

September 25, 2003

Steven R. Bisker, Attorney at Law
2800 Eisenhower Ave, Suite 100
Alexandria, Virginia 22314

Re: Construction and Development Member Business Loans (MBLs).

Dear Mr. Bisker:

You have asked several questions regarding the equity requirements for construction and development loans that we answer below.

As a general foundation for answering your questions, we note that NCUA's MBL rule defines a construction or development loan 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." 12 C.F.R. §723.21. If an MBL meets this definition, the credit union must make the loan in compliance with §723.3, including its requirement that the borrower have a 35% equity interest in the construction or development project. If an MBL does not meet the definition of a construction and development loan, then the loan is not subject to the §723.3 borrower equity requirement but rather remains subject to the MBL rule's loan-to-value (LTV) requirements found in §723.7 which generally sets a minimum LTV ratio at 80%.

Your questions and our answers are as follows:

1) An investor group wants to buy a warehouse/office complex that will be rented to third parties. Will they be required to put up 35% of the purchase price as their equity interest?

No, the borrower is not required to have a 35% interest in the office complex. When the NCUA Board adopted the definition of a construction and development loan in 1991, the Board stated in the final rule's preamble:

Construction or development loans are for the acquisition of land or property upon which improvements are planned. Examples of these types of loans included: (1) The purchase of raw land to be developed for resale as building lots; (2) the purchase of raw or developed land for the purpose of constructing housing or a commercial building; and (3) the purchase of an existing structure for rehabilitation in order to improve the economic value for resale or to improve income-producing potential.

56 Fed. Reg. 48421, 48423 (Sept. 25, 1991).¹ As such, the equity requirements of §723.3 do not apply to the purchase of a commercial building, provided that the building does not require any type of conversion or other improvements. The attached OGC legal opinion 00-0809, dated September 21, 2000, discusses this issue further.

2) An investor group wants to buy a piece of land and wants to build an office building on it which will be rented to third parties. Will they be required to put up 35% of the land costs and 35% of the cost of the building as their equity interest?

Yes, the borrower must have a 35% equity interest in the entire construction project because the borrower will use the loan to purchase raw or developed land for the purpose of constructing a commercial building.

3) An investor group already owns a warehouse/office complex that they rent to third parties; they want to refinance their current mortgage and borrow enough new money to renovate the buildings which they will continue to rent to third parties. Are they exempt from the provisions of §723.3 (as they already own and are not acquiring property) so that their required equity could be 20% versus 35%?

No, the loan is not exempt from §723.3 because it will be used towards the renovation of a commercial-use building with the apparent intended purpose of improving the value of the property.

4) An investor group already owns an office building that it rents to third parties and it wants to refinance its current mortgage. Is it exempt from the provisions of §723.3 (as it already owns and is not acquiring property) so that its required equity could be 20% versus 35%?

The borrower may refinance its current mortgage with the credit union without having a 35% equity interest in the office building, provided the borrower does not obtain the refinance for the purpose of renovating the office building or circumventing the requirements of §723.3 if the building was originally financed as a construction and development MBL under part 723.

5) A business wants to buy a warehouse/office complex that it will occupy. Is the business exempt from the provisions of §723.3 (since it will not rent the property to third parties) so that its required equity could be 20% versus 35%?

¹ The NCUA Board has not made any substantive changes to the definition of construction and development loan since its adoption, but the Board slightly modified the definition to make the rule easier to understand in 1999. 64 Fed. Reg. 28721, 28728 (May 27, 1999).

Yes, the borrower may obtain an MBL to purchase the warehouse or office complex without having a 35% equity interest in the building, provided the borrower is not obtaining the loan to make improvements in the building.

6) A business wants to buy a piece of land and wants to build an office building on it that will be occupied by the business. Is the business exempt from the provisions of §723.3 (since it will not rent the property to third parties) so that its required equity could be 20% versus 35%?

No, the borrower's loan must comply with §723.3 because the borrower will use the loan to acquire and develop land and a building for commercial use. Whether the borrower chooses to construct the building for its own commercial use or rent to other businesses is irrelevant because the borrower is constructing commercial property. When the NCUA Board first proposed to regulate construction and development MBLs, it stated the following rationale for establishing additional requirements on these types of loans:

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.

56 Fed. Reg. 2723, 2726 (Jan. 24, 1991). The risks identified by the Board are not mitigated by the borrower occupying the completed project rather than renting it to third parties. The borrower, therefore, must have a 35% equity interest in the construction and development project.

7) A business already owns a warehouse/office complex it occupies; it wants to refinance its current mortgage and borrow enough new money to renovate the buildings which it will continue to occupy. Is it exempt from the provisions of §723.3 (since it will not rent the property to third parties) so that its required equity could be 20% versus 35%?

No, as discussed in questions 3 and 6, the loan is not exempt from §723.3 because the borrower will use the loan proceeds towards the renovation of a commercial building. The fact that the borrower will occupy the completed project rather than rent it to third parties is irrelevant.

8) A business already owns an office building that it occupies and wants to refinance its current mortgage. Is it exempt from the provisions of §723.3 (since it

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will not rent the property to third parties) so that its required equity could be 20% versus 35%?

See our responses to questions 4 and 6.

9) Modification of 5-8: If the business occupies less than 100% of the respective properties and rents the rest to third parties, at what % of occupancy would it become subject to the provisions of §723.3 wherein it would be required to maintain equity of 35%?

See our response to question 4.

We note the NCUA Board issued a Notice of Proposed Rulemaking to amend the MBL rule in March. 68 Fed. Reg. 16450 (proposed April 4, 2003) (to be codified at 12 C.F.R. pt. 723). The proposed rule would lower the current mandatory equity requirements for construction and development MBLs by requiring a borrower to have a minimum of a 25%, rather than a 35%, equity interest in any construction or land development project. 12 C.F.R. §723.3(b); 68 Fed. Reg. at 16457.

Sincerely,

Sheila A. Albin
Associate General Counsel

GC/CJL:bhs
03-0430

Attachment