Construction Loans

Construction loans are high-risk loans that require sophisticated underwriting and administration. Construction loan policies should establish limits compatible with the credit union's size. The limits should integrate construction lending into the overall ALM plan. Credit unions should hire or contract with loan processors and underwriters trained and experienced in construction lending. NCUA Letter to Credit Unions No. 124 (June 1991) provides credit unions with real estate lending guidelines, which included information on residential construction loans. Generally, there are four types of construction loans:

- Loans to a developer to complete a commercial building such as a shopping center, office building, hotel, or apartment building;
- Loans to a developer to finance residential construction made on a speculative or "spec1' basis (i.e., homes built to sell later in the general market);
- Loans to a general contractor to finance single homes to persons who may or may not have obtained prearranged permanent financing; and,
- Loans to an owner for financing the construction of the owner's primary residence (whether or not the owner acts as the general contractor.)

The first three loan types are member business loans if they exceed $50,000. When owners act as general contractor, the credit unions must have tight controls to ensure construction progresses as planned. The major concerns involved in construction lending are:

- Failure of the builder to produce the anticipated product as contracted;
- Threat of prior or intervening liens placed on the mortgaged property;
- Unreliable market analysis resulting in either an unmarketable or difficult-to-market project; and,
- Inadequate funding for completing construction.

The following are possible unsafe and unsound operating practices:

- Disbursing funds in advance of construction progress. This could result in the credit union not having sufficient undisbursed funds to ensure project completion;

- Approving loan agreements, which do not include precautionary measures, to avoid the filing of mechanics' liens or stop notices. Mechanics' liens precede mortgage liens and stop notices can cause costly delays in construction;

- Approving loans for speculative or investment projects without (1) evaluating and approving feasibility studies, or (2) obtaining an independent appraisal of land value;

- Approving loans to investment borrowers without considering (1) their past performance records on similar projects, and (2) the proposed marketing program for the planned project;

- Approving loan agreements that do not include provisions for inspecting the construction's progress. Credit unions should disburse funds for labor and material according to progress of the project;

- Approving construction loans without prior review of builder's cost estimates to determine the accuracy and reasonableness of the estimates;

- Disbursing construction funds without supporting inspection reports;

- Approving loan agreements that do not require prior approval for changes in plans and specifications;

- Failing to segregate construction loan appraisal, inspection, and disbursement functions; and

- Granting loans to builders or developers with insufficient equity in the project. §723.3(b) of the NCUA Rules and Regulations requires 35 percent equity.

Land Loans

Loans collateralized by either raw acreage or improved property (having sewers, utilities, curbs, etc.) often contain high risk because of volatile land values and limited marketability compared to other real estate. Land loans usually require the following additional documents:

- Appraisal, Survey, and Zoning Requirements. When determining the soundness of the loan, the appraisal should consider the size of the property, the zoning requirements, the stated highest and best use of the land, access to highways, etc. A credit union should limit the LTV to no more than 60 -70 percent of the appraised value of the land. Some experts limit the LTV to 50 percent. This will depend on the quality of the land, planned use of the land, and how soon owners plan to develop it;

- Agreement that parties require credit union approval before making any improvements to the property; and,

- Title search and insurance. Credit unions should periodically inspect unimproved property to ensure the borrower does not make changes without the credit union's knowledge.

Member Business Loans

A member business loan includes any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for a commercial, corporate, other business investment property or venture, or agricultural purpose. NCUA Rules and Regulations §723.1 (b) lists the exceptions to this general rule.

Credit unions must separately identify member business loans in their records and in the aggregate on their financial reports and 5300 Call Report. Many credit unions do not properly identify their member business loans. A review of the loan collateral and purpose codes can help identify potential member business loans. Reviewing reports on amortization, new funds advanced, extensions and loans granted in excess of $50,000 may also assist in identifying these loans.

