide banks with the flexibility to lower or increase these limits on a loan-by-loan basis based upon support provided by other pertinent credit factors, so long as such loans are identified and the exceptions are prudently underwritten and documented. For credit unions to effectively compete in providing its members with loan products that meet their needs, credit unions desperately need to have the same flexibility in adopting policies and products that are commensurate with the credit union's actual risk. Not only does it make little sense to subject a loan where a minor portion of the proceeds are to be used for basic maintenance and repair to the same standards as a multi-million dollar loan to develop and erect an office building to be leased to third parties, it similarly does not make sense to subject an experienced commercial credit union lender to the same conservative limitations as a smaller credit union with very little member business lending experience, much less construction and development lending experience. With this in mind, we strongly suggest that in addition to the foregoing, the NCUA Board consider making exceptions to Section 723.3 for those credit unions with significant member business lending experience (for example, providing an automatic exemption from Section 723.3 for credit unions with a history of primarily making member business loans).

On behalf of ECCU, as well as all other credit unions making business loans, we strongly urge the NCUA Board to reconsider the proposed definition of construction and development loans, as well as the overall structure of Section 723.3, to ensure that the regulation does not unfairly impair a member's ability to obtain a loan from his or her credit union for legitimate, non-speculative purposes. If you have any questions or need further examples, please do not hesitate to contact me.

173

Sincerely,

Mark G. Holbrook
President/CEO

cc: Mary Dunn, Associate General Counsel
CUNA Regulatory Counsel

Catherine Orr, Senior Regulatory Counsel
CUNA Regulatory Advocacy Department

Robert Ennis, Regulatory Analyst
California Credit Union League