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Commercial Real Estate Lending Requirements (Credit Unions)

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Scope & Applicability

- **Applicability:** 12 CFR part 723 applies to all federally insured credit unions (FICUs). A FICU with total assets under $250 million, aggregate commercial loan balances under 15% of net worth, and commercial loans originated and sold in a calendar year under 15% of net worth is not required to comply with 12 CFR §§ 723.3 and 723.4, but remains subject to all other 12 CFR Part 723 requirements.

- **Excluded loan types:** 12 CFR part 723 does not apply to loans:
  - Made by corporate credit unions;
  - Made by one FICU to another;
  - Made to a credit union service organization (CUSO); or
  - Fully secured by a lien on a 1- to 4-family residential property that is the member's primary residence.

Board & Management Responsibilities

- **Board approval and oversight:** Before engaging in commercial lending, the Board must approve the commercial loan policy. The policy must also be reviewed before any material change to the lending program, in response to material changes in portfolio performance or economic conditions, and at least annually. The Board must ensure adequate staffing and receive regular briefings on the nature and level of portfolio risk, including its potential impact on earnings and net worth.
- **Senior management responsibilities:** Officers overseeing commercial lending must understand the FICU's commercial lending activities and must establish the risk management processes and controls necessary to manage those activities safely.
- **Staffing requirements:** The FICU must employ personnel with experience in: underwriting and processing the types of commercial loans it makes; overseeing and evaluating portfolio performance through a credit risk rating system; and conducting collection and loss mitigation activities.
- **Use of third parties:** A FICU may use a third party, including a CUSO, to satisfy staffing requirements. The third party must be independent from the borrower, the lending decision must remain with the FICU, and qualified FICU staff must exercise ongoing oversight of the third party's work.

Commercial Loan Policy Requirements

- **Required policy content:** The commercial loan policy must address: permitted loan types and geographic trade area; maximum concentration limits by loan category and by individual borrower or group of associated borrowers; required personnel qualifications; and loan approval authority levels commensurate with each approver's commercial lending expertise.
- **Underwriting standards:** Standards must address: depth of required financial analysis; due diligence on principals; evaluation of borrower projections; financial statement quality and verification; LTV ratio limits and collateral valuation methods for all authorized collateral types; and environmental due diligence.
- **Concentration limits:** Aggregate loans to a single borrower or group of associated borrowers may not exceed the greater of 15% of net worth or $100,000, plus an additional 10% of net worth if the excess is fully secured by readily marketable collateral.
- **Risk management:** The policy must provide for loan covenants, periodic loan review and collateral reevaluation, a credit risk rating system assigned at origination and reviewed as conditions warrant, and a process to identify and monitor policy exceptions.

  Note that: 12 CFR part 723 does not prescribe specific LTV thresholds. Each FICU must establish its own LTV limits in its commercial loan policy, commensurate with its risk profile and collateral type.

Collateral & Security

- **Collateral standard:** A FICU must require collateral commensurate with the level of risk associated with the size and type of each commercial loan, sufficient to ensure adequate loan balance protection and appropriate risk sharing with the borrower and principals.
- **Unsecured loans:** A FICU may make an unsecured commercial loan if it documents in the loan file that mitigating factors sufficiently offset the absence of collateral.
- **Personal guarantee:** Principals with a controlling interest in the borrower must provide their full and unconditional personal guarantee, or the FICU must document in the loan file that mitigating factors sufficiently offset the relevant risk.

  Note that: 12 CFR part 723 does not define specific collateral types or prescribe minimum LTV thresholds. Those determinations are established by each FICU's commercial loan policy under 12 CFR § 723.4.

Construction & Development Loans

- **Definition:** A construction or development loan is any financing arrangement enabling the borrower to acquire property to construct or renovate income-producing real property, including residential housing for sale or rent or commercial, agricultural, or industrial property, or to finance major expansion or renovation of such property.
- **Collateral valuation:** For construction or development loans, collateral value is the lesser of: cost to complete, comprising all qualifying costs in an approved construction budget including land value, hard construction costs, interest, contingency, and development fees at market rates; or prospective market value as-completed or as-stabilized, as determined by an independent appraiser under Uniform Standards of Professional Appraisal Practice standards.
- **Disbursement controls:** The commercial loan policy must require: review and approval of the construction budget by qualified FICU personnel before closing; a FICU-approved requisition and disbursement process; on-site inspections by qualified personnel certifying satisfactory completion of work before each disbursement; and confirmation of no intervening liens before each disbursement.

  Note that: Loans for maintenance, repairs, or improvements to existing income-producing property that do not change the property's use or materially affect its value are not construction or development loans under 12 CFR part 723.

Aggregate MBL Limit

- **Statutory cap:** A FICU's aggregate net member business loan (MBL) balances may not exceed the lesser of 1.75 times actual net worth or 1.75 times the minimum net worth required under the Federal Credit Union Act.
- **Exclusions from aggregate calculation:** The following are excluded from the MBL cap: commercial loans fully insured, guaranteed, or subject to an advance purchase commitment by a Federal or State agency or its political subdivision; non-member commercial loans or participation interests acquired from another lender in compliance with applicable law; and loans fully secured by a lien on a 1- to 4-family dwelling.
- **Net MBL balance calculation:** Net MBL balance equals outstanding principal plus unfunded commitments, reduced by: amounts secured by shares in the credit union or another financial institution; amounts secured by the member's primary residence; government-insured or guaranteed amounts; and participation interests sold that qualify as true sales under GAAP.
- **Statutory exemptions:** A FICU that: has a low-income designation; participates in the CDFI program; was chartered to make MBL loans; or had a history of primarily making commercial loans as of August 7, 1998, is exempt from the MBL cap.

Prohibited Activities

- **Ineligible borrowers:** A FICU may not make a commercial loan to: any senior management employee directly or indirectly involved in commercial loan underwriting, servicing, or collection; any immediate family member of such an employee; any associated borrower of such persons; or any compensated director, unless the Board approves and the director is recused from the decision.
- **Equity and joint venture arrangements:** A FICU may not make a commercial loan if it or any of its senior management employees would receive additional compensation tied to the profit or sale of the business or venture that benefits from the loan proceeds.
- **Third-party conflicts of interest:** Any third party used to satisfy 12 CFR part 723 requirements must be independent from the commercial loan transaction and may not hold a participation interest in the loan, hold an interest in the loan collateral, or receive compensation contingent on the loan closing.

  Note that: Under 12 CFR § 723.7(c)(3), a CUSO in which the FICU holds a controlling financial interest under GAAP may still be used to satisfy 12 CFR Part 723 staffing requirements even if the CUSO is not independent from the commercial loan transaction, provided the requirements of 12 CFR § 723.3(b)(3) are met.