

May 27, 2011

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

Re: Comments on Notice of Proposed Rulemaking, Incentive-Based Compensation

VIA ELECTRONIC MAIL: regcomments@ncua.gov

Dear Ms. Rupp:

The Michigan Credit Union League (MCUL) appreciates the opportunity to comment on the NCUA Board's proposed rule regarding incentive-based compensation. MCUL is a statewide trade association representing 95% of the credit unions located in Michigan. MCUL respectfully requests that the NCUA Board takes the following letter into serious consideration when deliberating the passage of a final rule.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") (Pub. L. 111-203, section 956, 124 Stat. 1376, 2011-2018 (2010)), which was signed into law on July 21, 2010, requires NCUA and the other federal financial institution regulators (the Agencies) to jointly prescribe regulations **or guidelines** with respect to incentive-based compensation practices at covered financial institutions. [Emphasis added]

MCUL understands the mandate and desire to create standards to avoid excessive compensation arrangements that could lead to material financial loss for a financial institution. However, MCUL does not believe that a regulation is necessary, as it does not provide sufficient guidance. MCUL believes that such this proposed rule, if finalized, would merely serve to penalize credit unions retroactively in the event a given loan product tied to an incentive program resulted in financial loss years after consummation, and excuse previously lax examiner oversight of a credit union's loan portfolio.

Background

The Dodd Frank Act requires NCUA and the other federal financial institution regulators to ensure that any standards adopted with regard to excessive compensation under section 956 of the Dodd-Frank Act are comparable to, and take into consideration, the compensation-related safety and soundness standards applicable to insured depository institutions under section 39 of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. 1831p- 1(c)).

MCUL strongly urges the NCUA Board to adopt the FDIA provisions in the form of guidelines (in line with the existing guidelines established by the other federal financial institution regulators that are consistent with the FDIA), as opposed to yet another regulation with vague terms that will be enforced through the subjective opinion of a given examiner.

Definitions

“Covered Financial Institutions”

Commenter were specifically asked to address whether credit union service organizations (“CUSOs”) should be treated as a CFI to better promote the purpose of section 956 and competitive equity.

MCUL does not believe CUSOs should be treated as a CFI for the simple fact that CUSOs are not considered financial institutions, they are not regulated by NCUA, and are not insured by the National Credit Union Share Insurance Fund.

“Executive Officer”

The proposed rule defines “executive officer” as “a person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following positions: President, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line.”

MCUL does not believe this definition is necessary, as a “covered person” includes “employees” who are part of an incentive-based compensation program. Therefore, the individuals listed in the definition above would be covered under the “employees” provision.

Required Reports

The Dodd-Frank Act requires CFIs to submit an annual report to their respective regulators disclosing the structure of the CFI’s incentive-based compensation arrangements sufficient to determine whether the program provides covered persons with excessive compensation, fees, or benefits, or could lead to material financial loss to the CFI.

MCUL does not support requiring credit unions to submit an annual report to NCUA. MCUL strongly urges the NCUA Board to require examiners to review incentive-based compensation arrangements as part of the credit union examination process.

It is not clear what department would receive these reports, or how they would be reviewed. MCUL does not see how a reviewer not as closely associated with the credit union as an examiner is would have the requisite knowledge of a given credit union to make the determination that the incentive-based compensation plan provided is sufficiently balanced, “is compatible with effective controls and risk management,” or “is supported by strong corporate governance.” Reviewers would also have less of an understanding of the scope and nature of a credit union’s compensation arrangements.

In addition to the operational efficiencies associated with reviewing incentive-based compensation program as part of the exam process, it would also ensure confidentiality, as the information would never have to leave the credit union (to the extent permitted by law).

Prohibitions

The proposed rule would prohibit a CFI from having incentive-based compensation arrangements that “may encourage inappropriate risks (a) by providing excessive compensation or (b) that could lead to material financial loss to the CFI.”

Excessive Compensation

Under the proposed rule, incentive-based compensation for a covered person would be considered “excessive” when “amounts paid are unreasonable or disproportionate to, among other things, the amount, nature, quality, and scope of services performed by the covered person.” The proposal outlines considerations NCUA will take into account when determining whether compensation is excessive.

MCUL is concerned that the proposal contains a catch-all of “any other factors the Agency determines to be relevant,” as this would empower examiners to make subjective determinations without clear authority to support their respective positions. MCUL urges the NCUA Board to remove this provision from the factors to be reviewed.

Inappropriate Risks that May Lead to Material Financial Loss

What is an “inappropriate risk” and how will that term be interpreted? This term is not defined in Section 39 of the FDIA, and the proposed rule does not expound upon this term.

Most incentive programs are tied to loan consummations. The risks associated with certain lending products were not known to credit unions at the time the loans were underwritten, and were not discovered, in some cases, until well after the loans were closed. Many members who defaulted on loans as a result of the economic downturn were those with lucrative incomes and strong credit scores.

As Chairman Matz pointed out in testimony before the Senate Committee on Banking, Housing, and Urban Affairs on December 9, 2010, “Despite overall adherence to sound underwriting practices, the credit union industry was not immune to the macroeconomic impact of high unemployment and home value declines.”

MCUL is concerned that an examiner’s assessment of an “inappropriate risk” could be determined years after a loan product was offered at a credit union. MCUL strongly believes that whether the Dodd-Frank Act mandates take the form of guidance or regulation, the term “inappropriate risk” should be measured as of the time a loan is granted, and not determined on an “after the fact” basis. This concern is heightened based on the proposal’s provisions regarding NCUA’s determination that an incentive-based compensation program is sufficiently “balanced.”

