NAVY FEDERAL Credit Union

Office of the President

20 July 2016

Mr. Gerard S. Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Notice of Proposed Rulemaking – Incentive-based Compensation Arrangements

Dear Mr. Poliquin:

Navy Federal Credit Union is providing comments on the National Credit Union Administration's Notice of Proposed Rulemaking (NPR) governing Incentive-based Compensation Arrangements (IBCA). By way of background, Navy Federal is the nation's largest natural person credit union with more than $78 billion in assets, over 6 million members, 287 branches, and a workforce of over 15,000 employees worldwide. We are committed to serving the needs of our members and improving their financial futures.

We do not support the proposed rule. We have substantial concerns with the framework proposed by NCUA as well as concerns with the underlying premises on which the rule is based.

It is commonplace to acknowledge credit unions neither caused, nor contributed to, the financial crisis. This view has been echoed by several regulators including CFPB Director, Richard Cordray who recently said, "We know that credit unions were not a culprit in the recent financial crisis." Despite the widespread acknowledgement that credit unions were not at the forefront of the financial crisis, NCUA's proposed rule would blanketly apply restrictions to all credit unions greater than $1 billion in assets, and, the more significant deferral, forfeiture and clawback provisions would **only apply to Navy Federal.** It is clear this rule was clearly designed to address abuses at large, internationally active banks; yet the provisions of the rule would apply to credit unions without addressing fundamental differences in business models, historical performance, and most importantly, compensation practices. Additionally, to establish the basis for this rule NCUA cites several inappropriate activities that took place in the banking industry during the financial crisis;

however, none of these activities occurred at Navy Federal, and in many cases, the activities are not even representative of a credit union's business model. While these activities may be relevant to large, internationally active banks, the belief that these activities form a sound basis for establishing IBCA controls at credit unions is simply false. **Credit unions are different and should not be subject to the same deferral, forfeiture and clawback restrictions as large banks.**

Specifically, the proposed rule does not consider fundamental differences in compensation practices between banks and credit unions. Banks typically have far higher total compensation levels, use IBCAs more aggressively, and offer their employees different types of compensation that provide greater incentives to boost short-term profits (i.e., equity based compensation). In fact, it is not uncommon for large bank senior executive officers and significant risk takers to receive an IBCA payout which is multiples of their base salary. Credit unions, Navy Federal in particular, are different. We do not use the same degree of IBCA leverage as part of our compensation philosophy because we pay a higher percentage of total compensation through base salary and a smaller portion through our bonus program. As such, the financial incentives to boost the IBCA payout through inappropriate risk taking do not exist at Navy Federal the way they exist at comparably-sized banks. The proposed rule does not reflect this important distinction; instead, **the rule applies the same thresholds, deferral, forfeiture and clawback provisions simply based on asset size.**

In addition to these broad concerns, we have significant specific concerns with several key provisions of the proposed rule. In many cases the rule establishes provisions that were clearly designed for large, internationally active banks. These provisions, if enacted, would create a burdensome and punitive rule specifically impacting just Navy Federal. Our concerns include:

- Applying deferral, forfeiture and clawback provisions to credit unions based solely on asset size is based on a flawed assumption that credit union asset size directly correlates to an increased incentive, and ability, to take inappropriate risk for the sake of self-enrichment. The history of Navy Federal and its annual bonus program does not support this conclusion. Additionally, credit unions are structurally prohibited from many short-term risk taking activities common at the large, internationally active banks.
- The test for determining a significant risk taker is flawed. The rule classifies all employees as significant risk takers without regard to their specific duties if they receive one-third of their compensation through a bonus and their relative compensation is in the top 2 percent for a Level 2 institution. Instead, an employee's classification needs to be tied to their ability to actually create or manage risk for the institution. The proposed rule does not meet this standard.
- The exposure test is inconsistent with other regulatory frameworks and it is not relevant to the credit union business model. The rule equates risk to a percent of capital without adjusting for the type of risk; an approach that is inconsistent with other regulatory frameworks. Additionally, the design of the exposure test does not align with how credit

unions manage their balance sheets and risk taking activities; it aligns with the banking model.

- The proposed rule creates potential tax consequences that are not properly addressed including: the impact of deferring income and, the implications of clawbacks in future years. To avoid harmful disparities in the timing and amount of potential tax consequences applied to credit union employees, it is imperative NCUA coordinate with the Internal Revenue Service (IRS) before any rule or guideline is published.

- The concept of deferral is not appropriate for the credit union business model because the revenue that serves as a basis for calculating bonuses is not generated immediately without regard for the long-term risks; this is different than large banks.

- The basis for establishing a seven year clawback period is inconsistent with the rationale stated in the proposal. The proposed rule refers to a seven year cycle as the time needed to weather economic and credit cycles. The rule also states the clawbacks are designed to recover funds in cases of fraud or material misrepresentation. Weathering credit cycles is not relevant to identifying fraud. Creating a seven year window for clawbacks appears to be just another way to extend the deferral period.

We discuss all of these concerns more fully in Attachment I. Additionally, Board Member McWatters published a set of questions at the April 21, 2016 NCUA Board Meeting and we have responded to those questions directed to credit unions. Our responses can be found in Attachment II.

Given our substantial concerns, we urge NCUA to use its regulatory discretion and rescind the proposed rule in favor of issuing guidelines that consider the vast differences between banks and credit unions. Addressing these differences will achieve a better balance between the requirements of Section 956 and the realities of credit union compensation practices. Specifically, we recommend NCUA:

- **Rescind the proposed rule**

- **Issue guidelines to establish sound compensation practices, effective risk management, and proper governance for all covered credit unions**

- **Eliminate deferral, forfeiture and clawback provisions that are based solely on asset size**

- **Reserve the right to apply additional restrictions, as necessary**

These actions represent a more balanced approach for ensuring compensation practices do not provide the incentive for inappropriate risk taking. Additional restrictions beyond these practices are inappropriate, unnecessary, and overly punitive to credit unions and Navy Federal. **We urge NCUA to recognize credit unions are different.** Given credit unions did not contribute to the financial crisis, I see no valid justification for implementing this rule. If however, NCUA deems some form of IBCA rule is necessary, then NCUA should develop a tailored set of parameters specifically addressing the unique nature of our industry, not the banking industry. For example, NCUA should adopt a fixed dollar threshold instead of using a relative compensation test because it allows credit unions to offer modest IBCAs without automatically being subject to punitive deferral, forfeiture and clawback restrictions.

In summary, Navy Federal does not support the proposed rule. There are too many structural and philosophical differences between credit unions and banks to support a rule that treats all institutions equally based only on their asset size. The issues we have highlighted will have a measurable and significant impact on Navy Federal's ability to serve its members. Even more concerning, many of these changes put credit unions at a **competitive disadvantage** with the banking industry. We cannot support a proposal that has such broad sweeping negative implications for Navy Federal; particularly when the increased restrictions are not commensurate with the level of risk, historical compensation practices, and the financial stability of credit unions and Navy Federal.

If you have any questions, please feel free to contact Vince Pennisi, Chief Financial Officer at (703) 255-8740.

Sincerely,

Cutler Dawson

Cutler Dawson
President/CEO

VP/sf

Attachments

Attachment I

This attachment is provided as a supplement to Navy Federal's response regarding NCUA's Proposed Incentive-Based Compensation Arrangements (IBCA) rule. It is organized in two sections: first, we provide our general comments on the rule, and second, we provide specific comments on individual sections in the proposed rule. The individual comments have been ordered to follow the sections of the proposed rule.

General Comments

1. **The rule addresses a problem that was not created by credit unions**
   Congress passed the Dodd-Frank Act as a response to the financial crisis and they intended Section 956 of the Act to *"prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions."* [1] The proposed rule also states, *"There is evidence that flawed incentive-based compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007."*[2] Clearly there were incentives and actions that led to inappropriate risk taking and unjust enrichment by taking long-term risks solely for the betterment of one's short-term incentive based compensation. Those actions were associated with large banks and Wall Street trading firms, not large scale consumer-oriented credit unions like Navy Federal. While the rule may be appropriate for the banking industry, it is misplaced within the credit union industry.

   It is commonplace to acknowledge credit unions neither caused nor contributed to the financial crisis. This view has been echoed by several regulators including CFPB Director, Richard Cordray who recently said, *"We know that credit unions were not a culprit in the recent financial crisis. I saw that during my time as Ohio Treasurer and Ohio Attorney General, where I saw events unfold in real time. Credit unions did not underwrite the bad loans that sank the housing market."* [3] In fact, credit unions became the institution of choice for many American consumers when traditional banks needed to retrench and rebuild their balance sheets. Credit unions were there to lend to their members and support America. In fact, some banks even began turning away depositors because the economics of taking deposits did not make sense for them. Instead, credit unions were there to provide a safe haven for members' deposits.

   Throughout this period, Navy Federal was at the forefront of serving its members. Since the financial crisis, we increased our loan to members by $30 Billion and we offered market leading deposit rates throughout the financial crisis. Through all of this, Navy Federal had an employee bonus program designed to reward employees for exceptional member service and achieving a balanced set of corporate objectives. Our bonus program never compromised our safety and soundness nor did it ever cause us a financial loss. Despite this strong record of performance, sound financial footing, and

[1] Dodd Frank Act, Section 956, Enhanced Compensation Structure Reporting
[2] Federal Register, Vol 81, No.112, Page 37674
[3] Prepared Remarks of CFPB Director Richard Cordray at the Credit Union National Association, dated Feb 23, 2016

long-track record of member service, Navy Federal's bonus program will be classified with the large banks simply because of Navy Federal's size. The proposed rule does not take into consideration differences between banks and credit unions; instead it seeks to address the issues with a single broad brush stroke.

Despite wide-spread recognition that credit unions were not part of the problem, NCUA has proposed a rule that would meet the requirements of Section 956 with the same fervor that the banking regulators have applied to the institutions that ***were*** at the heart of the problem. We do not believe this represents a reasoned and balanced approach.

We urge NCUA to rescind the proposed rule and meet the requirements of Section 956 by issuing guidelines that establish sound compensation practices, risk management procedures, and governance requirements without creating an undue burden on the credit union industry and needlessly subjecting Navy Federal's straight-forward employee bonus program to deferral, forfeiture and clawback provisions that were clearly designed for the large, internationally active banks.