Policies and Procedures
Member business lending requires special skills in underwriting, servicing, and collecting. Credit unions engaged in member business lending must use the services of an individual with at least two years experience in business lending. Credit unions must have the expertise to monitor the financial condition of member-borrowers through periodic receipt and analysis of financial data, when appropriate and necessary (e.g., open-end member business loans.)

Member business lending programs often affect liquidity and interest rate risk. Credit unions involved in this type of lending must have adequate ALM policies and procedures before the credit union starts making these loans. The commitment to the borrower may involve a long-term business relationship, even though the actual loan term is short. For example, an agricultural operating loan generally involves a long-term commitment to fund the annual operations, while the individual loan may mature in one year or less.

To adequately address transaction and compliance risks, credit unions must document internal controls, policies, practices, and procedures. This documentation should include the types of loans granted, copies of forms used, and any other pertinent information.

Underwriting
The underwriting process should include an evaluation of the character and integrity of the borrower, including the borrower's ability to manage the business, repay debt, and accumulate capital in the business. The credit union should also assess the condition of the industry in which the borrower operates, particularly as it affects the ability to repay.

The emphasis in underwriting member business loans shifts from the individual to the financial soundness of both the business and the member requesting the loan. To support their analysis of businesses, credit unions can use (1) commercial credit reports (e.g., Dun and Bradstreet), (2) individual credit reports, (3) balance sheet and income and expense statements, (4) cash flow statements, and (5) ratio analysis. Whenever a credit union requires a personal guarantee on a loan, it must evaluate the guarantor's financial strength. Some tools for the analysis include:

- Cash flow analysis. A credit union should only make the loan if the borrower has cash flow projections based on actual cash flow data. Many small businesses have trouble obtaining adequate and reliable cash flow information. Credit unions should not accept cash flow assumptions without data to show they are realistic. Borrowers must provide evidence they have sufficient funds available to service the debt.

The credit union should obtain tax returns and financial schedules of both the member and the business to properly analyze the cash flow statement. A quick test for cash flow is to add back to the profit-and-loss data of the business (net income) any non-cash expenditures (such as depreciation, adjustments to accounts receivable, etc.) and relate a positive resulting figure to the member's ability to cover loan payments.

- Net worth analysis. In addition to reviewing cash flow, the credit union should evaluate the strength of the business. One method of measuring profitability is to divide net profit by net worth, which results in the owner's return on investment.

Net worth is the equity or retained earnings of the business and represents the borrower's cushion before bankruptcy or insolvency occurs. Borrowers can distort net worth by overstating assets or understating liabilities. While borrowers often overvalue their assets, they can also understate liabilities both on their personal and business financial statements. A borrower must supply supportable financial data to the credit union.

- Collateral analysis. The underwriting process must include a determination of the value, liquidity, and lien status of the collateral. Prudent lending requires the borrower to have equity in the assets securing the loan. The credit union's member business loan policy must establish guidelines for the maximum LTV the credit union permits for various types of collateral, while meeting the minimum regulatory requirements. When establishing these values, the credit union must keep in mind the forced sale of collateral generally brings a minimal return in relation to the value of the assets of a viable business.

Considering the high percentage of new businesses that fail, the credit union must carefully analyze collateral and cash flow. If the borrower uses inventory as collateral, all the procedures discussed later in this chapter concerning floor plan loans apply. However, the forced sale value of inventory in process may cover only a fraction of the value of the finished product.

- Financial analysis ratios. Credit unions should analyze at least three years worth of data from financial statements before granting a loan. They should perform ongoing analysis after granting the loan. Forward, as well as historical projections are critical to sound financial analysis. Examples of basic capital and liquidity ratios can be found in Appendix 10C Member Business Loan Financial Ratios. Credit unions should use these ratios and, if necessary, establish additional ratios to analyze loans.

Credit unions may use published ratios relating to various industries as a standard for comparison (e.g., the Robert Morris ratios.) The credit union should maintain copies of the particular industry's standard ratios.

