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President & Chief Executive Officer

July 21, 2016

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

RE: Proposed Rule for Incentive-Based Compensation Arrangements

Dear Mr. Poliquin,

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association focusing exclusively on federal issues affecting the nation's federally-insured credit unions, I am writing in regards to the interagency proposed rule on incentive-based compensation (IBC). NAFCU urges the National Credit Union Administration (NCUA) and other Federal financial regulators (Agencies) to substantially revise this rule in acknowledgement that it should not apply to credit unions, is overly broad and complex, and lacks requisite clarity and guidance for good-faith compliance. Accordingly, this rule must be withdrawn and not applied to credit unions.

Before providing comment on the substance of the proposal, NAFCU and our members restate our earlier calls that Section 956 of the *Dodd-Frank Act* (Dodd-Frank) should not apply to credit unions. As the proposal's preamble explains, Congress enacted Dodd-Frank in response to the financial crisis, and intended Section 956 to specifically address Congress's belief that flawed IBC practices in the financial industry were one of the many factors contributing to the crisis that began in 2007. The preamble goes on to state that excessive IBC arrangements encouraged inappropriate risks that did not sufficiently expose the risk-takers to the consequences of their risk decisions over time.

While NAFCU agrees that risky behavior by large and unscrupulous actors led to the financial crisis, we strongly believe that rules designed to curb such actions should be directed at those entities that sparked the crisis, not credit unions. As countless regulators, legislators, and policy experts have repeatedly stated, credit unions did not cause the financial crisis, nor engage in the risky behavior that Section 956 is intended to address.

As confirmation of this fact, Consumer Financial Protection Bureau (CFPB) Director Richard Cordray stated during an April 19, 2016 speech that, "as I have consistently said in the past, the Bureau recognizes that community banks and credit unions did not cause the

financial crisis." Additionally, dozens of members of Congress have publicly shared the same sentiment. Given this widely-held knowledge, credit unions should not be covered by Section 956, or other provisions of Dodd-Frank that were enacted in response to the crisis.

Unfortunately, it will take Congressional action to remedy this disconnect between the law's intended purpose and its unintended effects. If Section 956 is truly designed to address the excessive risk taking that led to the financial crisis, it would be prudent for Congress to tailor this section so that it only applies to the largest financial institutions that were found to be culpable of excessive risks.

Additionally, NAFCU believes that applying Section 956 to credit unions and other small financial institutions unfairly rewards the large banks and financial players that caused the crisis. Unlike small financial institutions, large banks are able to afford compliance with complex and far-reaching regulations. Compliance costs actually give those institutions an advantage.

Supporting this belief, a May 2016 Fannie Mae study found that larger lenders have reported that increased mortgage regulations have led to competitive advantages over smaller lenders. Large financial institutions only gain market share every time a financial regulation is promulgated that covers credit unions. Clearly, this is not what Congress intended with Dodd-Frank or Section 956, which is designed as a response to the bad actions of Wall Street and mega-banks that led to the financial crisis. As such, this section should not apply to credit unions that have been, and continue to be, good actors. NAFCU's comments are detailed below but contain the following main points:

- This rule should not apply to credit unions and must be withdrawn.
- This rule should not rely on asset size as a determining factor.
- Guidance is a more appropriate tool than a rulemaking.
- This rule is too broad and would apply to certain arrangements unnecessarily.

Rule as Proposed is Unnecessarily Burdensome in Regards to Section 956's Objectives

NAFCU understands that even though credit unions are neither the focus of this rule, nor the culprit of the financial crisis, Dodd-Frank still requires NCUA to address IBC arrangements with the other Agencies. However, NAFCU strongly believes the Agencies should implement Section 956 in a less invasive manner while still achieving its stated goals. In particular, the Agencies should refine and improve the IBC guidance that already exists instead of promulgating new rules. Alternatively, if the Agencies move forward with a rulemaking instead of guidance, the final rule should reflect the unique business model of credit unions.