2. **The specific deferral, forfeiture and clawback provisions of the rule are not appropriate**
Section 956 of the Dodd-Frank Act requires Federal regulators to issue a guideline or rule prohibiting IBCAs that encourage inappropriate risk-taking by covered institutions. The joint rule proposed by the Agencies effectively consists of two parts: first, it establishes practices, risk management expectations and governance requirements for all covered institutions and; second, it sets forth specific deferral, forfeiture and clawback provisions for institutions greater than $50B in assets. As such, although all covered credit unions would be subject to enhanced practices, risk management standards and governance requirements, Navy Federal would be the ***only credit union*** subject to the deferral, forfeiture and clawback provisions in the proposed rule. Given the rule was designed for banks, and, given Navy Federal's business model, history of strong financial performance, and current compensation practices, this rule is unnecessary and places an undue burden on Navy Federal.

Additionally, the proposed rule cites examples of activities that justify the need to establish deferral, forfeiture, and clawback restrictions on IBCAs including: *"Significant losses caused by actions of individual traders or trading groups occurred at some of the largest financial institutions during and after the financial crisis... some institutions gave loan officers incentives to write a large amount of loans or gave traders incentives to generate high levels of trading revenues, without sufficient regard for the risks associated with those activities... the revenues that served as the basis for calculating bonuses were generated immediately, while the risk outcomes might not have been realized for months or years after the transactions were completed."*[4] Additionally, the proposed rule states *"The effect of flawed incentive-based compensation practices is demonstrated by the arrangements implemented by Washington Mutual (WaMu). According to the Senate Permanent Subcommittee on Investigations Staff's report on the failure of WaMu '[l]oan officers and processors were paid primarily on volume, not primarily on the quality of their loans, and were paid more for issuing higher risk loans. Loan officers and mortgage brokers were also paid more when they got borrowers*

[4] Federal Register, Vol 81, No.112, Page 37674

to pay higher interest rates, even if the borrower qualified for a lower rate—a practice that enriched WaMu in the short term, but made defaults more likely down the road.' "[5] None of these activities occurred at Navy Federal, and further, these activities are not a representative business model for the credit union industry. While these activities may be relevant to large, internationally active banking organizations, the basic premise that these activities are a basis for establishing IBCA controls at credit unions is false. Credit unions are different and should not be subject to the same restrictions as large banks.

More specifically, unlike large banks, Navy Federal ***does not*** have large scale capital markets operations or investment banking activities. Navy Federal ***does not*** give loan officers material incentives to underwrite large amount of loans or different types of loans based on the profit of the loan. Navy Federal ***does not*** have a trading operation where employees are incentivized to generate high levels of revenue. Navy Federal ***does not*** engage in activities where the revenue that serves as a basis for calculating bonuses is generated immediately without regard for the long-term risks. Simply put, the activities the Agencies state are the driving force behind the proposed rule ***do not apply*** to Navy Federal. As such, the justification for establishing deferral, forfeiture, and clawback provisions is not present at Navy Federal. Even though Navy Federal does not engage in these activities, Navy Federal would be subject to the deferral, forfeiture and clawback provisions of the rule simply because of its size, not because it operates in a way that encourages or rewards inappropriate risk taking. This is not consistent with the purpose of Section 956.

Additionally, compensation practices at the largest banks are vastly different than credit unions and Navy Federal. Banks typically have higher total compensation levels, use IBCAs more aggressively, and offer their employees different types of compensation that provide greater incentives to boost short-term profits (i.e., equity based compensation).[6] In fact, it is not uncommon for large bank senior executive officers and significant risk takers to receive a modest base salary with the majority of their income earned through an IBCA; the payout of which is often multiples of their base salary. Credit unions, Navy Federal in particular, are vastly different. We do not use the same degree of IBCA leverage in our compensation philosophy. We typically pay a higher percentage of total compensation through base salary and a smaller portion through our bonus program. As such, the financial incentives to take inappropriate risk to boost the IBCA payout at a comparably-sized bank do not exist at Navy Federal. The proposed rule does not reflect this important distinction. It applies the same thresholds, deferral, forfeiture and clawback provisions simply based on asset size without considering the differences between compensation practices between banks and credit unions.

NCUA should recognize the differences between the operations, business models and compensation practices of large banks and credit unions. Navy Federal does not engage in the activities that form the rationale for the proposed rule. The only reason Navy Federal would be subject to deferral, forfeiture and clawback provisions is because its asset size, by default, classifies it as a Level 2 credit

[5] Federal Register, Vol 81, No.112, Page 37674

[6] Additionally, equity-based compensation provides covered individuals the opportunity to gain further leverage if the equity performs well. This provides further incentives to take short-term risk to boost the value of both vested and unvested equity awards. This incremental leverage is not applicable to credit union employees because credit union IBCAs are limited to cash payments.

union. However, these classifications were designed using the activities of large banking organizations, not credit unions. There is no direct correlation between a credit union's asset size and the types of activities that contributed to the need for establishing this rule. NCUA should recognize these differences and limit the scope of its actions to issuing regulatory guidance that establishes sound compensation practices, risk management expectations, and governance requirements. NCUA ***should not*** adopt the asset-based thresholds for the deferral, forfeiture and clawback provisions in the proposed rule. NCUA can meet the Congressional requirements of Section 956 without creating a punitive rule that impacts Navy Federal solely because of its asset size.

3. **The rule was designed for large, internationally active banks; not credit unions**
The proposed rule was clearly designed for large, internationally active banks, not credit unions like Navy Federal. The proposed rule states *"The Agencies considered international developments in developing the 2011 Proposed Rule, mindful that some covered institutions operate in both domestic and international competitive environments."*[7] The Agencies clearly wanted to establish a regulatory framework that mirrored the actions taken by European regulators. The rule specifically states "*the Agencies recognize that international coordination in this area is important to ensure that internationally active financial organizations are subject to consistent requirements.*"[8]

The provisions in the rule are clearly designed to level the playing field between U.S. institutions and foreign institutions operating in the United States. The rule even provides an example of this rationale by stating, *"Applying the same requirements to these institutions would be consistent with other regulatory requirements that are applicable to foreign banking organizations operating in the United States and would not distort competition for human resources between U.S. banking organizations and foreign banking organizations operating in the United States."*[9] As discussed above, the provisions applicable to large, internationally active banks are not applicable to a domestic credit union.

NCUA should explicitly consider whether applying principles designed to achieve parity with international institutions is relevant to a domestic credit union. Navy Federal operates a consumer-oriented retail business model which is vastly different than large banks that operate both retail and wholesale operations. The proposed rule is silent on how the standards applicable to these larger, more diverse banks are applicable to the credit union industry and Navy Federal. The rule cites several examples of international developments aimed at curtailing risk-taking, primarily in wholesale, capital markets and trading operations. It does not discuss how these standards are applicable to credit unions. Although there may be a need for large bank regulators to evaluate international standards to achieve parity, those drivers are not germane to domestic credit unions.

We urge NCUA to rescind the thresholds established for large, internationally active banks; instead NCUA should issue a guideline for credit unions that establishes sound compensation practices, risk

[7] Federal Register, Vol 81, No.112, Page 37677/8
[8] Federal Register, Vol 81, No.112, Page 37678
[9] Federal Register, Vol 81, No.112, Page 37683

management procedures, and governance requirements. Creating thresholds for credit unions that were designed for banks is simply not appropriate.

4. **Instead of the rule, NCUA should tailor guidance for credit unions that establishes sound compensation practices without automatically requiring deferral, forfeiture and clawback**
As discussed above, the proposed rule consists of two parts: first, it establishes practices, risk management expectations and governance requirements for all institutions greater than $1B in assets and; second, it sets forth specific deferral, forfeiture and clawback provisions for institutions greater than $50B in assets.

   We urge NCUA to use its regulatory discretion and reject the currently proposed rule in favor of issuing guidelines that better consider the vast differences between banks and credit unions. Addressing these differences will achieve a better balance between the requirements of Section 956 and the realities of credit union compensation practices. Specifically, we recommend:

   - **NCUA should rescind the proposed rule.** The proposed rule does not appropriately consider the current and historical differences between bank and credit union business models, compensation practices, and differences between the financial incentives and ability to take excessive risk to bolster the IBCA payout.
   - **NCUA should issue guidelines to establish sound compensation practices, effective risk management, and proper governance.** The general provisions in the proposed rule that are applicable to all institutions greater than $1B are designed to ensure against excessive compensation; balance compensation against the possibility of material financial loss; establish performance measures that balance risk and reward, and; require greater Board oversight over the compensation practices of the credit union. These principles represent a reasonable approach to ensure compensation practices do not provide the incentive for inappropriate risk taking. Additional restrictions beyond these practices are inappropriate, unnecessary, and overly punitive to credit unions and Navy Federal.
   - **NCUA should eliminate the deferral, forfeiture and clawback provisions that are applied solely based on asset size.** For a credit union, asset size is not an effective barometer to determine whether IBCAs encourage excessive risk taking. Typically banks use IBCAs more aggressively than credit unions, thus the thresholds designed for banks are overly punitive for credit unions.
   - **NCUA should reserve the right to apply additional restrictions as necessary.** Rather than automatically applying significant IBCA restrictions based on asset size, given the relatively small population of credit unions impacted by the requirements of Section 956, NCUA should apply these restrictions only if it finds individual credit unions have engaged in compensation practices that create the potential for inappropriate risk taking. This approach gives NCUA the authority to prohibit IBCAs that encourage inappropriate risk taking without unilaterally applying significant restrictions absent direct evidence a problem exists. This is a more reasoned approach.

In other words, NCUA should treat all covered credit unions as Level 3 institutions. All covered credit unions would be subject to enhanced requirements for sound compensation practices in order to comply with Section 956, but, a credit union would not be subject to punitive restrictions without evidence their IBCA creates the potential for excessive risk taking. This balanced approach meets the Congressional requirements of Section 956 without creating a punitive rule that impacts Navy Federal solely because of its asset size.

Specific Comments on the Components of the Proposed Rule

1. The three level structure is not appropriate for credit unions

The proposed rule establishes three levels based solely on an institution's asset size. Supporting these classifications is an underlying belief by NCUA that there is a direct correlation between asset size and an increasing incentive to take inappropriate risk to boost short-term IBCA payouts. While the banking regulators believe this is true in their industry, it is not true in the credit union industry, and in particular, for Navy Federal.

Specifically, the proposed rule states *"The Agencies considered the varying levels of complexity and risks across covered institutions that would be subject to this proposed rule, as well as the **general correlation of asset size with those potential risks**, in proposing to distinguish covered institutions by their asset size... Moreover, these larger, more complex institutions also tend to be significant users of incentive-based compensation."* [10] [Emphasis Added]. While this may be applicable to the banking industry, this premise does not hold true for Navy Federal.