Documentation
Documentation for a member business loan also must include proper signatures from the parties to the transaction (those individuals permitted to borrow under the *FCU Act, FCU Bylaws,* and the *NCUA Rules and Regulations.)*§723.7 of the Regulations require the credit union not grant member business loans without the personal liability and guarantee of the principals, except where the borrower is a not-for-profit organization, as defined by the IRS (26 U.S.C. 501 .)

Lien filings often require the use of UCC documents. The credit union must file the necessary documents with appropriate local or state agencies, perform and document their search for prior liens, and keep their liens current, as required by their local or state agencies. Business assets also require proper insurance with appropriate loss payable clauses to the credit union.

Loan covenants documenting specific conditions of the loan are part of the member business loan note. Examples of loan covenants include (1) frequency of providing financial reports, (2) insurance renewal periods, (3) working capital requirements, (4) limits on owner draws, (5) permission for periodic onsite business inspections, and (6) call options, if the financial performance of the business deteriorates. An attorney experienced in loan covenants should prepare the loan agreement. Credit unions willing to take the risk of making a member business loan must recognize they need to pay for the expertise needed to document the loan agreements.

The credit union should know that too many covenants can expose the credit union to possible "lender liability", if the borrower defaults. Lender liability can also occur when a borrower becomes dependent on a lender for a constant supply of funds.

Environmental Protection Agency (EPA) Concerns
A credit union foreclosing on secured contaminated property should determine if a liability exists under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA.) CERCLA facilitates the cleanup of hazardous waste sites. The mere threat of a hazardous substance release can invoke liability under CERCLA, which covers environmental hazards in the air, water, and soil.

Technically, when the credit union forecloses on the collateral, it becomes the "owner" of the property and the EPA can hold lenders liable for hazardous waste cleanup. However, CERCLA can exempt parties that hold ownership primarily to protect their security interest, even when foreclosure leads to actual ownership. Legal guidance should help them determine the appropriate course of action.

Types of Member Business Loans

Examples of member business loans include investment property loans, working capital advances, term business loans, agricultural credit, and loans to individuals for business purposes. Some credit unions also grant letters of credit, which examiners may find particularly difficult to identify since they are an off-balance sheet contingent liability.

Rental Property Loans

The most common type of business loan is for rental property where the member obtains a credit union loan secured by an apartment building or a house, which the member then rents out. While real estate securing a member business loan may meet the requirements for exclusion from Part 723 of the *NCUA Rules and Regulations,* the examiner should treat the loan as a member business loan for review purposes.

When credit unions use rental income to qualify a borrower for a loan, the credit union should include the gross rental income as part of the borrower's gross income (after factoring in a reasonable vacancy rate), and the borrower's debt should include expenses related to the property.

Credit unions should support credit-granting decisions for rental property by determining the property's cash flow. For example, adding back depreciation to net rental income provides a good estimate of cash flow from rental property. Loan officers making rental property loans should have sufficient expertise in the rental property area, including a full understanding of Schedule E of the member's tax return.

Working Capital Loans

Working capital is the difference between current assets and current liabilities. This type of loan provides temporary capital in excess of normal needs. Working capital loans provide short-term funds that borrowers repay at the end of the cycle by converting inventory and accounts receivable into cash. Businesses engaged in manufacturing, distribution, retailing, and service-oriented operations use short-term working capital loans.

Regulatory requirements and sound business practices govern the collateral securing this type of loan. Usually, the credit union takes the borrower's accounts receivable or inventory as collateral. If the credit union takes inventory as collateral, the lien should include the phrase "and proceeds thereof' since inventory converts to cash or accounts receivable, as it is sold.

Since this type of loan is high-risk, a credit union must set financing limits. For example, since accounts receivable collateral will rarely bring 100 cents on the dollar in a forced sale, the credit union should limit the loan to an amount less than the book value (e.g., 50 percent.) In addition, credit unions should review the accounts receivable discount terms and aging records to determine collection activity of the business.

