League of Southeastern Credit Unions & Affiliates

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

Re: Incentive-based Compensation Arrangements (RIN 3133-AE48)

Mr. Poliquin,

The League of Southeastern Credit Unions (LSCU) appreciates the opportunity the National Credit Union Administration (NCUA) has provided to comment on the issue of executive compensation. LSCU believes that NCUA should adopt only those mandatory provisions specified by Congress in the Dodd-Frank Act. NCUA should refrain from any discretionary rulemaking regarding compensation because these proposed rules were created to address behavior at large banks. Credit unions are institutions that are so distinctive from banks that the mechanisms of this rule strain the rationale and regulatory framework of applying the rule to credit unions.

LSCU is a trade association that represents 270 credit unions in Florida and Alabama. Our mission is "To create an operating environment that enables credit unions to grow and succeed." Even though this regulation's jurisdiction is only over those credit unions with more than $1 billion in assets, the uncertainty surrounding which provisions of the proposed rule will apply to credit unions with assets between $10 and $50 billion may put a heavy burden on those affected credit unions. NCUA should work to limit the regulatory burden to those covered credit unions at a minimum as there is no significant evidence credit union executive compensation has been identified as a risk to the Share Insurance Fund or the economy as a whole.

Executive Compensation and the Great Recession

It is widely believed that executive compensation in the financial sector, specifically banks, was a contributing factor to the financial crisis.[1] The call to reform executive pay began well before the financial crisis, but that crisis gave Congress the impetus to reform executive pay (at least regarding financial institutions) with the Dodd-Frank Act. The focus of the pay reform is on limiting an executive's compensation for short-term growth, and it attempts to tie executive pay to long-term growth and institutional health.

It does not suit the purpose of this letter to discuss the organizational and behavioral theories of executive pay at financial institutions and their relation to the financial crisis. Though it can be said that bankers, using leverage, may make riskier investment decisions to ensure greater profitability for their shareholders, which is a primary consideration for regulators who are concerned with institutional and economic health. But it is unclear how effective regulating banker's pay will be in ensuring financial stability.[2]

The complexity of the problem cannot simply be distilled down to executives whose determination to increase profits leads to riskier investments. This ignores fundamental issues within the regulatory schemes, such as whether the risk weighting for assets reflects the true risk to the insurance scheme.[3] It could lead to bank shareholders tolerating greater operational risk because the risk to their investment is minimized due to the assumption that the government will bail out the bank rather than let it fail.[4] Even the nature of leverage (balance sheet, economic, and embedded) is so complex that no measure can capture its different dimensions simultaneously.[5] So even with the recognition that executive compensation played a role in precipitating the financial crisis, the range of other contributing factors indicates that efforts at reforming executive pay will have a limited influence in preventing other such events.

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[1]*See* Andrew Johnston, *Preventing the Next Financial Crisis? Regulating Bankers' Pay in Europe,* 41 J.L. Soc'y., No.1, 2014 at 7. *See also* Symposium, *Corporate Governance in the Financial Services Industry: Dodd-Frank Reforms to Banker Compensation Arrangements*, 47 Ind. L. Rev. 201 (2014).; Eric Chason, *The Uneasy Case for Deferring Banker Pay*, 73 La. L. Rev. 923, 924 (2013).

[2]Emilios Avgouleas & Jay Cullen, *Excessive Leverage and Bankers' Pay: Governance and Financial Stability Costs of a Symbiotic Relationship*, 21 Columbia J. Eur. L. at 2 (2014).

[3]*Id.* at 8.

[4]*Id.* at 4.

[5]*Id.* at 6.

The desire to reform executive compensation, which contributed to the financial crisis and the Great Recession, may be an appropriate remedy for some institutions, but it is wholly inappropriate for credit unions for several reasons:

1. Credit unions played no role in creating the financial crisis;[6]
2. Credit unions are generally much smaller than banks and therefore pose less risk to the financial system. The average institution asset size of banks to credit unions: $2.3 billion vs. $173 million[7] and banks hold 14 times more total assets than credit unions at $15.6 trillion vs. $1.1 trillion[8]; and perhaps most importantly,
3. Credit unions are inherently different than banks and therefore should be treated differently.