Navy Federal began its bonus program in 2001 when assets were $12 Billion. Our program, called "Partners in Performance," was designed to reward all employees for delivering exceptional service and value to our members. The program is based on three holistic measures of performance and it effectively balances risk and return. In other words, it is not based solely on transaction volume or income. The program's design does not reward individual business units to take excessive risk and it does not incent management to leverage risk for short-term profit. Most importantly, the program does not enrich a select portion of the company at the expense of the institution's safety and soundness.

The concept is simple, if Navy Federal does well serving its members, all employees share in the company's success. Most importantly, the program is applied unilaterally to every employee in the credit union. The drivers used to determine the overall level of bonus payout are the same for all employees ranging from an entry level member service representative or call center operator all the way through to the senior executive officers. In this way, all employees share equally in the success of Navy Federal.[11]

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[10] Federal Register, Vol 81, No.112, Page 37687

[11] The company payout percentage is determined equally for all employees. The dollar amount received by each employee is a function of base salary, position, and individual performance rating

Our program has worked very effectively since 2001 and has not produced any results which were inconsistent with the goals of the program or the principles of sound compensation practices referenced in the proposed rule. However, simply because Navy Federal has grown to $78 Billion in assets, our program will now become subject to the punitive deferral, forfeiture and clawback restrictions of a large Level 2 bank. In short, Navy Federal is being penalized for successfully serving its members, not because it uses an IBCA that creates an incentive to take inappropriate risk. The rule's thresholds are producing the wrong result.

Further undercutting NCUA's assertion that asset size correlates to increased levels of IBCA risk is the fact that over the fifteen years since Navy Federal implemented its bonus program, the structure of the program has not changed even though the company is over six times larger. Our program is essentially the same as when Navy Federal was $12 Billion in assets; yet simply by virtue of our asset size, many of Navy Federal's employees will now be subject to significant compensation restrictions that were designed for a different industry that took different risks. **NCUA's premise that asset growth has translated into greater opportunity to take inappropriate risk such that mandatory deferral, forfeiture and clawback provisions are necessary is simply not supported by the facts.**

To support the three asset-based levels in the proposed rule, NCUA also cites other regulatory frameworks, in particular the Dodd-Frank Act. Navy Federal believes these thresholds do not consider the lessons the regulatory community has gained since the passage of the Dodd-Frank Act. For example; Federal Reserve Governor Tarullo recently stated the Federal Reserve is considering a reprieve for banks that have less than $250 billion in assets.[12] Specifically, the Federal Reserve is considering exempting such lenders from a portion of the stress tests that evaluate each firm's plans for managing capital and risk and he hopes to have these changes in place for 2017. Additionally Governor Tarullo, who is responsible for overseeing the Federal Reserve's regulations, said *"the 2010 Dodd-Frank Act may have gone too far in subjecting all banks with more than $50 billion of assets to stringent oversight. While raising the threshold requires action by Congress, Tarullo said revising the stress tests is within the Fed's power."*[13] Clearly the Federal Reserve is considering drawing a clearer distinction between the large, systemically important banks, and the large regional banks that fall into the $50B to $250B category. The Federal Reserve has recognized the thresholds in the Dodd-Frank Act may have gone too far and the provisions necessary to oversee large, internationally active banks are not appropriate for large regional banks in the $50B to $250B range, much less a large credit union like Navy Federal.

Given the sentiment at the Federal Reserve, and most importantly, the differences between banks and credit unions, we urge NCUA to recognize the thresholds designed for large banks are not appropriate for credit unions. As noted in our general comments section, we recommend NCUA rescind the proposed rule; issue guidelines to establish sound compensation practices, effective risk management, and proper governance; eliminate the deferral, forfeiture and clawback provisions that are applied automatically based on asset size; and, reserve the right to apply

[12] www.bloomberg.com/news/articles/2016-06-02/tarullo-says-eight-biggest-banks-to-face-higher-capital-rules
[13] www.bloomberg.com/news/articles/2016-06-02/tarullo-says-eight-biggest-banks-to-face-higher-capital-rules

additional restrictions as necessary. We strongly urge NCUA to follow the direction the Federal Reserve is taking with stress testing by applying regulatory discretion and recognizing there are structural differences between credit unions and banks and apply a different set of standards to Navy Federal than would be applied if Navy Federal were a bank, which it is not.

2. **The Chief Information Officer should not be classified as a Senior Executive Officer**
Navy Federal does not believe it is appropriate to include these types of positions in the definition of senior executive officer. We agree with NCUA's assertion these positions are responsible for the development and implementation of the information technology infrastructure necessary to support the business activities of the institution; however, typically these individuals are not directly involved in determining the degree to which risk is taken, or overseeing the controls and risk management frameworks around these risk taking activities. As such, although these positions are part of an organization's senior executive staff, they do not have the same scope of responsibilities with regard to risk taking and risk management.

Additionally, because these individuals are senior executives, it is likely they will be captured in the Significant Risk Taker category if their variable compensation exceeds the currently proposed relative compensation test. As such, if the relative compensation test is approved as proposed, they would already be subject to some form of deferral, forfeiture and clawback provision.

3. **The test for determining a Significant Risk Taker is flawed**
The proposal classifies covered individuals into two categories: either senior executive officers or significant risk takers. The rule states the definition of significant risk taker is *"intended to include individuals who are not senior executive officers but who are in the position to put a Level 1 or Level 2 covered institution at risk of material financial loss."*[14] In short, the rule is attempting to capture those individuals who have the ability to commit the institution to material financial risk.

NCUA says the enhanced provisions of the rule *"would be applicable only to covered persons who received annual base salary and incentive-based compensation of which at least one third is incentive-based compensation (one-third threshold)."*[15] NCUA's rationale for this "one-third threshold" is *"Under the proposed rule, in order for covered persons to be designated as significant risk-takers, the covered persons would have to be awarded a level of incentive-based compensation that would be sufficient to influence their risk-taking behavior. In order to ensure that significant risk-takers are only those covered persons who have incentive-based compensation arrangements that could provide incentives to engage in inappropriate risk-taking, only covered persons who meet the one-third threshold could be significant risk-takers."*[16] As such, any Navy Federal employee who receives at least one-third of their total compensation in the form of an annual bonus is subject to the tests to determine if they are significant risk taker.

[14] Federal Register, Vol 81, No.112, Page 37679
[15] Federal Register, Vol 81, No.112, Page 37693
[16] Federal Register, Vol 81, No.112, Page 37693

According to NCUA, *"The proposed definition of ''significant risk-taker'' incorporates two tests for determining whether a covered person is a significant risk-taker.* ***A covered person would be a significant risk-taker if either test was met.*** *The first test is based on the amounts of annual base salary and incentive-based compensation of a covered person relative to other covered persons working for the covered institution and its affiliate covered institutions (the ''relative compensation test''). This test is intended to determine whether the individual is among the top 5 percent (for Level 1 covered institutions) or top 2 percent (for Level 2 covered institutions) of highest compensated covered persons in the entire consolidated organization, including affiliated covered institutions. The second test is based on whether the covered person has authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution (the ''exposure test'')."*[17] [Emphasis added]. We believe there is a flaw in NCUA's reasoning as it pertains to the relative compensation test for determining whether an individual is truly a significant risk taker.

The relative compensation test states, *"For a Level 1 covered institution, a covered person would be a significant risk-taker if the person receives annual base salary and incentive-based compensation for the last calendar year that ended at least180 days before the performance period that places the person among the highest 5 percent of all covered persons in salary and incentive-based compensation (excluding senior executive officers) of the Level 1 covered institution and, in the cases of the OCC, the Board, the FDIC, and the SEC, any section 956 affiliates of the Level 1 covered institution. For Level 2 covered institutions, the threshold would be 2 percent rather than 5 percent."*[18] The proposed definition of a significant risk taker makes a fundamentally flawed assumption that all employees who receive one-third of their compensation through an IBCA and who are in the top 5 or 2 percent of relative compensation are automatically significant risk takers as defined by the rule.

NCUA states its rationale for the relative compensation test is, *"[in their] supervisory experience, the amount of a covered person's annual base salary and incentive-based compensation can reasonably be expected to relate to the amount of responsibility that the covered person has within an organization, and covered persons with a higher level of responsibility generally either (1) have a greater ability to expose a covered institution to financial loss or (2) supervise covered persons who have a greater ability to expose a covered institution to financial loss. For this reason, the Agencies are proposing to use the relative compensation test as one basis for identifying significant risk-takers."*[19] We do not agree relative compensation alone is an indicator of risk-taking, or risk management responsibility.

Consider the example of a senior executive in charge of administrative functions (e.g., facilities, purchasing, etc.). As a member of the senior staff, this executive would likely earn at least one-third of his/her compensation through an IBCA and he/she would likely be in the top 2 or 5 percent under the relative compensation test. As such, this executive would automatically be

[17] Federal Register, Vol 81, No.112, Page 37692
[18] Federal Register, Vol 81, No.112, Page 37694
[19] Federal Register, Vol 81, No.112, Page 37694

considered a significant risk taker and would be subject to the deferral, forfeiture and clawback provisions of the proposed rule even though he/she has ***no risk taking authority*** and his/her actions ***cannot influence the level of business risk***. This result is neither consistent with NCUA's stated definition of a significant risk taker, nor with what Congress intended with Section 956. The reasoning behind the relative compensation test is flawed.

Determining whether an individual is a significant risk taker ***must be*** tied to an assessment of the individual's ability to actually ***create or manage risk*** for the institution. The proposed exposure test appears to be designed to capture this premise; however, under the proposed rule an individual would be considered a significant risk taker if they fail ***either*** the relative compensation test or the exposure test. We believe an exposure test, if properly constructed, would suffice thereby making the relative compensation test is unnecessary.[20] For example, an individual becomes subject to the exposure test if their IBCA is greater than one-third of their compensation; then the exposure test determines if the individual has the ability to commit the institution to risk. These two tests are sufficient to determine whether an individual has the financial incentive ***and*** the ability to take inappropriate risk. The relative compensation test, which is burdensome to administer, is unnecessary. We urge NCUA to revisit the framework.

4. **The exposure test, as proposed, is not appropriate for credit unions**
NCUA states, *"Under the exposure test, a covered person would be a significant risk-taker with regard to a Level 1 or Level 2 covered institution if the individual may commit or expose 0.5 percent or more of capital of the covered institution."*[21] The exposure test creates two significant concerns for Navy Federal. First, the rule equates risk to a percent of capital without adjusting for the type of risk; an approach that is inconsistent with other regulatory frameworks. Second, the design of the exposure test does not pertain to the credit union business model.

   a. First, NCUA's broad-brush creation of a 0.5% exposure test does not consider the type of asset being generated and the underlying risk to safety and soundness from this asset. Consider the inherent differences between risk takers who buy U.S. Treasury securities as a temporary warehouse for excess cash versus individuals who originate long-term riskier loans. Under the proposed framework, the exposure test would apply equally to these two individuals despite being engaged in vastly different risk taking activities.