If the credit union takes accounts receivable as security, the loan covenants should require the borrower to regularly check the credit rating of the major debtors on the receivable list. The credit union should receive a monthly aging of the accounts receivable past due and make periodic onsite inspections to determine the accuracy of the borrower's aging and reporting records. The credit union should also determine if the borrower has pledged inventory against another loan (e.g., a UCC filing search.)

When taking inventory as collateral, the credit union must perform periodic onsite inspections to ensure the borrower maintains a reliable inventory control system. The credit union should perform test checks on the inventory control system to ensure the accuracy of the total amount of reported inventory.

In all cases, credit unions should obtain quarterly profit and loss statements (including past statements, preferably for two or more years) from the borrower to evaluate the continued viability of the business.

Term Business Loans

Normally, members use term business loans to acquire capital assets such as plant and equipment. Regulatory requirements govern the collateral securing this type of loan. Due to the extended loan period, term loans contain more interest rate risk than do short-term advances. Because of the greater risk, credit unions should require amortization payments. Loan agreements will also contain restrictive covenants (conditions agreed to by the borrower) for the life of the loan.

Agricultural Loans

Agricultural loans range from mortgages on real estate to equipment, livestock, growing crops, operating loans, or personal loans. A credit union making farm real estate loans must take into account various factors that may not occur in other real estate loans. For example, credit unions making farm loans should (1) value not only acreage, but the productivity of those acres; (2) consider erosion and wastage along with fertility, since repayment may occur over an extended amount of time; and (3) look to the farm's productivity over a series of years as the source of repayment. Changes in price levels affect net worth.

To ensure repayment of the loan, credit unions should determine the agricultural operation earns sufficient income to pay taxes, personal living expenses (if applicable), operating expenses (including crop and herd insurance, if required), and reasonable allowances to maintain the productivity of the land and income flows. A farmer or rancher must demonstrate managerial efficiency by maintaining operating costs consistent with the productive unit type the borrower offers as security. Some owners, or farm or ranch managers, operate farms or ranches inefficiently because they economize too much in the use of labor-saving machinery, while others invest in more mechanization than the farm income can support.

If the amount of agriculture loans represents a significant risk to the credit union examiners can use the following questions as guidelines when evaluating internal controls for agriculture loans:

- Livestock loans:

  - Does the credit union require inspections at the time it makes livestock loans?
  - Does the credit union require the borrower to provide proof of ownership at that time?
  - Does the credit union require inspectors to properly date and sign the inspection report?
  - Does the inspection report note the condition of the animals?
  - Does the credit union require periodic inspections when appropriate for the type of livestock loan?
  - Has the credit union made proper notification to and reviewed with appropriate brand inspection or recording offices to ensure the borrower has proper title to the livestock?
  - Is the brand registered with the appropriate local or state agencies?
  - Is the brand registered in the borrower's name?
  - Has the credit union established a tickler file to ensure the borrower reregisters the brand every nth year as required by local or state agencies?
  - Does the credit union file security agreements with appropriate local and state authorities?
  - Does the credit union require assignment of milk check agreements on dairy loans?

- Crop loans:

  - Does the credit union require inspections of growing crops before it advances funds?
  - Does the credit union require borrowers to obtain crop insurance, where appropriate?
  - Does the credit union closely monitor disbursements to ensure the borrower channels loan proceeds into the farm operation and uses the proceeds as intended?
  - Are disbursement checks made out jointly to the borrower and vendor?

Letters of Credit

A letter of credit substitutes the creditworthiness of the credit union for that of the individual or corporation. Credit unions may earn a fee for issuing a letter of credit. Most credit unions do not offer them.

Credit unions disclose letters of credit, which are off-balance sheet contingent liabilities, using footnotes to the financial statements. When credit unions fail to disclose letters of credit, examiners may detect them through fee income spikes occurring in a single month.

