Vermont Banking Division

REGULATION B-2012-01:

CREDIT UNION MEMBER BUSINESS LOANS
(Regulation B-2012-01 supersedes and replaces Regulation B-2000-01)

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Section 1. Authority, Scope and Purpose. This regulation is promulgated pursuant to 8 V.S.A. §§30203 and 32401 for the purpose of setting guidelines for credit unions to make member business loans. This regulation provides the basis for a system of member business lending that is consistent with safe and sound credit union practices. The objective of this regulation is to ensure that member business loans are made in such a way as to minimize the controllable risks inherent in this type of lending.

Section 2. Definitions. As used in this regulation:

(1) "Associated member" means any member of the credit union with a common ownership, investment, or other pecuniary interest in the business or commercial endeavor for which the business loan is being made.

(2) "Construction or development loan" means a financing arrangement for acquiring property or rights to property, including land or structures, with the intent to use it for or convert it to income producing property such as residential housing for rental or sale; commercial use; industrial use or similar uses. A construction or development loan also includes a financing arrangement for the major renovation or development of property already owned by the member that will convert the property to income producing property, that will convert the use of income producing property to a different use, or that is a major expansion of its current use. A construction and development loan does not include a loan to finance maintenance, repairs, or improvements to an existing income producing property that does not change its use.

The following examples illustrate when a loan is or is not a construction or development loan:

Example 1. If a member borrows money to repair a roof on a barn on an existing farming operation, this is a member business loan but is not a construction or development loan. A construction or development loan does not include a loan for routine maintenance of a member's existing business or a loan to enhance or expand a member's existing business unless those renovations convert the property to a different use or are so major as to be considered the equivalent of converting the use of the property.

Example 2. A loan to convert a movie theater into a restaurant is a construction or development loan. A loan to convert a large Victorian home used for residential purposes into a six-room inn also would be a construction or development loan. In both instances, the loans are for the purpose of converting the use of the properties. By contrast, a loan to repair the roof or replace the carpet and wallpaper of an operating inn would not be a construction or development loan as it neither converts the use of the property, nor is so major a renovation to be considered the equivalent of converting the use of the property.

Example 3. A loan to expand the parking lot of a small strip shopping center would not be a construction or development loan, but a loan to renovate the small strip shopping center into a mega-mall would be a construction or development loan as it would be viewed as a major renovation that converts the use of the property.

Example 4. A hotel with a fair market value of $10 million borrows $1 million to build an exercise facility in the hotel to enhance the property. The loan amount is 10% of the fair market value of the property. This is not a construction or development loan. It is a member business loan to improve or renovate an existing income producing property, but it is not so major a renovation as to be considered the equivalent of converting the use of the property. In another scenario, a hotel with a fair market value of $10 million borrows $5 million to build a luxury health spa on the hotel grounds. The loan amount is 50% of the fair market value of the property. This is a construction or development loan, even if the use of the property has not been converted, as the renovation is so major as to be considered the equivalent of converting the use of the property.

(3) "Loan-to-value ratio" means the aggregate amount of all sums borrowed including outstanding balances plus any unfunded commitment or line of credit from all sources on an item of collateral divided by the market value of the collateral.

(4) "Member business loan" means any loan, line of credit, or letter of credit, (including any unfunded commitments) the proceeds of which will be used by the member for any of the following purposes:

(a) commercial;

(b) corporate;

(c) agricultural; or

(d) other business investment property or venture;

A member business loan also includes any interest a credit union obtains in a loan made by another lender where the proceeds of the loan will be or are used by the member for any of the purposes described in (a) – (d) above.

Provided however, the following shall not be considered a member business loan for the purposes of this regulation:

(i) A loan that is fully secured by a lien on a 1 to 4 unit dwelling that is the member's primary residence.

(ii) A loan that is fully secured by shares in the credit union or by perfected security interests in federally insured deposits in other financial institutions.

(iii) A loan, the repayment of which is fully guaranteed or fully insured by the federal government or by the state of Vermont or any of its political subdivisions. A binding advance commitment to purchase a member business loan in full by any such entity shall be considered a guarantee for the purposes of this paragraph.

