The Wisconsin Credit Union League

One League, One Focus - Your Success!

Submitted via email: regcomments@ncua.gov

July 20, 2016

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

Re: Notice of Proposed Rulemaking for Incentive-Based Compensation Arrangements
RIN 3133–AE48

Dear Mr. Poliquin:

On behalf of Wisconsin's credit unions® and their 2.75 million members, The Wisconsin Credit Union League is writing to voice our concerns regarding the National Credit Union Administration's (NCUA's) notice of proposed rulemaking for incentive-based compensation arrangements.

We support this proposal's broad goals: reining in short-sighted incentive-based compensation programs that endanger institutions, insurance funds, taxpayers, and the U.S. economy. It is clear that the imprudent compensation structures of certain *very large* institutions were major factors that contributed to the subprime mortgage crisis. As the proposal explains: "Some compensation arrangements rewarded employees – including non-executive personnel like traders with large position limits, underwriters, and loan officers – for increasing an institution's revenue or short-term profit without sufficient recognition of the risks the employees' activities posed to the institutions, and therefore potentially to the broader financial system."

We support the regulators' (and Congress') intentions. However, we question whether these rules are really the best tool to achieve these goals for covered credit unions. In particular, we believe that the NCUA should not participate in this joint proposal. We respectfully encourage the NCUA to withdraw it and issue guidance, instead. Such guidance could better serve our industry by establishing best practices in a format that allows the NCUA to expand on and fully explain its expectations. These proposed rules, on the other hand, are 1) unnecessary, 2) ambiguous, and 3) intrusive.

<u>The Proposed Rules are Unnecessary</u>

In §956 of the Dodd-Frank Act, Congress requires the NCUA and the other federal regulators to "jointly prescribe *regulations <u>or</u> guidelines* that prohibit any types of incentive-based payment arrangement … that the regulators determine encourages inappropriate risks by covered financial institutions (1) by providing an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation, fees, or benefits; or (2) that could lead to material financial loss to the covered financial institution." The legislation goes on to require that the regulators' "standards for compensation" must be "comparable" to FDIC standards.

Congress did not require the NCUA to issue regulations or participate in joint rule-making. The NCUA is free to issue guidance instead, and that would be a better approach. These regulations are a solution in search of a problem, because credit unions do not award the kinds of irresponsible incentives these rules are meant to prohibit.

N25 W23131 Paul Road Pewaukee, Wisconsin 53072-5779
Phone: (262) 549-0200 or (800) 242-0833 Fax: (262) 549-7722 Web: www.theleague.coop
Member Credit Union National Association

It seems necessary to remind the NCUA and other regulators that America's credit unions – member owned, not-for-profit, financial cooperatives – did not cause the Great Recession. Consumer Financial Protection Bureau Director Richard Cordray acknowledged as much at a 2015 meeting of the Credit Union Advisory Council:

> The Consumer Bureau is well aware that credit unions were not one of the causes of the financial crisis. You were not underwriting the bad loans that brought down the housing market. Instead, you were sounding the alarm bells well before the sinking of the economy.

We could not agree more. Credit unions did not use outlandish bonuses to incentivize short-term gains. Credit union executives and so-called "risk takers" did not engage in the reckless behaviors that caused the housing crisis. Credit unions did not require government bailouts as the housing markets tumbled. Certain big banks and other bad actors, not credit unions, gambled on unmanageable risks, damaged America's economy and spurred the passage of Dodd-Frank. This joint proposal should apply only to the institutions that caused harm. Instead, it treats all financial institutions with more than $1 billion in assets as if they are uniformly in need of intrusive government micro-management.

Furthermore, Wisconsin has just 11 so-called "tier 3 credit unions" – institutions with average total consolidated assets greater than or equal to $1 billion – which this rule would cover. None have more than $10 billion in assets, the threshold at which the NCUA could choose to subject them to certain Level 1 & 2 rules. Nationwide there is only one "level 2" credit union – with $50 billion to $250 billion in assets – and no "level 1" credit unions. Thus, the brunt of these requirements would fall on institutions that bankers would barely consider "medium sized" – hardly so large that they threaten U.S. economic stability.

