March 17, 2008

Shannon E. Price, Attorney at Law
300 Office Park Drive, Suite 240
Birmingham, Alabama 35223

Re: Reclassifying Construction and Development Loans.

Dear Mr. Price:

You have asked when a credit union may reclassify a construction and development loan (C&D loan), which is a type of member business loan (MBL), as simply an MBL so the loan is not subject to the additional C&D loan requirements in NCUA's MBL rule. 12 C.F.R. Part 723. A credit union may reclassify a C&D loan as an MBL when the level and kind of risks for which those limits are in place are no longer present, meaning, if the loan were refinanced at that point, it would not be classified as a C&D loan. A credit union must be able to justify reclassifying a loan and, although we cannot provide a single formula or test, we discuss below factors the NCUA will consider in determining if reclassification is permissible.

With certain exceptions not relevant to the question you present, an MBL is a loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for commercial, corporate, other business investment property or venture or agricultural purposes. 12 C.F.R. §723.1.

A C&D loan is defined as a financing arrangement for acquiring property or rights to property, including land or structures, with the intent to convert it to income-producing property such as residential housing for rental or sale; commercial use; industrial use; or similar uses. A C&D loan includes a financing arrangement for the major renovation or development of property already owned by the borrower that will convert the property to income producing property or convert the use of income producing property to a different use from its use before the major renovation or development or is a major expansion of its current use. A C&D loan does not include a loan to finance maintenance, repairs, or improvements to an existing income producing property that do not change its use. 12 C.F.R. §723.21.

MBLs generally are riskier than consumer loans and are subject to more stringent statutory and regulatory limits, such as an aggregate cap, 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.

The additional regulatory limits on C&D loans address safety and soundness concerns by enhancing underwriting standards and limiting a credit union's exposure to the additional risks associated with this kind of business lending. All C&D loans at their origination are, by definition, linked to a speculative project with a sufficiently high degree of development risk warranting more stringent regulatory limitations. The risk is related to 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 that 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).

Safety and soundness considerations make it critical that credit unions recognize and evaluate the true level of C&D loan risk and report that risk to NCUA on their quarterly call reports. This means a credit union may not reclassify a C&D loan as an ordinary MBL unless the loan no longer poses the risks associated with C&D loans. Factors the NCUA may consider in determining if a reclassification is permissible include: (1) whether the speculative project tied to the loan has been completed and has stabilized to the point where (a) the project is a viable ongoing business concern with sufficient cash flow to service the debt on an ongoing basis or (b) can be sold for an amount sufficient to fully repay the loan; and (2) if the loan were refinanced whether it would still be classified as a C&D loan under the MBL rule.

The success or failure of a development project depends on particular facts and circumstances and we cannot provide a single, bright-line test or formula to determine when a C&D loan may properly be reclassified. Rather, a credit union will have to analyze C&D loans on a case-by-case basis to determine if and when a loan can be reclassified. Credit unions with questions about the propriety of reclassifying a particular C&D loan as an MBL should consult with examination or regional staff.

Sincerely,

/S/

Sheila A. Albin
Associate General Counsel

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