As mentioned above, IBC guidance currently exists, as evidenced by Section 956's reference to section 39(c) of the Federal Deposit Insurance Act, requiring that any IBC rule should be comparable. Further negating the need for this rule, the Agencies are not

mandated to promulgate rules, but have the discretion to develop guidance, instead. Section 956 (a)(1) of Dodd-Frank mandates that "[t]he appropriate Federal regulators jointly shall prescribe regulations **or** guidelines..." (emphasis added). NAFCU urges the Agencies to issue guidelines instead of adding the complexity and breadth of another rule. Promulgating guidelines offers the Agencies the flexibility to craft provisions that are more closely aligned with their particular industries. In addition to section 39(c) discussed above, several Agencies have already issued guidance on IBC arrangements.

The Federal Banking Agencies proposed, and then later adopted, the 2010 Federal Banking Agency Guidance governing IBC programs, which applies to all banking organizations regardless of asset size. This guidance uses a principles-based approach to ensure that IBC arrangements appropriately tie rewards to longer-term performance and do not undermine the safety and soundness of banking organizations or create undue risks to the financial system.

More specific to credit unions, NCUA already has the authority to examine credit unions' compensation packages and arrangements as a way to ensure a credit union's safety and soundness. In fact, NCUA's CAMEL Rating System already considers many, if not all, of the provisions covered under this rule. For example, Chapter 7 of NCUA's Examiner Guide contains several pages dedicated to ensuring that a credit union's compensation for executives encourages safety and soundness. The guide directs examiners to note "unsafe and unsound compensation practices." It also cites numerous examples of unsound compensation practices, including compensation arrangements that provide incentives contrary to the safe and sound operation of the credit union, such as compensation based primarily on short-term operating results that may encourage unreasonable risk-taking to achieve short-term profits.

The proposal's preamble acknowledges that although recent progress has been made in addressing IBC-related risk through existing guidance, current practices are still in need of improvement. This includes better targeting of performance measures and risk metrics to specific activities, more consistent application of risk adjustments, and better documentation of the decision-making process. NAFCU believes that such improvements would be better and more efficiently achieved through revisions and updates to the guidance already in place. Guidance is much more likely to be updated on an on-going basis, and tailored to the risk that the individual institution poses. Rules, on the other hand, are unwieldy, stale, and blunt tactics that unintentionally rope in less-risky actors with high-risk ones.

Section 956 of Dodd-Frank was intended to guarantee that bad actors not already subject to such regulatory authority were brought to the same standards, not necessarily to create even stricter and more burdensome requirements. Given the Agencies' independent progress on addressing excessive risk related to excessive compensation, this rule is no longer needed, although refinements to existing guidelines would be welcome.

Regardless of whether guidelines or rules are issued, the Agencies should acknowledge the unique nature of credit union business models. Accordingly, NAFCU believes the Agencies should incorporate reasonable accommodations that reduce the rule's complexity so as to facilitate compliance for boards and management.

Business models of credit unions are inherently different from the other entities covered under this rule. Credit unions don't have shareholders, they have members-owners. Further, credit union boards are predominantly made-up of unpaid, volunteer members. Unfortunately, the proposal imposes increased oversight and governance responsibilities on these volunteer boards, including the requirements that boards (1) conduct oversight of the IBC program, (2) approve IBC arrangements for senior executive officers, and (3) approve any material exceptions or adjustments to the IBC arrangements for senior executives. These are complicated matters even for a paid or professional board. As a result of these requirements, this rule will become untenable for credit union boards unless an exception or provision is provided that considers the volunteer nature of credit union boards.

Beyond credit union business models, NAFCU believes the Agencies have discretion to correlate differing standards for individual credit unions based on the inherent risk related to a credit union's practices and products, rather than depend on a credit union's asset size. Section 956 does not mandate that this rule apply to all credit unions with assets $1 billion and above, but instead provides an explicit exemption for credit unions that are below $1 billion in assets. Further, there is nothing in Section 956 requiring the Agencies to set requirements based on asset size.