(iv) One or more business purpose loans as described in (a) – (d) above (excluding loans described in (i), (ii), or (iii) of this subsection 4) to a member or associated members, which in the aggregate do not exceed $50,000.00. The entire amount of such a loan that exceeds $50,000.00, or the entire amount of the loan that causes the aggregate amount to exceed $50,000.00, is a member business loan.

For purposes of any risk based net worth calculation, once a loan is classified as a member business loan it remains a member business loan until the loan is paid in full or otherwise discharged.

(5) "Net worth" means retained earnings at quarter end as determined under Generally Accepted Accounting Principles. Retained earnings normally include undivided earnings, regular reserves and any other appropriations designated by management or regulatory authorities. Only undivided earnings and appropriations of undivided earnings are included in net worth. For low income designated credit unions, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders, and the National Credit Union Share Insurance Fund ("NCUSIF"). For any credit union, net worth does not include the allowance for loan and lease losses account.

Section 3. Policy Requirements. A credit union that engages in the business of making member business loans shall adopt specific member business loan policies, which shall be reviewed at least annually. The member business loan policies shall be consistent with safe and sound

practices and shall be appropriate to the size of the credit union and the nature and scope of its operations.

The credit union must utilize the services of personnel with qualifications and experience (minimum of 5 years) with the type of lending in which the credit union will engage. The qualifications and experience must provide the credit union sufficient expertise given the complexity and risk exposure of the loans in which the credit union intends to engage. Credit unions do not have to hire staff to meet the requirements of this section, however, the credit union must ensure that the expertise is available. A credit union can meet the experience requirement through various approaches. For example, a credit union can use the services of a credit union service organization ("CUSO"), an employee of another credit union, an independent contractor, or other third parties. However, the actual decision to grant, purchase, or participate in a loan must reside with the credit union.

The member business loan policies, at a minimum, shall address all of the following areas:

(1) Types of business loans to be made.

(2) Trade area.

(3) The maximum amount of credit union assets, relative to credit union net worth, that will be invested in member business loans.

(4) The maximum amount of credit union assets, relative to the credit union net worth, that will be invested in a given category or type of business.

(5) The maximum amount of credit union assets, relative to credit union net worth, that will be invested in a given category or type of member business loan.

(6) The maximum amount of credit union assets, relative to credit union net worth, that will be loaned to any one member or associated members, subject to Section 4 of this regulation.

(7) The qualifications and experience of personnel (minimum of 5 years) involved in making and administering member business loans.

(8) Collateral requirements, which must include all of the following:

> (a) Loan-to-value (LTV) ratios. The maximum loan-to-value ratio for all liens must not exceed 80%, unless the value in excess of 80% is covered through private mortgage insurance or equivalent type of insurance, or insured, guaranteed, or subject to advance commitment to purchase by an agency of the federal government, an agency of a state or any of its political subdivisions, but in no case may the ratio exceed 95%. The credit union may make vehicle loans without complying with this loan to value ratio, provided the vehicle is a car, van, pick-up truck, or sports utility vehicle and is not part of a fleet of vehicles;

(b) Determination of value;

(c) Determination of ownership, including title search and UCC searches;

(d) Insurance requirements;

(e) Environmental impact assessments;

(f) Steps to be taken to secure various types of collateral, including obtaining proper corporate resolutions and security agreements authorizing the pledge of business assets.

(g) How often the credit union will reevaluate the value and the marketability of the collateral.

(9) Analysis and documentation of the member's ability to repay the loan consistent with, at a minimum, the following underwriting requirements:

(a) Present financial status based on documentation supporting each request for an extension of credit or an increase in an existing loan or line of credit, which shall address all of the following:

(i) A balance sheet, or its equivalent if a sole proprietorship;

(ii) An income statement, or its equivalent if a sole proprietorship;

(iii) A cash flow analysis;

(iv) Tax returns for the two most recent years;

(v) Analysis of debt-to-income and loan-to-value ratios;

(vi) Personal guarantees of the principals;

(vii) Current credit report of the business and principals; and

(viii) The periodic updating of financial statements, tax returns, and other documentation.