   For Navy Federal, the proposed framework implies a $43 million threshold.[22] This threshold would mean a significant number of Navy Federal employees may become subject to the deferral, forfeiture and clawback provisions of the rule even though their activities do not create material risk for the institution. For example, within our investment portfolio management group, those individuals charged with buying short-term U.S. Treasuries as a warehouse for excess cash could become subject to this rule. We do not believe this is what Congress intended when it enacted Section 956. Similarly, Congress could not have intended

[20] We do not believe the proposed exposure test is properly constructed for credit unions. See Attachment I, #4
[21] Federal Register, Vol 81, No.112, Page 37695
[22] The $43 million threshold is derived by multiplying 0.5% times $8.6 Billion of capital

that our deposit taking employees, who help members open share certificate or checking accounts, could be subject to this exposure test. Within the lending community, moreover, the impact of this threshold is more significant; as many as 300 to 400 people could potentially be considered significant risk takers irrespective of the type of loans they originate; the exposure test treats short-term collateralized auto loans the same as long-term commercial real-estate transactions or unsecured lines of credit. Clearly the risk of these different activities is not the same; yet the exposure test treats them equally.

There is a long-standing regulatory premise that different activities create different exposures. This is most visible in the Risk Based Capital frameworks. Under these regimes, Federal regulators, including NCUA, recognize different asset classes present different risks to the organization. However, this long standing bedrock principle was overlooked when this rule was created. Employees who conduct low risk transactions (like investing in U.S. Treasuries) could potentially be subject to the same deferral, forfeiture and clawback provisions as those employees who create more significant risks for the institution. We urge NCUA to reconsider the structure of the exposure test. The exposure test should be calibrated based on the type of activity similar to the way risk-based capital measures are adjusted.[23]

b. Second, the design of the exposure test does not pertain to the credit union business model. In large, complex, and organizationally diverse banking institutions, the heads of different business lines are allocated capital and they are required to generate a minimum return on that allocated capital. Often, these businesses operate as functionally, and geographically, separate entities. As such, the heads of these businesses are appropriately compensated through IBCAs based on the returns they generate from their allocated capital. For example, a trading desk may be allocated $100 Million in capital and then be required to earn a minimum rate of return on that capital; as such, the traders' IBCA payouts will be largely based on the performance of that trading desk. This framework creates both the incentive and the ability to take risk. In the banking context there is a direct correlation between capital utilization and IBCAs. In other words, at banks, there is the potential for boosting an IBCA payout through excessive risk taking.

   This framework is not applicable to Navy Federal. We do not allocate capital to specific business lines and then reward employees in these businesses based on the returns of their allocated capital. The employees impacted by the 0.5 percent exposure test are simply executing the normal lending, deposit taking and funding activities of the credit union. These employees are not compensated for individual risk taking activities; the fundamental premise that they are in a position to enrich themselves through excessive or inappropriate risk taking simply does not apply to Navy Federal.

   The rule also states, *"If a covered person had no specific maximum amount of lending for the year, but instead his or her lending was subject to approval on a rolling basis, then the covered person would be assumed to have an authorized annual lending amount in excess of*

[23] Alternatively, NCUA could adopt an expected risk framework similar to a "Value-at-Risk" approach for determining the amount of capital at risk.

the 0.5 percent threshold."[24] This is overly punitive to Navy Federal. As noted above, the framework proposed by NCUA assumes a way of doing business that is not reflective of Navy Federal's operations. In large banks loan officers (and traders) are allocated capital or given lines of authority. Navy Federal does not use this practice. Navy Federal applies much tighter controls over its lending activities; loan underwriters have approval limits based on individual transactions. However, over the course of the year, the accumulated volume of transactions will likely cross the 0.5 percent threshold but transactions are reviewed routinely throughout the year and loan underwriters are not acting independently without oversight, controls and supervision.

Lastly, a key distinction is – Navy Federal's employees are ***not*** directly compensated for their volume, they are merely executing the day to day lending operations under the guidelines established by corporate policies. If NCUA approves the proposed framework, many of our loan underwriters could needlessly become subject to deferral, forfeiture and clawback provisions. Navy Federal's employees do not have the financial incentive, or the ability, to take inappropriate risks. The 0.5 percent threshold is not applicable to the credit union business model.

We urge NCUA to eliminate the exposure test to prevent a large group of Navy Federal employees from being impacted by a rule that was clearly designed for banks with a different business model and a different compensation structure.

5. **A Dollar Threshold is a significantly more appropriate framework for a credit union**
As noted above, Navy Federal does not support the proposed rule and recommends NCUA rescind the proposal in favor of issuing guidelines that establish standards for compensation, risk management and Board governance. Navy Federal also recommends eliminating any mandatory deferral, forfeiture and clawback provisions based solely on asset size without regard to the specific nature of a credit union's IBCA.

Our recommendation notwithstanding, a key element of the proposed rule is determining if the covered individual has the financial incentive to take inappropriate risk. The proposed rule automatically traps all senior executive officers in that category and it establishes a relative compensation test for determining which employees would be considered significant risk takers. This approach is based on the compensation practices of large banks and it does not consider how credit unions use IBCAs. Because banks use IBCAs more aggressively, their senior executives and significant risk takers often receive IBCA payouts which are multiples of their base salary; a practice that is not applicable to the credit union industry. This clearly creates an incentive at large banks that does not exist at credit unions. **A better approach would be to eliminate the automatic inclusion of senior executives and the relative compensation test for significant risk takers in favor of setting a fixed dollar threshold for all credit union employees.**

[24] Federal Register, Vol 81, No.112, Page 37696

If a compensation threshold is required, Navy Federal strongly supports the concept of a dollar threshold test instead of the relative compensation test. As noted in the proposed rule, *"One advantage of a dollar threshold test compared to the relative compensation test is that it could be less burdensome to implement and monitor. With a dollar threshold test covered institutions can determine whether an individual covered person meets the dollar threshold test of the significant risk-taker definition by reviewing the compensation of only that single individual."*[25]

Navy Federal believes a fixed dollar threshold, adjusted for inflation, is a better threshold than the relative compensation test. We believe there is a common sense threshold NCUA can establish where IBCAs do not create sufficient incentive to take inappropriate risks. In the proposal, NCUA requests specific feedback on whether *"a dollar threshold test, as described above, [would] achieve the statutory objectives better than the relative compensation test? Why or why not? If using a dollar threshold test, and assuming a mechanism for inflation adjustment, would $1 million be the right threshold or should it be higher or lower? For example, would a threshold of $2 million dollars be more appropriate?"*[26]

If a compensation threshold is required, we urge NCUA adopt a $1 million threshold but apply the threshold ***only*** to the IBCA, not total compensation.[27] The purpose of the proposed rule is to eliminate IBCAs that drive excessive risk taking; as such, restrictions should focus on the amount of the IBCA instead of limiting total compensation.[28] Any regulatory actions or restrictions should only apply to senior executive officers and significant risk takers with an IBCA above the $1 million threshold. Senior executive officers and significant risk takers with an IBCA below the threshold would be considered lacking sufficient financial incentive to take inappropriate risk. For example, a senior executive officer with a $1,000,000 base salary and a $500,000 IBCA has much less incentive to take inappropriate risk to boost their IBCA than a senior executive officer with a $300,000 base salary and a $1,200,000 IBCA even though both executive's total compensation is $1,500,000. In this example, the executive with the IBCA under $1 million would be viewed as lacking sufficient financial incentive to take inappropriate risks, whereas the executive with greater IBCA leverage would be considered to have sufficient financial incentive. We believe NCUA's objective of ensuring IBCAs do not encourage inappropriate risk taking can be better accomplished by setting a fixed dollar threshold, adjusted for inflation, on the IBCA.

Navy Federal prefers establishing a dollar threshold on the IBCA only; however, an alternative approach would be to establish a dollar threshold on total compensation but ***only subject the amount over the threshold to the provisions of the rule***. In effect, NCUA could establish a safe-harbor threshold for total compensation and any amounts above this threshold would be subject to deferral, forfeiture and clawback. The premise of this approach is to limit the benefits of excessive risk taking without subjecting all of the IBCA to significant deferral, forfeiture and

[25] Federal Register, Vol 81, No.112, Page 37697
[26] Federal Register, Vol 81, No.112, Page 37699
[27] Should NCUA choose to apply a dollar threshold to total compensation; we believe a $2 million threshold is more appropriate. Lastly, NCUA could adopt different dollar thresholds for senior executive officers and significant risk takers (e.g., $1 million for significant risk takers and $2 million for senior executive officers).
[28] Guidelines on excessive compensation are in place to address inappropriate total compensation packages

clawback provisions. This approach also recognizes that institutions, like Navy Federal, reward its employees for performance that is not only driven by risk taking activities. Creating a safe-harbor threshold allows an institution to create performance-based bonus plans that pay for performance without paying for excessive risk taking. This enables an institution to compensate its employees for performing well during the ordinary course of business, while also creating a system of protections if the employee attempts to enrich themselves through excessive risk taking. For example, NCUA could establish a $1 million threshold whereby only compensation that exceeds $1 million would be subject to the provisions of the rule. For example, if an employee earned $600,000 in base salary and $600,000 in an IBCA, the employee would earn $1 million immediately and the remaining $200,000 would be subject to the deferral, forfeiture and clawback provisions of the proposed rule.

We believe establishing a fixed threshold eliminates the impetus to take excessive risk in a materially better way than the proposed relative compensation tests. A fixed dollar approach would be much easier to administer for the institution and easier for the regulator to monitor. We believe this is a more balanced approach that meets the needs of the regulator without needlessly penalizing institutions like Navy Federal.

6. **The definition of what constitutes Excessive Compensation needs to be enhanced**
The proposed rule invites comparison with *"(4) compensation practices at [a] comparable credit union, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets."*[29] However, Navy Federal is substantially larger than its credit union peers. In order to attract and retain talented employees, Navy Federal must consider the compensation practices of similarly sized financial institutions across the entire spectrum of financial services including credit unions, financial services companies and banks. We request NCUA amend the language from "comparable credit unions" to the language proposed by the Agencies in the joint rule, specifically, "comparable covered institutions." Alternatively, NCUA could amend the language to say "comparable financial institutions."