Proposed Rule under § 956 of Dodd-Frank and Credit Unions

§ 751.4 General Application Provisions

One concern of the proposed regulation is that much of the language in parts a) and b) is subjective. These sections provide clarity for a subjective concept with another subjective concept. To identify "inappropriate" risks, an institution provides a covered person with "excessive" compensation. And "excessive" compensation is pay that is "unreasonable or disproportionate" to the value of the covered person's services with "unreasonable" value being determined by consideration of six factors, though not limited to only those factors. Without a clear method of weighing these factors, covered persons will be subject to judicial interpretation of this rule, creating enforcement disparities among courts.

Then there is section (d) *Performance Measures* part (2), where incentive compensation will not be considered appropriately balancing risk unless non-financial performance overrides financial measures of performance. This makes no sense. Credit unions are financial institutions, and their primary purpose is to serve their members' financial needs. A credit union should be judged on how successful it is at satisfying those needs. A rational compensation scheme would focus primarily (perhaps not exclusively) on financial measures of performance.

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[6] Richard Cordray, Director, Consumer Fin. Protection Bureau, Address at Credit Union National Association Conference (Feb 23, 2016).
[7] Mike Shenk, *Credit Unions & Banks Fallacies: Facts and Recent Trends Year-End 2014* at 2 (2014).
[8] *Id.*

§ 751.6 - Reservation of Authority for Level 3 Credit Unions

The proposal to give NCUA the authority to hold Level 3 credit unions with assets between $10 billion to $50 billion should be rejected. Data from the first quarter call reports of 2016[9] indicated that presently this would include five credit unions that could be subject to Level 1 and 2 rules, even though they fit into Level 3. Presently, only one credit union, Navy Federal Credit Union, would meet the criteria to be subject to heavy-handed proposals for executive compensation.

There does not appear to be a justification for wanting to push credit unions that fit into the Level 3 into Level 2 scrutiny and therefore into a more burdensome regulatory scheme. Perhaps the justification is that without the ability to push Level 3 credit unions into the Level 2 compensation framework, only one credit union presently will be subject to the multi-faceted executive compensation scheme. There would be no need to have different asset levels to peg NCUA's scrutiny over executive compensation; if NCUA can hold a Level 3 credit union to many of the same requirements reserved for Level 1 and 2 credit unions. This scenario reinforces the fact that these rules were developed with big banks in mind and are wholly inappropriate for credit unions.

§ 751.7 – Deferral and Clawback

This provision allowing clawback of an executive's incentive-based compensation (bonus) seven years after it vests is both excessive and superfluous. The reason this clawback provision seems excessive is the extensive timeframe during which an executive's deferred bonus may be rescinded. The proposal states that bonuses may be recovered from an executive seven years after it vests. Theoretically if a bonus package vests three years after the particular financial performance it is based on, the credit union could take back the bonus 10 years after the said performance. If this is a proper understanding of how this provision could work, this seems very excessive.

Also, how would the process work for tiered vesting? For instance, one example would be when 20% of the executive's bonus is paid annually over a five-years period, beginning the year after the financial

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[9] http://www.usacreditunions.com/top-100-credit-unions-by-cash-assets

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performance it is based on. Would the clawback work to rescind the bonus of an executive at the final vesting date or the first, or each proportionally?

This provision is superfluous because remedies already exist in the law for recovering monies from bad actors[10] that are the culprits this part of the regulation is targeting. Moreover, the claw back can be triggered if the *credit union determines* an executive engaged in: misconduct, fraud, or intentional misrepresentation. Would the determination require the credit union to prove those actions in a court of law or administrative process? It would not be unthinkable that new executives, who may not like the previous executive's decisions, may look for an opportunity to reduce the amount the credit union is obliged to pay. Essentially, there should be a mechanism to provide for due process in determining actions where compensation can be revoked.

Conclusion

Though there is evidence that executive compensation played a role in the financial crisis, it is unclear as to how much restrictions on executive compensation will prevent risky behavior within the financial sector. But it is clear that these changes will put a further burden on credit unions that are already suffering from regulatory costs because this rule affects the largest credit unions that face the most scrutiny. LSCU reiterates that NCUA should limit the proposed rules to those strictly laid out by Congress and refrain from any discretionary rule-making.

Sincerely,

Mike Lee
Director of Regulatory Advocacy

[10] *See* Ala. Code § 6-5-100 (1975); Ala. Code § 6-5-103 (1975); Fla. Stat. § 817.16; Fla. Stat. § 772.104; 12 U.S.C. § 5565.