(b) Analysis of the member's initial and ongoing financial capacity to repay the debt, including the review of at least 2 years of pro-forma financial statements and cash flow projections.

(c) A feasibility analysis of the project considering local economic conditions and comparative industry trends for the type of venture involved.

(d) Capacity of the member to repay from assets not related to the venture in case of failure.

(e) Certification by the appropriately designated loan officer or credit committee that the loan under consideration meets all applicable credit union and statutory requirements.

(10) The interest rates and maturities of member business loans, which shall be consistent with the purpose, security, and creditworthiness of the borrower and sound lending policies;

(11) General loan procedures which include:

(a) loan monitoring;

(b) servicing and follow-up; and

(c) collections.

(12) Requirements for personal liability and guarantees of principals.

(13) Identification, by position, of the officials and senior management employees who are prohibited from receiving member business loans which, at a minimum, shall include individuals who perform the following functions regardless of the title given to such person: the credit union's chief executive officer, any assistant chief executive officers, the chief financial officer, and any associated member, immediate family member or household member of such persons.

(14) Guidelines for the purchase and sale of member business loans and loan participations, if the credit union engages in that activity.

Section 4. Loans to One Borrower. Subject to the limitations set forth in Section 7 hereof, the aggregate amount of outstanding member business loans (including any unfunded commitments) to any one member or group of associated members shall not exceed 15% of the credit union's net worth or $100,000.00, whichever is higher. If any portion of a member business loan is secured by shares in the credit union or deposits in another financial institution, or is fully or partially insured or guaranteed by, or subject to an advance commitment to purchase by, any agency of the Federal government or of a state or any of its political subdivisions, such portion shall not be used in calculating the 15% limit or the $100,000.00 limit, whichever is higher.

Section 5. Small Business Administration and U.S. Department of Agriculture Rural Development Loan Programs. A credit union authorized to make member business loans that makes a loan as part of a Small Business Administration guaranteed loan program or as part of a U.S. Department of Agriculture Rural Development guaranteed loan program with loan requirements that are less restrictive than those required by this regulation may follow the loan requirements of the relevant Small Business Administration or U.S. Department of Agriculture Rural Development guaranteed loan program to the extent they are consistent with this regulation. The collateral and security requirements of Section 3 (8)(a) and Section 6 do not

apply to member business loans made as part of a Small Business Administration or as part of a U.S. Department of Agriculture Rural Development guaranteed loan program.

Section 6. Construction Loans. Construction and development of commercial or residential property are subject to the following additional requirements:

(1) The aggregate of all construction and development loans must not exceed 15% of the credit union's net worth. To determine the aggregate, a credit union may exclude any portion of a loan:

(a) Secured by shares in the credit union;

(b) Secured by federally insured deposits in another financial institution;

(c) Fully or partially insured or guaranteed by any agency of the federal government, state, or its political subdivisions;

(d) Subject to an advance commitment to purchase by an agency of the federal government, state, or its political subdivisions; or

(e) To finance the construction of a single family residence if a prospective homeowner has contracted to purchase the property.

(2) The member must have a minimum of 25% equity interest in the project being financed. This minimum equity requirement shall not apply in the case of a loan made to finance the construction of a single-family residence if a prospective homeowner has contracted to purchase the property, however, the collateral requirements of Section 3(8) shall apply.

(3) The funds may be released only after on-site, written inspections by qualified personnel and according to a preapproved draw schedule and any other conditions as set forth in the loan documentation.

(4) The credit union must not make any construction and development loans unless it utilizes the services of an individual with at least five years of direct experience in construction and development lending.

Section 7. Member Business Loans Aggregate Limit. Unless the Commissioner gives his or her prior consent, the aggregate limit of a credit union's outstanding member business loans (including any unfunded commitments) shall be the lesser of 1.75 times the credit union's net worth or 12.25% of the credit union's total assets. Loans that are exempt from the definition of member business loans shall not be used in calculating the aggregate loan limit.