7. **The definition of what constitutes Material Financial Loss needs to be clarified**
The proposed rule does not specify how NCUA will evaluate whether an IBCA creates the possibility of material financial loss. We recommend NCUA provide specific thresholds, and/or guidance, that delineate how NCUA will evaluate the concept of material financial loss.

For those credit unions subject to stress testing, we recommend the basis for determining whether an institution is at risk for material financial loss should be based on the results of the stress tests. Institutions subject to NCUA's stress tests undergo rigorous evaluations of their financial risk and risk management programs. These institutions are also required to maintain sufficient capital to absorb material adverse events and still have sufficient capital to remain a safe and sound financial institution after the stress tests have been applied. As such, we recommend NCUA

[29] Federal Register, Vol 81, No.112, Page 37709

adopt a material loss threshold that would only apply if the credit union was unable to maintain its regulatory post-stress test capital ratio. As long as the credit union maintains sufficient capital to pass the stress test, the concept of material financial loss should not apply.

8. **NCUA should resolve tax consequences with the Internal Revenue Service before the proposed rule is issued**

   The proposed rule creates two potential tax consequences that are not properly addressed in the proposed rule. First, what is the impact of deferring income on credit union employee's personal income taxes? Second, for employees who experience clawbacks of previously vested income, how will previously paid taxes be treated? These uncertainties can raise significant, and potentially material, issues for credit union employees. It is imperative NCUA coordinate with the Internal Revenue Service (IRS) before any rule or guideline is published.

   a. **Deferral:** For covered persons at credit unions, *"NCUA's rule also permits acceleration of payment if the covered person must pay income taxes on the entire amount of an award, including deferred amounts, at the time of award."*[30] Given the potential to have a significant impact on covered individuals, we urge NCUA to coordinate with the Internal Revenue Service ***before*** the final rule is published to ensure all impacts are known and properly considered before the rule or guideline is published. We also ask NCUA to clarify with the IRS how the impact of the tax liability will be determined. For example, the impact on single-income households may be different than the impact on dual-income households because dual-income households will likely have a higher marginal tax bracket.

      We urge the NCUA to work with the IRS to exempt affected individuals from tax liability due to the deferral of IBCAs until the IBCA vests; the same approached used for banks. If the Internal Revenue Service in unable to provide this exemption, the final rule should provide credit unions sufficient flexibility to neutralize the tax impacts for all impacted employees taking into consideration each employee's marginal tax bracket when filing their tax returns.

   b. **Clawback:** The tax implications of clawbacks have not been addressed in the rule. In cases where clawbacks would be enforced, the rule does not specify whether the clawback would seek to recover the pre-tax or post-tax vested award. If the rule seeks to recover the pre-tax amount, how will the tax liability be unwound? If the rule seeks to recover only the post-tax amount, how will the post-tax amount be determined given the unique nature of each employee's personal tax situation? The rule needs to provide greater clarity on how personal tax consequences will be addressed if the clawback provisions were enacted. We urge NCUA to coordinate with the IRS to provide clarity how this would be accomplished.

[30] Federal Register, Vol 81, No.112, Page 37717

Lastly, the credit union specific provision of the rule allowing the accelerated vesting of IBCAs to pay the tax liability creates an unintended penalty and a competitive disadvantage when compared to the banks. Under the proposed rule, employees can earn a reasonable rate of return on the deferred award; however, the amount on which that rate of return is earned will be less for a credit union employee than a bank employee because of the immediate tax liability created when the award is granted. Consider a bank employee who has a $200,000 award deferred for three years which earns 3% over the deferral period. The bank employee would have $218,545, at the end of the three years. A credit union employee would have to pay taxes on the award at the onset. Assuming a tax rate of 35%, the credit union employee would pay $70,000 in taxes and defer $130,000. At the end of the deferral period, the credit union employee would have $142,055. The bank employee earned $18,545 during the deferral period while the credit union employee only earned $12,055 because taxes were paid at the onset which reduced the principle amount deferred.[31] This creates another disadvantage for credit union employees. We urge NCUA to seek an exemption from the IRS for any tax liability created from IBCA awards that are granted but not yet vested.

9. **Deferring income is not appropriate given the credit union business model**
The proposal specifically requests comments on whether the deferral periods and percentages are appropriate for Level 1 and Level 2 institutions. As highlighted in our General Comments above, the deferral, forfeiture, and clawback provisions of the proposed rule have been designed for large, internationally active banks and they are not appropriate for a large credit union.

As noted above, Navy Federal ***does not*** have large scale capital markets operations or investment banking activities. Navy Federal ***does not*** give loan officers material incentives to underwrite large amount of loans or different types of loans based on the profit of the loan. Navy Federal ***does not*** have a trading operation where employees are incentivized to generate high levels of trading revenues. Navy Federal ***does not*** engage in activities where the revenue that serves as a basis for calculating bonuses is generated immediately without regard for the long-term risks. In short, the activities referenced in the proposal as the driving force behind the creation of the proposed rule ***do not*** apply to Navy Federal. Simply put, the basis for establishing the deferral, forfeiture, and clawback provisions ***is not*** present at Navy Federal.

More specifically, the deferral periods and percentages are not appropriate given the fundamental differences between the business models of large, internationally active, money-center banks and Navy Federal. Large banks typically have significant trading and investment banking operations. These operations compensate their employees in fundamentally different ways than Navy Federal. Traders and investment bankers typically receive a majority of their incentive-based compensation from the earnings produced by their own trading desk. Additionally, these earnings are typically based on the ***present value of future income***, not necessarily the income that was actually realized by the financial institution in that year. This is a critical distinction between how large banks compensate their risk takers and how Navy Federal pays its bonuses.

[31] Once adjusted for taxes, the difference becomes $4,219.

In a large bank, traders and investment bankers enter into long-term financial transactions. The ***expected future cash flows*** from these transactions are discounted to a present value and earnings are based on this present value. This can lead to significant revenue recognition in the current year even though the majority of the earnings will not be realized until several years into the future. Depending on how these contracts perform over time this can create a mismatch between the earnings used for incentive-based compensation, and the actual earnings the bank will receive over time. Additionally, this mismatch could be further compounded because higher risk transactions, when discounted, can result in greater present values and greater short-term revenue recognition; however, the risk of achieving these earnings would also be greater. In short, there can be a structural mismatch between the earnings banks use to determine incentive-based compensation payouts and the long-term realization of those earnings. Credit unions do not take this approach.

Lastly, some banking institutions had IBCAs that rewarded employees for achieving volume-based thresholds irrespective of the risk of the underlying transactions. For example, some IBCAs were based on the number of mortgage loan applications, or in some cases, the number of sub-prime or option-ARM mortgage loan applications. Incentive-based awards were given to employees without considering the potential risks from these types of transactions. As such, the concept of deferral seeks to ensure IBCAs delay vesting income for a period of time to allow seasoning to occur in these portfolios. In other words, employees who achieve significant levels of incentive-based compensation need to be subject to deferral, forfeiture and clawback to ensure the quality of the assets being originated perform as expected over time.

The concept of deferral is not necessary for credit unions, particularly Navy Federal, because the practices at issue with the large banks are not used at Navy Federal. First, Navy Federal does not compensate its employees based on the performance of a specific line of business. Navy Federal's bonus program is based on balanced total corporate objectives across multiple activities. Additionally, Navy Federal's bonus program heavily considers non-financial metrics; as such, the incentive for an employee to take incremental risk to boost earnings so it can translate into a higher incentive-based compensation payout simply does not exist.

Second, and most importantly, the mismatch created by using present value accounting to accelerate earnings does not exist at Navy Federal. Navy Federal does not engage in capital markets, trading or investment banking activities; as such, it does not have business lines that create material accelerated earnings.[32] The earnings used to determine the annual bonus for all employees is based overwhelmingly on the accumulated earnings from prior year's transactions that are being realized in the current year. In other words, the majority of earnings used to determine the bonus payout have already gone through a seasoning period; an additional deferral

[32] Navy Federal does sell some of its own mortgage loan production to the GSEs. As such, it records a gain on sale and a Mortgage Servicing Right from these transactions. Navy Federal does not have residual obligations from these transactions; hence, they are classified as a true sale and Navy Federal is not exposed to credit risk. These activities are materially different from the wholesale loan aggregation and securitization activities of some of the large investment banks.

period to see how risk unfolds is unnecessary. For example, 2016's earnings reflect the accumulated income from loans originated in prior years, and in some cases, these loans have been on the books for substantial periods of time (i.e., mortgages and credit cards). These loans have already gone through a seasoning period and the earnings used to determine Navy Federal's annual bonus are based on the ***actual*** earnings received, not expected earnings in the future. This is a fundamental difference between the present value revenue recognition used by the trading operations of large banks and the traditional accrual accounting used by retail financial services institutions like Navy Federal.[33]

The concept of deferral is largely based on ensuring the risks reflected in current period earnings have time to manifest themselves, hence the income associated with those earnings should be deferred. When an institution, or line of business, has income from either all or a high percentage of accelerated earnings, this concept has validity. However, when an institution uses an accrual basis for recognizing earnings, the concept is no longer necessary. Consider a 3.5% 30 year fixed rate mortgage loan originated in 2012 during the last refinance wave. This loan will earn 3.5% each year until the loan prepays or matures. Only the interest income actually received will be recorded into earnings and this income will be offset by the funding costs and any reserves necessary for anticipated credit risk.[34] In this example, only income ***actually earned*** will flow into the 2016 earnings base used to determine IBCAs. This dynamic is the same for all types of interest income. Similarly, fee income is recognized in the period in which it is actually earned.[35] As such, Navy Federal's income reflects income actually received, not income that is expected to be received over a long period of time. We urge NCUA to eliminate the requirement to defer income given the structure of Navy Federal's IBCA and the structure of its business model.

Similar to our perspective on deferring short-term IBCAs, the deferral, forfeiture and clawback provisions on long-term IBCAs should be applied only to those credit unions NCUA believes have compensation practices that result in safety and soundness concerns, or provide the financial incentive and wherewithal to take inappropriate risk. To accomplish this, NCUA should not apply the long-term deferral requirements to any credit union, but instead, retain the right to apply the Level 1 or Level 2 provisions should NCUA demonstrate the credit union's IBCA does not meet the standards discussed in the proposed rule

10. The caps on IBCA payouts do not consider differences in compensation practices between large banks and credit unions

The proposed rule would limit maximum payouts to 125 and 150 percent of the pre-set target, depending on an employee's classification between senior executive officer and significant risk

[33] The retail portion of the banks would also use accrual revenue recognition; however, the primary driver of the financial crisis was the wholesale aggregation, structuring and securitization of loans. There were far fewer issues from those financial institutions who focused on retail financial services.