The proposal applies differing requirements to covered credit unions based on asset size, with an increased asset size correlating to more prescriptive requirements. Accordingly, stricter and more prescriptive guidelines should revolve on the riskiness of the credit union, not on the asset size. The practices of a credit union are much better indicators of risk than a simplistic analysis based on assets. Therefore, NAFCU urges the Agencies to only apply this rule in conjunction with the risk findings from examinations for the Management component of the CAMEL Rating System. This is discussed further in the section below.

NAFCU Recommends Clarified Guidelines and Revised Definitions

Overall, NAFCU and our members believe this rule contains several sections that raise uncertainty, warranting that more guidance or official interpretation is published with the final rule. Ideally, this guidance could provide greater context for the rule, more objective criteria for how examiners will apply the rule, and greater explanation for how credit unions could comply with the rule.

Reservation of Authority for Level 3 Institutions

The proposal vests too much discretion with the examiners in determining what meets the

definition of "excessive compensation" and "material financial loss." In particular, many of our members are concerned about section 751.6, which would allow examiners to require certain Level 3 credit unions to comply with some or all of the more rigorous requirements applicable to Level 1 and Level 2 credit unions, depending on the complexity of the credit union's operations or compensation practices.

NAFCU strongly objects to this section as the process and procedure by which this authority is triggered is too opaque. The rule does not provide any objective criteria for what factors would trigger more rigorous requirements for a Level 3 credit union, and the preamble vaguely explains that NCUA procedures would "include reasonable advance written notice of the proposed action, including a description of the basis for the proposed action, and opportunity for the covered institution to respond." That explanation is too ambiguous for a credit union to be able to contemplate and plan for NCUA action in this regard. NAFCU strongly urges NCUA to be more descriptive in how it would determine whether a credit union is operating in a fashion that warrants further requirements.

Further, NAFCU believes that deferral, clawback and forfeiture provisions should not automatically apply to Level 2 and Level 1 covered credit unions by default. Nothing in Section 956 requires the Agencies to promulgate a "one size fits all rule." As proposed, there will likely be many instances of a covered credit union being improperly classified as Level 2 or Level 1 due to its asset sizes, regardless of the actual complexity of the credit union's IBC arrangements. Instead, NAFCU and our members advocate that this proposal should be tailored to specific issues and implemented on a case by case basis, depending on the risk profile of the individual credit union.

Finally, if NCUA believes that the complexity of a credit union's operations or compensation practices warrant more onerous requirements, then conversely, the same logic should apply to Level 1 and Level 2 credit unions that exhibit *less* complex operations. These less risky credit unions should only be required to comply with Level 3 requirements.

Exceptions for De-Minimis IBC Arrangements, Non-Senior Executives and Non-Significant Risk-Takers

NAFCU has heard from our members that there are several IBC plans currently offered that would be covered by this rule, but would have no nexus to the intent of Section 956. These would include organization-wide plans based on non-financial goals such as member satisfaction. Additionally, many credit unions provide gift cards or compensation on non-financial related projects, such as teller competitions intended to increase cross-market opportunities, or increased efficiencies from traditional cost centers such as IT, Human Resources or Legal departments. Although these would technically be covered IBC arrangements, it is highly unlikely that Congress intended to curb the practice of a credit union awarding a small dollar gift card to a teller for generating the most in-bound marketing leads.

Additionally, NAFCU opposes the broad definition of "covered persons." NCUA would define the term to mean "any executive officer, employee, or director of a credit union." This incredibly broad definition is indicative of the overly-broad nature of the proposed rule. The proposal is intended to minimize unnecessary risk-taking. However, the rule, in practice, can capture the incentive-based compensation arrangement of any credit union employee that has such an agreement.

Consequently, NAFCU believes the proposal will create unnecessary burdens for credit unions that are required to report incentive-based compensation arrangements for individuals who have little or no realistic possibility of creating risk issues. Accordingly, NAFCU urges NCUA to only apply this rule to senior executives and significant risk takers. Alternatively, NAFCU asks NCUA to clarify that IBC plans and employees should only be covered by this rule if the IBC arrangement has a direct and consequential nexus to a credit union's safety and soundness.

Revised Definition and Test of Significant Risk Taker

Section 751.2(hh) of the proposed rule defines a "significant risk taker" as an individual who is not a senior executive, but who receives one-third of his or her total compensation through an IBC plan and meets one of two following tests.

