

October 23, 2008

Bruce M. Beaudette, President/CEO  
Sunmark Federal Credit Union  
P.O. Box 16370  
Albany, NY 12212-6370

Re: Construction and development lending.

Dear Mr. Beaudette:

You have asked if a loan made by your credit union for the purpose of acquiring undeveloped land should be classified as a construction and development loan (C&D loan) when no loan proceeds are intended to be used to develop the property. This type of loan should be classified as a C&D loan under NCUA's regulations.

Your letter describes an arrangement in which a borrower uses loan proceeds to acquire undeveloped land with the intention of improving the property. In your example, however, the borrower intends to use subsequent financing, which the credit union may or may not provide, to pay off the acquisition loan and finance the construction. No property development occurs until the borrower obtains subsequent financing.

Our rule subjects member business loans (MBL) to stringent statutory and regulatory limits, such as an aggregate loan limit, loan-to-value ratio requirements, and restricted authority to make loans to one borrower. 12 C.F.R. Part 723. C&D loans are the riskiest kind of MBL and, therefore, are subject to even more stringent regulatory limits. For example, a C&D loan borrower must have a minimum of 25% equity interest in the project being financed, the aggregate cap on C&D loans a credit union may make is limited to 15% of the credit union's net worth, and the funds may only be released after onsite inspections by the credit union and in accordance with a preapproved draw schedule. 12 C.F.R. §723.3.

These additional regulatory limits reflect the additional risks associated with this kind of business lending. Typically, these risks include the uncertainty of the project's success, the borrower's reliance on the sale of the project or the project's future cash flow to repay the loan, and the fact market conditions at the beginning of a project can change significantly before a project is completed. These concerns are specifically discussed in the preamble to the final rule in 2005. 70 Fed. Reg. 75719 (December 21, 2005).

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Your research on this issue uncovered an NCUA legal opinion from 1996 addressing the question of whether a loan to acquire land for investment purposes, without a present intent to develop the property, qualifies as a C&D loan. The letter equates the concept of a present intention of development with intent to develop "during the life of the loan" and concludes the absence of such intent takes the loan out of the C&D classification. OGC Op. 96-0937 (October 24, 1996). In a subsequent letter to the same addressee, we reiterated that conclusion, stating "[t]he loan does not fall within the definition of a construction and development loan, if the member has no intent, at the time the loan application is submitted, to convert the land into income producing property during the lifetime of the loan." OGC Op. 97-0426 (May 15, 1997). You ask if this rationale still holds and supports a similar conclusion where a borrower has a present intent to develop a property but will use separate financing to repay the acquisition loan and accomplish the development.

Our rule defines a C&D loan as a financing arrangement for acquiring property, including land, with the intent to convert it to income producing property. 12 C.F.R. §723.21. These criteria are present in your example. Loan proceeds fund the acquisition of the property, which the borrower intends will eventually produce income. Even though the borrower has no intention to use loan proceeds for development or to rely on income produced from the property to service the debt, the borrower's ability to repay the acquisition loan depends on obtaining a second loan, either from the credit union or another lender. The decision to grant the second loan must take into account the risks and uncertainty associated with speculative real estate development. The first and second loans are, therefore, tied together. Each exhibits the same types of risks.

We might reach a different conclusion if the credit union's underwriting of the first loan were based on the borrower's ability to repay without regard to income generated from the property's eventual development, the loan were set up with a regular amortization, and the appraised value of the land excluded any income considerations. Where, however, repayment of the acquisition loan depends on a second loan to develop the property, we think application of the C&D loan criteria to both loans is appropriate.

You may address any questions to me or to Staff Attorney Ross Kendall.

Sincerely,

/S/

Sheila A. Albin  
Associate General Counsel

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