Balance of Risk and Financial Rewards

Under the proposed rule, to assess whether incentive-based compensation arrangements are balanced, NCUA will consider the full range of risks associated with a covered person’s activities, “as well as the time horizon over which those risks may be realized. The activities of a

covered person may create a wide range of risks for a CFI, including credit, market, liquidity, operational, legal, compliance, and reputational risks. Some of these risks may be realized in the short term, ***while others may become apparent only over the long term.*** [Emphasis added]

MCUL believes that so long as sound underwriting systems are in place and employed, there should be no reason to delay incentives for any extended period of time. Doing so risks an assumption that a credit union's loan portfolio contains "inappropriate" risk that would subject the credit union to administrative action. It should be enough that the credit union is in a strong financial position, sound underwriting principals are in place, incentives are reasonable in relation to a credit union's financial position, and a monitoring system in place to ensure that incentives are not exposing the credit union to excessive risk.

Larger Covered Financial Institutions

Deferral Arrangements Required for Executive Officers

The proposed rule would establish a deferral requirement for larger covered financial institutions (i.e., those with \$10 billion or more in total consolidated assets). At these institutions, at least 50% percent of the incentive-based compensation of an "executive officer" would have to be deferred over a period of at least three (3) years.

The proposed rule also would require that deferred amounts paid be adjusted for actual losses of the CFI or other measures or aspects of performance that are realized or become better known during the deferral period.

Again, MCUL believes that so long as underwriting systems are in place, incentives are reasonable in relation to a credit union's financial position, and a monitoring system in place to ensure that incentives are not exposing the credit union to excessive risk, there is no need for any special requirements for larger CFIs.

Special Review and Approval Requirement for Other Designated Individuals

The proposed rule would require that, at a larger CFI, the board of directors, or a committee thereof, identify those covered persons (other than executive officers) that individually have the ability to expose the institution to possible losses that are "substantial in relation to the institution's size, capital, or overall risk tolerance."

MCUL does not believe this requirement provides sufficient guidance, but perhaps more importantly, does not believe that there is a need for a special review regarding larger CFIs. The guidance for CFIs is sufficient to encompass larger CFIs as well.

Policies and Procedures

The proposed rule would require CFIs to have policies and procedures governing the award of incentive-based compensation as a way to help ensure the full implementation of the proposed prohibitions.

MCUL supports the policy requirement for incentive-based compensation programs. MCUL believes this is the document that should be required to be presented to examiners, rather than requiring credit unions to submit a separate document to NCUA on an annual basis. Therefore, MCUL urges the NCUA Board to remove the reporting provision from the policy requirements.

MCUL is concerned with the requirement that the policy “must be monitored by a group or person ‘independent’ of the covered person, where practicable in light of the institution’s size and complexity, of incentive-based compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive-based compensation payments are reduced to reflect adverse risk outcomes or high levels of risk taken. To be considered ‘independent,’ the group or person at the CFI must have a separate reporting line to senior management from the covered person who is creating the risks so as to help ensure that the analysis of risk is unbiased...”

MCUL believes the board should be the final arbiter of the appropriateness of a credit union’s incentive-based compensation policy. This is supported by the proposed governance provisions requiring directors to: (1) be responsible for actively overseeing the incentive-based compensation arrangements; (2) ensure said arrangements are appropriately balanced; and (3) actively oversee the development and operation of the CFI’s incentive-based compensation systems and related control processes.

Conclusion

MCUL strongly urges the NCUA Board to refrain adding to the ever-increasing regulatory burden on credit unions. MCUL does not believe that a regulation is necessary to address the safety and soundness issues associated with incentive-based compensation arrangements, as the proposed rule does not provide sufficient guidance.

MCUL is concerned that such a regulation would be administered in a punitive fashion whenever financial loss occurs, regardless of the reason. MCUL also views this proposal as a means of retroactively excusing and rectifying previously lax examiner oversight of a credit union’s loan portfolio.

MCUL believes former Chairman JoAnn Johnson said it best in her testimony on June 5, 2008 to the Senate Banking Committee regarding the state of the credit union industry:

“Since 1995, NCUA has issued **guidance** on risk-based lending and specific mortgage lending guidance that has identified potential problem areas, particularly regarding Subprime lending, credit risk management, due diligence and stringent evaluation of third party relationships. Home Equity Lines of Credit (HELOCs) and so-called exotic mortgage products, such as “interest-only” and “payment optional,” were also covered by this guidance. In concert with my fellow regulators, joint guidance regarding workout arrangements, Subprime lending and loss mitigation was issued. [Emphasis added]

"These were aimed at increasing credit union awareness of the potential pitfalls inherent in a rapidly-changing and complex lending landscape. It is also a constant reminder to the industry of NCUA’s vigilant posture when it comes to identifying and managing risk.

Mary Rupp
National Credit Union Administration
May 27, 2011
Page 6

While NCUA appreciates the desire of credit unions to serve their members as fully as possible, we recognize that there is no substitute for strong supervision that enhances safe and sound operations. [Emphasis added]

MCUL agrees that there is no substitute for strong *supervision* that enhances safe and sound operations – not strong *regulation*.

Sincerely,

A handwritten signature in black ink, appearing to be 'DA', written in a cursive style.

Dave Adams
Chief Executive Officer