[34] Under the current GAAP framework, expected credit losses are limited to the Loss Emergence Period. Under the FASB's new CECL rule, expected credit losses for the life of the loan will be adjusted in annual earnings making the deferral for credit risk even less necessary when using accrual based earnings recognition.

[35] FAS91 requires Navy Federal to defer both origination income and expense over the life of the loan.

taker. The proposed rule states the premise for this restriction is *"this type of upside leverage in incentive-based compensation plans may encourage covered persons to take inappropriate risks."*[36]

NCUA's perspective assumes a direct correlation between taking risk and an individual's payout under Navy Federal's bonus program. As discussed above, Navy Federal's bonus program is not structured in this manner; excessive risks taken by individuals or risks taken by business lines would not directly impact their near-term bonus payout. Three factors support this conclusion: Navy Federal's non-financial metrics represent a large part of determining the actual bonus payout each year; individual performance, which includes factors beyond business performance, is a key driver of each employee's bonus; and lastly, Navy Federal does not accelerate earnings from long-term risky transactions. As such, Navy Federal's bonus program does not have the direct financial incentives outlined in NCUA's proposal.

The proposal also states *"The Agencies are proposing these limits, in part, because they are consistent with the current industry practice at large banking organizations. Moreover, high levels of upside leverage (e.g., 200 percent to 300 percent above the target amount) could lead to senior executive officers and significant risk-takers taking inappropriate risks to maximize the opportunity to double or triple their incentive-based compensation. Recognizing the potential for inappropriate risk-taking with such high levels of leverage, the Federal Banking Agencies have worked with large banking organizations to reduce leverage levels to a range of 125 percent to 150 percent. Such a range continues to provide for flexibility in the design and operation of incentive-based compensation arrangements in covered institutions while it addresses the potential for inappropriate risk-taking where leverage opportunities are large or uncapped."*[37]

NCUA should not set the ranges equal to the large banks because the ranges are based on compensation practices applicable to large banks, not credit unions. Differences in compensation philosophy (i.e., compensation levels, pay-mix, and types of compensation) can result in significantly different impacts to covered employees. Historically, banks pay risk-taking employees lower base salaries and use higher payouts on IBCAs to ensure total compensation remains market competitive. Often, bank IBCAs are multiples of an employee's base salary thereby establishing a clear financial incentive to deliver short-term financial results. Also, since large banks are publically traded, the incentive to drive short-term results to increase the stock price is prevalent. Conversely, credit unions rely more heavily on base salary to ensure employees earn market-based compensation and credit unions cannot incent short-term risk taking behavior though equity based incentives. Given these different compensation philosophies, the proposed caps would negatively impact credit unions more than banks.

For example, assume a bank employs a significant risk taker and the market-based total compensation for that position is $300,000. The bank chooses to pay the employee a base salary of $100,000 with a target IBCA percentage of 200% (i.e., $200,000). The proposed rule would limit the maximum IBCA payout to 150% or $300,000. As such, the employee's total

[36] Federal Register, Vol 81, No.112, Page 37725
[37] Federal Register, Vol 81, No.112, Page 37734

compensation could not exceed $400,000 ($100,000 base salary plus a maximum of $300,000 from the IBCA)[38]. Alternatively, a credit union fills the same position but elects to pay the employee a base salary of $250,000 with a bonus of 20%. The credit union elects to pay the higher base salary because its compensation philosophy is different than banks'. In both cases the employee's market-based total compensation is $300,000 but the degree of potential leverage is different. The bank employee can earn an additional $100,000 in incentive-based compensation while the credit union employee is limited to $25,000. The caps in the proposed rule create a disparity between the bank employee and the credit union employee simply because the bank employee has a materially higher IBCA target percentage. This creates a disadvantage for credit unions, or any other financial institution, that relies less heavily on IBCAs. Oddly, the rule gives institutions an incentive to drive greater upside into their compensation programs by using increased levels of IBCA target amounts; this appears to be inconsistent with the general premise that higher IBCA payouts can create the incentive to take additional risk.

Although this example is simplified, it highlights the issue. Since the cap is based on the target level, different compensation philosophies result in materially different impacts for similar positions. Any proposed cap needs to be adjusted to reflect the amount of initial leverage implied by the base IBCA targets. NCUA should also evaluate whether the 125 to 150 percent cap is appropriate for the credit union industry and not rely on the percentages derived from the banking industry.

Additionally, the rule does not specify whether the 125 to 150 percent limitation applies to incremental bonus payouts attributable to individual performance versus corporate performance. Navy Federal adjusts an individual employee's bonus based on their annual performance rating which includes factors such as championing our corporate culture and delivering exceptional member service. High performing and exceptional employees receive an additional percentage. The proposal needs to clarify whether this type of additional percentage would be subject to the 125 to 150 cap.

Lastly, the proposed rule does not address how financial institutions should set target compensation for commission-based employees. The proposed rule is silent on whether institutions should set "target" commissions in absolute dollar terms, or, whether the commission rate itself should be limited. If the latter, how would a tiered commission structured be addressed? NCUA needs to provide greater clarity on how commission based earnings would be subject to the provisions of the proposed rule.

11. **The basis for clawbacks is not aligned with the credit union business model and the length of the clawback period is not calibrated appropriately**

Navy Federal does not support the proposed clawback provisions. The proposed rule states *"Clawback would be exercised under an identified set of circumstances. These circumstances*

[38] Additionally, banks use a combination of cash and equity instruments to pay their IBCAs. Equity instruments provide employees further leverage based on the performance of the underlying company. This is different than the credit union model which relies exclusively on cash.

include situations where a senior executive officer or significant risk-taker engaged in: (1) Misconduct that resulted in significant financial or reputational harm to the covered institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the senior executive officer's or significant risk-taker's incentive-based compensation."[39] It appears the rule's intent is to provide the basis for an institution to recover funds from a senior executive office or significant risk taker if the actions of these individuals were subsequently found to be inappropriate or fraudulent.

The rule leaves significant room for interpretation and creates a material overhang on past employees' financial futures as they may have to defend their actions up to 10 years after the fact. For example, the definition of misconduct leaves significant room for interpretation, as does the definition of reputational harm. Additionally, ascribing reputational harm to a single event may be difficult. Reputational harm may come from other events that either preceded or accompanied the event in question making it difficult for an institution to make a specific claim that an employee's misconduct led to significant reputational harm. NCUA needs to better identify the definition of these parameters.

Navy Federal is also opposed to the proposed seven year time frame. The proposed rule states, *"The Agencies are proposing seven years as the length of the review period because it is slightly longer than the length of the average business cycle in the United States and is close to the lower end of the range of average credit cycles."*[40] This rationale appears to be inconsistent with the basis for establishing a clawback period. The proposed rule states a clawback period is necessary to recover funds in the cases of misconduct, fraud or intentional misrepresentation; none of these factors are relevant to the average business or credit cycle. The basis for choosing seven years appears to be another form of extending the range to recover funds if risk-taking decisions underperform. There is a fundamental difference between attempting to recover funds due to fraud and attempting to recover funds because the business or credit cycle was different than what was expected several years prior. Absent a clear rationale for setting the clawback threshold to seven years, Navy Federal urges NCUA to eliminate the clawback provision in the proposed rule.

Lastly, the Agencies site Section 304 of the Sarbanes-Oxley Act of 2002 and Section 10D of the Securities Exchange Act of 1934 as examples where clawback provisions are already in place. We urge NCUA to consider these Acts were designed to protect public investors' interests and are not applicable to credit unions. Additionally, the timeframe specified in Section 10D of the Securities Exchange Act of 1934 which relates to material noncompliance with financial reporting requirements stemming from an accounting restatement is only three years, not the seven years proposed in this rule. We urge NCUA to consider the differences between clawback provisions established to protect public security investors' interests and not unilaterally apply these provisions to the clawback of credit union bonuses.

[39] Federal Register, Vol 81, No.112, Page 37731/32

[40] Federal Register, Vol 81, No.112, Page 37732

Attachment II

This attachment is provided as a supplement to Navy Federal's response regarding NCUA's Proposed Incentive-based Compensation Agreements (IBCA) rule. In this section we address select questions raised by NCUA Board Member McWatters. Many of the responses contained in this attachment are also discussed more fully in Attachment I.

1. **Section 956 of the Act provides that regulators may address incentive-based compensation arrangements through "regulations or guidelines." Would the use of guidelines, instead of rules, offer a feasible approach to the implementation of Section 956? Could the NCUA issue guidelines if any of the other agencies adopt a rulemaking?**
   Navy Federal strongly believes NCUA should address the requirements of Section 956 through guidelines rather than a prescriptive rule. As stated in the jointly proposed rule, the primary purpose of the rule is to ensure IBCAs do not *"encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss."*[41] The proposed rule was clearly drafted to address the IBCAs at the largest, internationally active banks and it is not appropriate for the credit union industry. Instead, by issuing a separate guideline, NCUA can still follow the requirements of Section 956 while tailoring the regulatory framework to the unique, and fundamentally different, business models of credit unions. Lastly, issuing a guideline gives NCUA the added benefit of more easily responding to changes in business conditions, changes in the specific business models of the covered credit unions, and changing best practices for compensation practices within the financial services industry.

2. **I am not aware that credit unions extensively engage in the types of compensation practices that Section 956 seeks to address. Moreover, if examiners implement this rule too broadly, I would have real concerns. How may the agency modify the proposal so as to minimize opportunities for examiners to micromanage the compensation practices of credit unions? As applied to the credit union community, would the proposed rule survive an objective, transparent cost-benefit analysis?**
   Navy Federal has never engaged in the types of compensation practices outlined in Section 956; however, based on the specific guidelines proposed in the rule, Navy Federal's annual employee bonus program would fall under the deferral, forfeiture and clawback provisions of the proposed rule. We do not believe limiting the type of bonus program used by Navy Federal was the intent of the Section 956 and we urge NCUA to adjust the parameters applied to the credit union industry.

   In 2001 Navy Federal created a "Partners in Performance" program to reward all employees for delivering exception service and value to our members. The program is based on three holistic measures of performance and effectively balances risk and return. In other words, it is not based solely on transaction volume or income. The program's design does not reward individual business units to take on excessive risk and it does not reward management to leverage risk for short-term

[41] Federal Register, Vol 81, No.112, Page 37678

profit. Most importantly, the program does not enrich a select portion of the company at the expense of the institution's safety and soundness. The concept is simple, if Navy Federal does well serving its members, all employees share in the company's success. Most importantly, the program is applied unilaterally to every employee in the institution. The drivers used to determine the overall level of bonus payout are the same for all employees ranging from entry level member service representatives and call center operators through the senior executive officers. In this way, all employees share equally in the success of Navy Federal.[42] Unlike the drivers addressed in Section 956, business units are not rewarded for their individual success; instead Navy Federal rewards all employees equally based on the total performance of the entire company.