The first test hinges on the individual's total compensation, and whether the individual is among the top 5 percent (for Level 1 credit unions) or top 2 percent (for Level 2 credit unions) of highest compensated covered persons in the credit union. The second test is based on whether the individual has the authority to commit or expose 0.5 percent or more of the net worth or total capital of the covered credit union. NAFCU has several concerns with this definition and related tests.

In regards to the first test, known as the relative compensation test, NAFCU believes that there are a considerable number of top-earner credit union employees that receive a substantial portion of their salary through IBC plans, but have no reasonable relationship to influencing risk-taking decisions at a credit union. A common example of this scenario would be a high paid, in-house attorney that avoided a costly law-suit and consequently received a large IBC arrangement. Under the relative compensation test, this individual would be deemed a significant risk taker even though it is quite clear that he or she did not increase the credit union's risk, but arguably decreased the amount of risk.

Additionally, the second test, known as the exposure test, fails to adequately contemplate different levels of risk associated with certain asset classes. For example, at a $55 billion credit union with $5.5 billion of capital, it would be quite common for an investment officer to manage an investment portfolio of $30 million or more (which is 0.5 percent of the credit union's capital). If that investment officer received one-third of his or her total compensation through an IBC plan, then that person would be deemed a significant risk taker, regardless of the fact that the individual may be limited to investing in US Treasuries or agency bonds, which are by definition, plain vanilla, low- to no-risk instruments

available. NAFCU does not believe that this is the scenario that Congress intended to include when drafting Section 956.

Accordingly, NAFCU believes that the relative compensation and the exposure tests are too broad in setting the definition of significant risk taker, and inappropriately hinge the definition on salaries or routine job functions, which might correlate with risk, but are certainly not causative. NAFCU urges NCUA to modify the definition so it directly depends on an appropriate metric that actually measures the degree of risk-taking activities. The definition of significant risk taker should be narrowly tailored to only cover those individuals that are in the position to put a Level 1 or 2 covered credit union at risk of material financial loss.

Tax Implications

Because this proposal involves far reaching tax implications related to mandatory acceleration and clawbacks of vested income, NAFCU strongly recommends that the Agencies collaborate with the Internal Revenue Service (IRS) on the implementation of this rule. In particular, NAFCU is concerned that this rule would create redundant requirements, possibly resulting in conflicting guidance. For example, as the Agencies are likely aware, the IRS recently proposed a rule that would cover nonqualified deferred compensation plans, which might duplicate the deferral requirements mandated under this proposed rule.

To address these issues, NCUA should engage the IRS in order to remove duplicative regulatory burdens, and to carefully consider the possible negative effects of the rule if finalized as proposed.

Record Retention Requirement is Too Onerous

Section 751.4(f) of the proposed rule would require all covered institutions to annually create and retain for seven years records documenting the structure of incentive-based compensation arrangements, and receive appropriate oversight of the institution's incentive-based compensation arrangements from its board of directors. While NAFCU understands the provision's intent to serve as evidence and basis of possible clawbacks, we do not believe this lengthy retention requirement is needed for Level 3 credit unions. In fact, seven years appears to be one of more stringent requirements for any federal rule requiring record retention.

Unintended Consequences of Covering Other Entities

The Federal Home Loan Bank (FHLBank) System is an important partner to many of our member credit unions, and we note that the proposed rule would subject the Federal Home Loan Banks to the extensive restrictions applicable to Level 2 institutions. We urge the Agencies to avoid impeding the Federal Home Loan Banks' ability to attract and retain the

talented individuals needed to make the System function effectively for the benefit of FHLBank member institutions and the communities they serve.

We strongly believe that this rule will stifle growth, innovation, and diversification within credit unions. Should you have any questions or would like to discuss these issues further, please do not hesitate to contact me at (703) 842-2215 or dberger@nafcu.org, or Carrie Hunt, NAFCU's Executive Vice President of Government Affairs and General Counsel at (703) 842-2234 or chunt@nafcu.org.

Sincerely,

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CC:

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