Executive Compensation Solutions
Creating Value Through Innovation

May 18, 2011

Ms. Mary Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Proposed Interagency Rule for Incentive-Based Compensation Arrangements (Docket No. OCC-2011-0001; NCUA reference RIN 3133-AD88)

Dear Ms. Rupp:

Thank you for the opportunity to comment on the proposed "Interagency Rule for Incentive-Based Compensation Arrangements" (Docket No. OCC-2011-0001; NCUA reference RIN 3133-AD88) (the "proposed rule").

As a provider of executive compensation services to the credit union movement, Executive Compensation Solutions ("ECS") appreciates the efforts of the agencies to reduce the exposure of financial institutions to financial losses resulting from incentive compensation arrangements that drive executives to take inappropriate risks. ECS agrees that incentive compensation should be an "at risk" element of a total executive compensation package. It should be tied to sustainable and verifiable results for the organization and for individual performance. We agree that executives of these institutions should not benefit when the ultimate result is a detriment to the institution and its shareholders, stakeholders, and members.

In reviewing the content and establishing context for the proposed regulations, we have identified several areas that raise questions and comments. We appreciate your consideration of the areas we have identified as well as our suggested alternatives where we deemed them appropriate.

Provisions Affecting Covered Institutions

The proposed rule has two requirement levels for procedures and reporting of incentive compensation awarded to credit union officers (and to non-officer employees) who can expose the financial institution to material loss. The first level affects credit unions with assets of $1 billion or more ("covered institutions").

All covered institutions would be subject to prohibitions on providing excessive incentive compensation or incentive compensation that could lead to material financial loss. These institutions would also be required to submit annual reports to their regulatory agencies and establish and maintain policies and procedures governing incentive compensation.

The second level of the proposed regulation affects credit unions with assets of $10 billion or more, and other financial institutions with assets of $50 billion or more. These institutions are required to defer at least 50% of incentive compensation paid to executive officers for at least three years. Their boards of directors must also identify persons who individually have the ability to expose the institution to material losses and approve any incentive compensation arrangements for those people.

All covered institutions are subject to procedural and reporting requirements on an annual basis. They must provide a clear description of the incentive-based compensation arrangements for persons covered under the proposed rule and specify any material changes that have occurred to the arrangements since the last report. The annual report must state the reasons why the incentive compensation does not encourage excessive risk taking. For credit unions with assets at or over $10 billion (and, again, for other financial institutions with assets of $50 billion or more), the report must also include a description of incentive compensation policies and procedures for officers and employees who could expose the institution to substantial losses.

A significant concern that we have with the NCUA provisions under the interagency rule is that it establishes a different standard for credit unions than for its for-profit counterparts. This is in regard to the payment deferral threshold for "larger covered financial institutions." In the initial draft of the interagency rule, larger covered financial institutions were defined as "those with $50 billion or more in total consolidated assets." The NCUA provisions changed this threshold level for credit unions to $10 billion or more. There is no logical reason that credit unions should be held to a different standard than their for-profit counterparts. By providing a much lower standard, credit unions are adversely affected in their ability to recruit talent on a level playing field, and an additional regulatory burden is imposed on credit unions that others do not have. This translates to time and expense on the part of both the credit union and the NCUA in complying with and enforcing a rule to which other financial institutions are not subject.

<u>Time Horizons for Deferral of Incentive-Based Income</u>

ECS works with credit union boards to establish performance metrics and has designed many performance-linked retention, reward, and retirement plans. We believe that the intent of the proposed rule is to create a definitive link between appropriate and successful management of the credit union and 'at risk' compensation. To fully evaluate the results of management actions, a waiting period for such compensation is reasonable. The deferral period to receive an incentive award should logically be matched with an appropriate period over which longer-term results of financial decisions can be measured. As the proposed rule is currently drafted, it does not appear that there is a tie between the time horizon of the risk and the deferral period for payment. It also does not clarify whether there is any distinction in the time frame for deferral if the payment is a retirement benefit. If it is a retirement benefit, but has an element of performance metrics intrinsic in the benefit design, does the deferral period apply, or is the triggering event for payment (retirement) sufficiently distinct to allow for payment at the intended retirement date? As currently drafted, the proposed rule seems to indicate that payments earned a year before retirement could potentially be delayed into post-retirement periods, which does not appear to be the intent of the rule.