Although the credit union disburses no funds when it approves a letter of credit, sound internal controls for member business loans require lenders to treat a letter of credit like a funded loan (i.e., if the member cannot service the debt, the collateral must be liquid.)

Two types of letters of credit are (1) the commercial letter of credit, and (2) the standby letter of credit. Often, a commercial letter of credit finances the sale of goods between a buyer and seller. The seller ships the goods to the buyer and submits an invoice. To avoid risk of nonpayment for the goods, the seller may require the buyer to obtain a letter of credit. Commercial letters of credit, secured by cash deposits, pose little risk to an institution as long as the credit union receives proper documentation from the beneficiary (seller.)

A standby letter of credit represents an irrevocable commitment to pay if the member defaults on an obligation. When issuing standby letters of credit, credit unions should determine that adequate collateral secures these letters of credit. Application forms should automatically convert to collateralized notes when members draw upon their letters of credit. Standby letters of credit have many uses. A request for a demand for payment of a standby letter usually signals something is wrong. Nonperformance or default that triggers payment of a standby letter of credit signals financial weakness, whereas payment under a commercial letter of credit suggests a normal business transaction.

Floor Plan Loans

Floor plan lending, a form of wholesale or inventory financing, finances items for dealers, including automobiles, mobile homes, boats, large home appliances, furniture, television, and stereo equipment. Under a written contract between the credit union and the dealer, a specific piece of equipment collateralizes each loan advanced. As the dealer sells a piece of collateral, the contract requires the dealer to repay those funds advanced for that collateral sold. A common policy requires dealers to invest 10 to 20 percent of their own funds.

Credit unions rarely engage in floor plan lending, which is specialized lending with above-normal risks. Loan officers working in the area of floor plan lending require special expertise.

This type of financing usually involves the use of a trust receipt. The written contract between the credit union and the dealer specifies the credit union will release to the dealer title to a specific piece of collateral sold with the stipulation the credit union will hold title to such collateral in trust until time of sale. The contract usually gives the dealer the right to sell the inventory, but normally at not less than the "release price." The credit union should request the dealer to authorize the credit union to periodically inspect the inventory, examine the dealer's records, and upon any default by the dealer to declare a forfeiture of the dealer's interest in the inventory. The credit union can verify inventory for reasonableness against tax forms.

To reduce the risk involved in this type of financing, the credit union should ensure prompt repayment by frequently inspecting the dealer's inventory (to determine exactly which units the dealer has sold), record inspection dates, the name of the inspector, and an itemized list of collateral.

Floor plan financing contracts should also provide for partial repayments on unsold inventory. For example, contracts frequently require the dealer to pay down the invoice price by 10 percent after 90 days and then make a 5 percent partial payment each month thereafter. Under such a plan, the credit union would require the dealer pay in full the note financing any units not sold after one year. This plan encourages inventory turnover and helps the credit union avoid financing out-of-date inventory.

Credit unions should require periodic financial statements from the dealers, monitor the dealers' financial position, and address any over-leveraging that may occur. Problems result when a dealer floor plans inventory with several lenders and uses the proceeds from the sale of the inventory for purposes other than to repay the floor plan loan.

Examination Guidance

The review of the member business loan portfolio could document the credit unions compliance with:

- Member business loan requirements of Part 723**;** and,
- Loan maturity limits of §701.21(c)(4).

Examiners may complete the Business Loan questionnaire, which documents (1) whether the credit union complies with the NCUA Rules and Regulations**,** and (2) whether safety and soundness concerns exist in the credit union's member business lending practices. Examiners may also benefit from developing continuing workpapers for tracking member business loans from one examination to the next.

Examiners should report on the status of member business lending in credit unions whose member business loans exceed regulatory limits specified in §723.16 (the aggregate of member business loans plus unfunded commitments equal the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets.)