Even though our program does not engage in the practices that Section 956 is trying to curtail, our program would fall under the definition of an IBCA and, as a result, several hundred Navy Federal employees could be subject to the provisions of a Level 2 institution including deferral, forfeiture and clawback. We encourage NCUA to adopt guidelines akin to the ones applied to Level 3 institutions but apply these to all credit unions irrespective of asset size. These guidelines should establish parameters for safe and sound compensation practices similar to those referenced in the Federal Deposit Insurance Act (12 U.S.C. 1831). These guidelines establish general parameters for ensuring compensation practices do not create risk to the safety and soundness of the institution. NCUA can achieve this stability through guidelines rather than requiring credit unions to defer the annual bonuses of several layers of employees.

Lastly, we do not believe the proposed rules would pass an objective, transparent cost-benefit analysis. Navy Federal's bonus program has never put the institution, or the share-insurance fund, at risk. Even during the height of the financial crisis, Navy Federal earned positive net income. We do not believe the proposed framework aligns with Navy Federal's plain-vanilla bonus program, nor the historical performance of Navy Federal. As such, we do not believe this rule would pass an objective cost-benefit analysis.

3. **What do commenters think of the design of the proposed rule? Are there changes that the agency should make to reduce its complexity so as to facilitate compliance for boards and management in a more efficient and cost effective manner?**
The rule is unnecessarily burdensome for credit unions. Credit unions do not engage in the types of compensation practices used at large, internationally active, banks. The rule seeks to impose a set of restrictions based on asset size which do not directly correlate to financial incentives for taking inappropriate risk. In short, the proposed rule was designed for large banks and is inappropriately being applied to the credit union industry without sufficient customization for the unique differences between credit unions and large banks.

Navy Federal, by virtue of its asset size, will be the ***only*** credit union subject to the enhanced restrictions of a Level 2 institution. Navy Federal does not engage in the types of compensation practices at issue, nor does the incentive to take long-term risks to enhance short-term bonus payout

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[42] The company payout percentage is determined equally for all employees. The dollar amount received by each employee is a function of base salary, position and individual performance.

exist at Navy Federal. The proposed rule will needlessly apply a significant set of restrictions on Navy Federal, its employees, and its competitive position.

Given the differences in the business models, financial incentives, and history of solid financial performance, NCUA should not apply the proposed Level 1 or Level 2 restrictions to any credit union based solely on their asset size. Instead, NCUA should apply the Level 3 principles for sound compensation practices, risk management and governance to all credit unions. Additionally, NCUA should retain the right to apply additional restrictions to credit unions only in cases where compensation practices are found to threaten safety and soundness or create an inappropriate environment to take unacceptable levels of risk. This approach allows NCUA to establish sound principles across the industry without needlessly creating punitive restrictions on Navy Federal and any other credit unions that may exceed the $50B threshold in the future.

Lastly, NCUA should achieve these objectives through guidelines rather than a rule. Given the differences between the issues at large banks and credit unions, a rule is unnecessary. Establishing sounds practices can be accomplished through guidance and effective monitoring by NCUA staff.

4. **Does the proposal sufficiently articulate what constitutes permissible incentive-based compensation arrangements? Is it clear that the proposed rule does not apply to an individual's salary and bonus, even if the person is a senior executive official or other covered individual, unless the compensation is provided as an incentive for the credit union to take inappropriate risk? In my view, the proposed rule should not apply to salaries and bonuses offered in the ordinary course of business unless the compensation arrangement unambiguously encourages inappropriate risk taking by the granting credit union.**

Navy Federal does not believe the proposed rule should apply to salaries and bonuses offered in the ordinary course of business. However, our interpretation of the proposed rule is salaries and bonuses offered in the ordinary course of business ***would be*** subject to the provisions of the rule. As a Level 2 institution, this means as many as 300-400 covered employees' annual bonuses earned in the ordinary course of business could be subject to deferral, forfeiture and clawback for a period as long as 10 years.[43] We have a significant concern with this approach.

As noted above, Navy Federal has a uniformly applied employee bonus program designed to reward all employees for achieving balanced corporate goals and member service. As a result, covered individuals would be subject to deferral, forfeiture and clawback provisions even though the bonus program does not incent them individually, or collectively, to take on risk beyond the ordinary course of Navy Federal's day to day business activities. The affected individuals will have their annual bonuses impacted by this rule simply because a portion of their ordinary compensation is variable.

We do not believe subjecting bonuses earned in the ordinary course of business is appropriate given Navy Federal's business activities, financial strength and low level of risk. Navy Federal routinely manages all of its risks within the limits set by its Board of Directors, and Navy Federal has never

[43] Assumes a 3 year deferral for a pro-rata share of the short-term annual bonuses plus a 7 year clawback period.

been subject to a regulatory exam or risk review where the level of business risk taken by the institution was deemed inappropriate or excessive. Navy Federal maintains a very healthy capital position with $9.6 billion in reserves.[44] We also have over $30 Billion of available liquidity. Despite our 83 year track record of sound financial management, strong balance sheet, and conservative business model, Navy Federal's straight-forward bonus program would fall under the auspices of the proposed rule. Navy Federal strongly believes its bonus program is a component of compensation for ordinary business practices rather than an incentive for taking additional risks.

Additionally there are aspects of our bonus program that are not related to the business results of Navy Federal, yet they impact the amount an employee receives as part of their bonus. For example, all employee bonuses are adjusted based on individual performance. Key components of this performance assessment include things like: effective employee management and development, adherence to Navy Federal's culture and core principles, work ethic, and achieving personal development goals. None of these drivers are related to inappropriate risk taking; however, they will influence the amount of the bonus. As such, two employees in the same role may be treated differently under the proposed rule simply because one performs better in their role. For example, an employee may fall outside of the covered population if they are performing adequately in their role. Instead, the employee who is performing at an Exceptional level would receive a higher bonus because of their individual performance, and as a result, may fall into one of the categories that make them subject to the provision of the rule (e.g., top 2 percent or one-third of total compensation). This highlights one of the structural problems with the proposed rule; it assumes IBCAs are designed to reward covered employees for risk taking activities and applies a broad-brush approach to these bonuses without delineating between elements of variable compensation that represent income earned as part of the ordinary course of operations versus IBCAs that encourage inappropriate risk taking.

We believe this is not the intent of Section 956. We believe Congress intended Federal regulators to evaluate whether IBCAs unduly enriched employees for creating short-term gains by taking long-term risks. We do not believe Congress intended employees of a retail credit union to be subject to the same deferral, forfeiture and clawback provisions as large, internationally active financial institutions. We urge NCUA to rescind the proposed rule and issue guidelines that better reflect the inherent differences between the bonus practices at Navy Federal and those of large banks.

5. **Another perspective on this issue-under the proposal, no credit union may establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the credit union (i) by providing a covered person with "excessive compensation," fees, or benefits, or (ii) that could lead to "material financial loss" to the credit union. Does the proposal sufficiently clarify what these provisions mean and what is specifically expected of credit unions? Do the definitions of "excessive compensation" and "material financial loss" vest excessive discretion with examiners and regulators? How should the NCUA undertake to implement such broad based and arguably ambiguous authority in a fair, accountable, and transparent manner? Will the agency issue**

[44] As of June 30th, 2016 Navy Federal has $8.6 billion in net worth and $1.0 billion in the Allowance for Loan and Lease Losses.

additional guidance to examiners and the credit union community regarding the day-to-day implementation of the proposed rule?
The proposal lacks clarity on the definition of "excessive compensation" and "material financial loss" and it subjects covered institutions to the interpretations of NCUA examiners. As a result, covered institutions may be subject to changing interpretations from the same Agency as time passes, or, as different exam teams form different assessments.

The detailed preamble accompanying the proposed rule filed in the Federal Register attempts to define the term excessive compensation. The proposal states *"compensation, fees and benefits would be considered excessive... when amounts paid are unreasonable or disproportionate to the value of the services performed by a covered person, taking into account all relevant factors."*[45] The proposal further states, *"...factors would include: (1) The combined value of all compensation, fees, or benefits provided to the covered person; (2) the compensation history of the covered person and other individuals with comparable expertise at the covered institution; (3) the financial condition of the covered institution; (4) compensation practices at comparable covered institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution's operations and assets; (5) for post-employment benefits, the projected total cost and benefit to the covered institution; and (6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution."*[46]

The proposed rule acknowledges it would be difficult for some institutions (e.g., mutual savings associations and banks) to identify comparable covered institutions. As such, the proposed rule itself recognizes there are situations where the standards proposed leave significant room for interpretation. The proposed rule states the Agencies *"intend to work closely with these institutions to identify comparable institutions to help ensure compliance with the proposed rule."*[47] Clearly this sets the precedent the Federal regulator will be directly involved in setting the standard for comparison. Within the credit union industry, this creates a significant concern for Navy Federal as the size of our operations does not lend itself to direct comparison with other credit unions. We urge NCUA to specify how it would make these determinations when there are no similarly sized, geographically equivalent, or comparably complex institutions within the credit union industry.

6. **The proposal would grandfather existing plans. Should it also clarify that credit unions may add new employees or officials to existing plans without triggering compliance requirements?**
The proposed rule states, *"A covered institution is not required to comply with the requirements of this part with respect to any incentive-based compensation plan with a performance period that begins before [the compliance date]."*[48] We interpret the rule to mean any plan that has begun its performance period before the effective date of the proposed rule plus 540 days would not be impacted by this rule; however, any plan where the performance period begins after the implementation date of the new rule would be subject to the elements of the rule even if the plan was

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[45] Federal Register, Vol 81, No.112, Page 37709 (footnote 116)
[46] Federal Register, Vol 81, No.112, Page 37709
[47] Federal Register, Vol 81, No.112, Page 37709
[48] Federal Register, Vol 81, No.112, Page 37800

identical to the plan in place before the rule was implemented. As such, we interpret grandfathering to simply mean, plans do not need to be changed during the transition period between filing of the final rule in the Federal Register plus 540 days (assuming that feature remains). We urge NCUA to clarify this interpretation and specifically address whether there are any other grandfathering provisions.

During the transition period, Navy Federal agrees the grandfathering of plans should extend to any employee who transitions into the covered population.