<u>Reconciliation of IRC 457 requirements, IRC 409A requirements and the proposed Interagency Rule</u>

Credit unions, as tax-exempt institutions, are subject to a unique set of Internal Revenue Service Code regulations, particularly Section 457, that define the timing of taxation of vested benefits. In short, Section 457 requires payment of tax on a benefit at the point in time that it is vested, therefore eliminating any substantial risk of forfeiture. Does the mandated deferral as anticipated under the proposed rule impose a substantial risk of forfeiture that would provide for a delay of the tax liability until the incentive compensation is actually paid? If so, these rules would change a long-standing taxation provision of Section 457. This conflict must be reconciled.

Credit unions must also subscribe to the provisions of Section 409A, which provides for penalties on inappropriately structured non-qualified executive deferred compensation arrangements. In fact, credit unions must comply with both IRC 457 and IRC 409A, even though they are in conflict in some areas. While the IRS had given indications that they will be providing guidance on these conflicting provisions, such guidance has yet to be issued, and credit unions have been subject to both sets of rules since the effective date of Section 409A.

For example, IRC Section 409A allows participants in non-qualified deferred compensation plans to postpone the receipt of deferred payments by a minimum of five years, if an election is made a year in advance of the payment due date. Contrarily, Section 457(f) is generally interpreted to require the payment of taxes on the originally scheduled date of a payment even if the payment is delayed in compliance with Section 409A.

The suggested 3-year deferral period for larger covered financial institutions (in the case of credit unions alone, those with assets over $10 billion) appears to create a conflict, in part, with the IRS rules governing substantial risk of forfeiture and subsequent taxation of benefits. The rule may create potential unintended tax consequences for executives receiving deferred payments of incentive compensation that are scheduled for payment before the 3-year period has been completed. In the case of a retirement date within the 3-year period, the payment would appear to be taxed under the provisions of 457, but the distribution of the money might be delayed until a later date. We suggest that the timing of vesting and taxation should be clearly delineated in the rule and be coordinated with the provisions of IRC 457.

Under the terms of the executive deferred compensation plan, there may also be other circumstances under which an acceleration of otherwise deferred payments could occur, such as change of control, involuntary termination (not for cause), disability, or death. It should be noted that these potential accelerating events are outside of the executive's own control, and therefore do not violate the 409A rules. How those payments are treated, both in terms of eligibility for payment and the tax implications of the payment eligible event, are not addressed in the proposed rule, and must be clarified in a final rule.

<u>Differentiation as To Retention and Retirement Plans</u>

The scope and affect of the proposed rule on existing incentive compensation and deferred compensation arrangements must also be specified. It is our opinion that existing arrangements under Section 457(f) of the IRS Code should be grandfathered and unaffected by the proposed rule. These arrangements could be subject to the procedural and reporting requirements for documentation purposes without unreasonable burden on the institutions.

The distinction between incentive-based compensation and deferred compensation arrangements should also be clarified. Credit unions and other covered financial institutions must be able to reasonably attract, reward, and retain key executive talent and also to provide non-qualified plan benefits to supplement retirement income. It is our view that a defined benefit or defined contribution plan guaranteed under the terms of a legal agreement is different than an incentive plan linked to performance. We suggest there be a clearly defined line between retirement and retention plans and those types of plans subject to the interagency rule (long-term incentive plans, for example).

Detailed procedures for the deferral of incentive compensation payments and evaluation of any adjustments required from long-term financial results should be included in the final rule.

Procedures for Proper Execution of the Rule

The proposed rule is silent as to whether each individual award is deferred and reviewed or whether all awards are aggregated. Without guidance on these issues, incentive compensation payments could be tied up in regulatory compliance for much longer than the intended delay period.

Appropriate accounting treatment for benefit liabilities created under these arrangements should also be specified.

Conclusion

We appreciate the opportunity to comment on the proposed interagency rule. We certainly believe that most credit unions already understand that the provisions of the proposed rule are good practice and are already in substantive compliance. The proposed rule codifies such best practices, but leaves some important issues unclear and potentially in conflict with other laws and regulations. While the proposal creates an important framework to limit potential abuses that might arise from excessive compensation, or compensation that encourages inappropriate risk taking, the vesting, distribution, and adjustments required in the event of unsustained performance should be clarified as part of the rule. Distinctions should also be provided as to the clearly different platform and intent of retention and retirement plans that are not necessarily based on specific performance measurements.

With such additional clarity, we are encouraged by the intent of the Dodd-Frank Bill and the provisions of the interagency rule, which support the recognition of work well done based on longer-term evaluations of performance metrics. We believe the proposal is an addition to an important set of NCUA rules and guidance that encourage competitive compensation practice and provide valuable protections for credit unions and their members.

Regards,

Jane E. Upton

Jane Upton
Principal