A credit union may submit a request to the Commissioner to exceed the above aggregate member business loan limitation. An exception to the aggregate member business loan limitation is not effective until it is specifically approved in writing by the Commissioner. In no event may the aggregate member business loan limitation exceed any limitation establish by state law, federal

law, or by applicable regulations (including regulations and limitations established by the National Credit Union Administration ("NCUA") or any successor thereto).

The request to increase the credit union's aggregate member business loan amount must include:

(1) A copy of the credit union's member business loan policy;

(2) The higher limit sought;

(3) An explanation of the need to raise the limit;

(4) Documentation supporting the credit union's ability to manage the increased member business loan activity;

(5) An analysis of the credit union's prior expertise making member business loans, including, at a minimum:

(a) The history of loan losses and loan delinquency;

(b) Volume and cyclical or seasonal patterns;

(c) Diversification of loan portfolio;

(d) Concentrations of credit to any member or group of associated members in excess of 15% of net worth;

(e) Underwriting standards and practices;

(f) Types of loans grouped by purpose and collateral;

(g) The qualifications and experience of personnel responsible for underwriting and administering member business loans; and

(h) Such additional information as the Commissioner may request.

The Commissioner may approve or deny the request in his or her sole discretion. Federal regulations may require the approval of the NCUA or its successor in addition to the Commissioner's approval.

Section 8. Prohibitions, Unsecured Loans.

(1) A credit union may not grant a member business loan if any additional income received by the credit union or senior management employees is tied to the profit or sale of the business or commercial endeavor for which the loan is made.

(2) A credit union shall not make unsecured member business loans, except the following:

(a) An unsecured loan made by a credit union where the loan and the credit union meet each of the following criteria:

(i) The aggregate of unsecured member business loans to any one member or group of associated members does not exceed $100,000.00 or 2.5% of the credit union's net worth, whichever is less; and

(ii) The aggregate of all unsecured member business loans under this subsection (b) does not exceed 10% of the credit union's net worth;

and

(b) Credit card line of credit programs offered to non-natural persons that are limited to routine purposes normally made available under such programs

Section 9. Loan Purchases and Loan Participations. Any loan purchased and any loan participation held by a credit union that would constitute a member business loan if made to a member shall be considered a member business loan for purposes of this regulation. Such purchased loan or loan participation is subject to all of the requirements and limitations of this regulation, including underwriting requirements, individual loan limits, and aggregate loan limits.

Section 10. Allowance for Loan Loss Account. An allowance for member business loan losses account shall be established in accordance with Generally Accepted Accounting Principles.

Section 11. Commissioner Approval. A credit union shall obtain the Commissioner's written approval prior to engaging in the business of making member business loans. The Commissioner may condition such approval upon review of the following:

(1) The written loan policy adopted by the board of the credit union;

(2) Sample copies of all loan and security documents to be used by the credit union in connection with member business loans, including, without limitation, copies of notes, loan agreements, securities agreements, and form corporate resolutions.

(3) Written member business loan monitoring and collection procedures to be employed by the credit union;

(4) The qualifications and experience of credit union personnel involved in the approval, closing, and administering of member business loans on behalf of the credit union.

(5) The credit union is well capitalized under the prompt corrective action guidelines of the National Credit Union Administration.

(6) Such additional matters as the Commissioner deems relevant.

The Commissioner may restrict a credit union's member business loan activity to certain products, types, or categories of member business loans.

A credit union that has made business loans under an authorization under this regulation and that is not, as of its most recent quarterly call report, well capitalized, may not make any member business loans, until such time as the credit union becomes well capitalized, as reflected in a subsequent quarterly call report, and obtains the approval of the Commissioner.

Section 12. Record Keeping Requirements. Member business loans must be separately identified in the credit union's records, and in the aggregate on the credit union's financial reports.

Section 13. Effective Date. This regulation is effective May 15, 2012.

Section 14. Severability. If any provision of this regulation, or the application of it to any person or circumstance, is determined to be invalid by a court of competent jurisdiction, such invalidity shall not affect other provisions of this regulation which can be given effect without the invalid provision or application, and to that end the provisions of this regulation are severable.