7. **The proposal addresses performance measures by credit union employees. Should the proposal reserve these issues to the discretion of credit union boards and management?**
Performance measures should be left to the discretion of the Board of Directors. Section 956 requires the regulatory agencies to ensure an institution's IBCAs do not create the incentive for inappropriate risk taking. NCUA can implement its Congressional mandate without specifically prescribing the performance measures used to determine the bonus payout. Decisions about performance measures, and how to balance risk and reward, are best left to each credit union's Board of Directors.

NCUA already has examination authority over a credit union's compensation packages under their safety and soundness review. The results of this review are already part of an institution's CAMEL rating, thus NCUA already has an existing avenue to discuss any concerns with the Board of Directors. It is an unnecessary burden to prescribe types of performance measures in this rule.

8. **The proposed rule would require covered credit union boards to approve incentive-based compensation arrangements, subjecting them, even though they are generally volunteers, to even more professional responsibility and examiner scrutiny. Is this necessary for credit unions? Do viable alternatives exist? By what standards will the NCUA assess such board action or inaction? Will the agency offer safe-harbor guidance?**
Navy Federal's Board takes an active role in the bonus program. The Board reviews the structure of the program, sets balanced annual targets commensurate with their level of risk tolerance and the overall objectives for the credit union, and approves the final payout once all objectives and performance metrics have been finalized. We have always used this approach and plan to continue to use it going forward.

The proposed rule places a greater administrative burden on the Board and its various sub-committees. It requires the creation of a dedicated, independent Compensation Committee. It also requires the compensation committee *"obtain input and assessments from various parties."* [49] These assessments must be written reports and analysis provided by other Board committees (e.g., Audit and Risk Committees) as well as reports from management attesting to the risk management controls surrounding the administration and ultimate payout of the bonus program.

[49] Federal Register, Vol 81, No.112, Page 37738

As highlighted above, NCUA could achieve the same objective by issuing guidance to covered credit unions outlining oversight expectations rather than issuing a prescriptive rule that adds administrative burden the Board of Directors. We urge NCUA to consider leveraging its ability to address the Section 956 requirements through guidance rather than a perspective rule designed to establish practices that are more relevant to the structure and practices of the largest banks.

9. **The proposal has three categories of compliance, with Level 1 and 2 credit unions subject to enhanced requirements. Under the proposal, the NCUA may subject certain Level 3 credit unions to the more stringent requirements of Level 1 or 2, even if a Level 3 credit union does not otherwise meet the criteria. Is this necessary and appropriate? Should credit unions possess the right to appeal such determination if the NCUA concludes a compensation arrangement is covered under the rule and the credit union disagrees? If not, what due process rights apply to aggrieved credit unions? Further, what due process rights are credit unions afforded under the proposed rule regarding other potential areas of dispute with the agency?**
Navy Federal believes the thresholds in the proposed rule for the Levels are not appropriate for the credit union industry. The basic premise of the rule is there is a direct correlation between asset size and an increasing incentive to take inappropriate risk to boost the short-term IBCA payout. While the banking regulators believe this is true in their industry, it is not true in the credit union industry, and in particular, for Navy Federal.

Navy Federal began its bonus program in 2001 when assets were $12 Billion. Our program is based on three holistic measures of performance and effectively balances risk and return. It does not reward individual business units to take on excessive risk and it does not reward management to leverage risk for short-term profit. Most importantly, the program does not enrich a select portion of the company at the expense of the institution's safety and soundness. The concept is simple, if Navy Federal does well serving its members, all employees share equally in the company's success. Our program has worked very effectively since 2001 and has not produced any results which were inconsistent with the goals of the program or the principles of sound compensation referenced in the proposed rule. However, the proposed rule would now subject Navy Federal employees to punitive deferral, forfeiture and clawback provisions simply because it has grown to $78 Billion in assets. It is important to note that over the fifteen years since we have implemented our bonus program, the structure of our program has not changed. The premise that asset growth has translated into greater opportunity to take inappropriate risk such that mandatory deferral, forfeiture and clawback provisions are necessary is simply not supported by the facts. NCUA needs to consider the unique differences between banks and credit unions before adopting an asset-based threshold that was developed based on the operations of large, internationally active banks.

10. **It is my understanding that the proposal would require a Level 1 or 2 institution to reclaim, defer, reduce, or withhold an employee's covered compensation for the poor financial performance of the credit union that is due to deviation from the credit union's risk parameters, or if the credit union must correct a financial statement for a material error, among other items. Should the rule, instead, directly link the operation of the clawback to the**

actions of the specific credit union employee or official? Is it appropriate for a non-culpable recipient to forfeit an incentive-based compensation award due to the actions of other persons?
As discussed more fully in Attachment I, Navy Federal opposes the clawback provision in the proposed rule. First, the clawback provisions are inappropriate to the credit union business model because the types of activities and revenue recognition standards that create the incentive to take long-term risk for short-term profit are not part of Navy Federal's business model. Second, the proposed rules lacks clarity; there is too much ambiguity with respect to how clawbacks would be initiated, applied and subsequently managed in a way that properly balances the needs of the institution and the rights of former employees.

Should NCUA decide to proceed with a clawback provision, clawbacks should be very limited in scope and only apply in cases where clear fraud and misrepresentation are evident. For example, if a material restatement occurred because fraud was committed, then the clawback provisions of the rule, if adopted by NCUA, should only apply to the individuals involved in the fraud. Specifically, the clawback should be limited to ***only*** those individuals culpable; the clawback ***should not*** extend to other senior executive officers or significant risk takers. Additionally, a material misstatement that was caused by an unknown accounting or systems error which has the unintended impact of retroactively adjusting the earnings used to derive the IBCA payout should not be subject to clawback provisions. All businesses assume a certain degree of operational risk and they put controls in place to mitigate these risks; however, unknown risks can, and do, occur. It would be inappropriate to hold employees culpable for unintended actions, even if they inadvertently received compensation that was elevated. The purpose of the clawback provision is to ensure bank employees who received substantial amounts of incentive-based compensation did not receive that compensation by perpetuating fraud or misrepresentation. This is entirely different than a subsequent error that occurred during the normal course of business.

11. **Level 1 and 2 institutions would have specific caps on the amount of incentive based compensation they may provide individuals. Are such caps appropriate and, if so, should each covered credit union set the cap?**
NCUA should not adopt the proposed caps because they are not necessary under the credit union business model and they put credit unions at a competitive disadvantage.

Establishing a cap assumes a direct correlation between taking risk and an individual's payout under Navy Federal's bonus program. As discussed above, Navy Federal's bonus program is not structured in this manner; excessive risks taken by individuals or risks taken by business lines would not directly impact the near-term bonus payout. Three factors support this conclusion: Navy Federal's non-financial metrics represent a large part of determining the actual bonus payout each year; individual performance, which includes factors beyond business performance, is a key driver of each employee's bonus, and lastly; Navy Federal does not accelerate earnings from long-term risky transactions. As such, Navy Federal's bonus program does not have the direct financial incentives outlined in NCUA's proposal. Establishing a cap on the payout would be a needless limitation on the program and would not meet the standard of reducing incentives to take inappropriate risk.

Additionally, the rule does not specify whether the 125 to 150 percent limitation applies to incremental bonus payouts attributable to individual performance versus corporate performance. Navy Federal adjusts an individual employee's bonus based on their annual performance rating which includes factors such as championing our corporate culture and delivering exceptional member service. High performing and exceptional employees receive an additional percentage. The proposal needs to clarify if this is subject to the 125 to 150 cap.

Lastly, the proposed rule does not address how financial institutions should set target compensation for commission-based employees. The proposed rule is silent on whether institutions should set "target" commissions in absolute dollar terms, or, whether the commission rate itself should be limited. If the latter, how would a tiered commission structured be addressed? NCUA needs to provide greater clarity on how commission based earnings would be subject to the provisions of the proposed rule.

12. Should the proposal prohibit volume based covered compensation?
Navy Federal does not believe volume based incentives, when used appropriately, should be eliminated. The principles of sounds compensation management discuss balancing risk and reward. Clearly structuring an individual's IBCA based solely on loan origination volume of sub-prime mortgages is likely to be problematic. Conversely, establishing goals to improve efficiency (e.g., call center throughput) can be part of an effective overall set of corporate objectives. In short, volume based incentives need to be used judiciously and viewed under a watchful lens that balances risk and reward.

13. Should the tax equalization provision between credit unions and banks also consider bracket creep resulting from the acceleration of credit union incentive based compensation awards into taxable income in the year the award is granted by the credit union to the covered person?
Yes. We urge NCUA to review the potential tax consequences that are not properly addressed in the proposed rule. Specifically, what is the impact of deferring income on credit union employee's personal income taxes, and, for employees who experience clawbacks of previously vested income, how will previously paid taxes be treated? These uncertainties can raise significant, and potentially material, issues for credit union employees. It is imperative NCUA coordinate with the Internal Revenue Service (IRS) before any rule or guideline is published.

We ask NCUA to clarify with the IRS how the impact of the tax liability will be determined. For example, the impact on single-income households may be different than dual-income households because dual-income households will likely have a higher marginal tax bracket.

Lastly, the credit union specific provision of the rule allowing the accelerated vesting of IBCAs to pay the tax liability creates an unintended penalty and a competitive disadvantage when compared to the banks. Under the proposed rule, employees can earn a reasonable rate of return on the deferred award; however, the amount on which that rate of return is earned will be less for a credit union employee than a bank employee because of the immediate tax liability created when the award is granted. Consider a bank employee who has a $200,000 award deferred for three years which earns 3% over the deferral period. The bank employee would have $218,545, at the end of the three years. A credit union employee would have to pay taxes on the award at the onset. Assuming a tax rate of 35%, the credit union employee would pay $70,000 in taxes and defer $130,000. At the end of the deferral period, the credit union employee would have $142,055. The bank employee earned $18,545 during the deferral period while the credit union employee only earned $12,055 because taxes were paid at the onset which reduced the principle amount deferred.[50] This creates another disadvantage for credit union employees. We urge NCUA to seek an exemption from the IRS for any tax liability created from IBCA awards that are granted but not yet vested.

14. **How does the clawback provision operate if a recipient has previously paid tax on the incentive-based compensation award?**
    The proposed rule is unclear on the tax implications of funds recovered through the clawback provision. In cases where clawbacks would be enforced, the rule does not specify whether the clawback would seek to recover the pre-tax or post-tax vested award. If the rule seeks to recover the pre-tax amount, how will the tax liability be unwound? If the rule seeks to recover only the post-tax amount, how will the post-tax amount be determined given the unique nature of each employee's personal tax situation? The rule needs to provide greater clarity on how personal tax consequences will be addressed if the clawback provisions where enacted.

[50] Once adjusted for taxes, the difference becomes $4,219.