If the NCUA worries about isolated outliers in the credit union industry paying excessive bonuses, it already has tools to address those concerns via its "safety and soundness" examinations. It can, and should, issue guidance to let credit unions know examiners' expectations for compensation. The NCUA can rely on its existing supervisory authority to address such problems as they arise, without burdensome new rules. A rigid set of regulations is not needed.

The Proposed Rules Are Ambiguous

Other commenters have complained that the proposed rules are ambiguous. We agree. In fact, we worry that some sections are so vague they may be constitutionally invalid.

U.S. Supreme Court recently reiterated the long-standing principal that regulations must give regulated parties fair notice of what they require. In *FCC v. Fox*, 132 S. Ct. 2307, 183 L. Ed. 2d 234 (2012) the court wrote:

> The fundamental principle that laws regulating persons or entities must give fair notice of what conduct is required or proscribed, see, *e.g.*, *Connally* v. *General Constr. Co.*, 269 U. S. 385, 391, is essential to the protections provided by the Fifth Amendment's Due Process Clause, see *United States* v. *Williams*, 553 U. S. 285, 304, which requires the invalidation of impermissibly vague laws. A conviction or punishment fails to comply with due process if the statute or regulation under which it is obtained "fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement." *Ibid.* The void for vagueness doctrine addresses at least two connected but discrete due process concerns: Regulated parties should know what is required of them so they may act accordingly; and precision and guidance are necessary so that those enforcing the law do not act in an arbitrary or discriminatory way.

Some parts of these proposed regulations give little "fair notice" of what they would require. For example, §751.4 would apply to all levels of covered credit unions. It would prohibit an incentive-based compensation arrangement that "encourages *inappropriate* risks" either by paying "*excessive* compensation" *or* that "could lead to *material* financial loss." Where the proposal attempts to define those terms – inappropriate, excessive, and material – its examples and definitions only add layers of ambiguity.

- Compensation would be considered "excessive" when it is "unreasonable" – a circular, and thus meaningless, definition. (Compensation would *also* be excessive if it's "disproportionate to the value of the services performed" considering "all relevant factors," including a brief list of factors, such as compensation programs at comparable credit unions.)

- An incentive-based compensation arrangement would be presumed to encourage "inappropriate risks that could lead to a material financial loss" unless the arrangement:

  (1) Appropriately balances risk and reward;
  (2) Is compatible with effective risk management and controls; and
  (3) Is supported by effective governance.

  What constitutes "effective risk management" or "effective governance" for a level 3 credit union? The proposed rules don't say. Section 751.9 attempts to define "effective risk management," but only for level 1 and 2 credit unions. Section 751.10 attempts to define "effective governance," but again, only for level 1 and 2 credit unions. Level 3 credit unions – nearly all of the credit unions that would be subject to this rule – would be left in the dark on the parameters of these two standards. They could not predict with reasonable certainty whether a given compensation program encourages risks that examiners might deem "inappropriate." Without better definitions or detailed guidance, regulators would have unfettered discretion to make these determinations –allowing for arbitrary or discriminatory enforcement in violation of the vagueness doctrine.

- "Material" financial loss is undefined.

Even the fundamental term "incentive-based compensation" could be defined more specifically. The proposal defines it as "any variable compensation, fees, or benefits that *serve as an incentive or reward for performance*." The regulators' "Supplementary Information" explains: "The proposed definition clarifies that compensation, fees, and benefits that are paid *for reasons other than to induce performance* would not be included. For example, compensation, fees, or benefits that are awarded solely for, and the payment of *which is solely tied to, continued employment (e.g., salary or a retention award that is conditioned solely on continued employment)* would not be considered incentive-based compensation." The exceptions the regulators describe would be welcome clarifications, but the rules should spell them out more explicitly. They are of limited value buried in the Supplementary Information.

And even with the regulators' explanation, ambiguity remains. For example, some credit unions offer their executive 457(f) Supplemental Retirement Plans, deferred compensation plans designed to help retain talent. These plans allow for additional long-term compensation in exchange for an executive's commitment to remain with the credit union. Because of IRS rules – which require that there be a "substantial risk of forfeiture" – payment under a 457(f) plan is conditioned on the employee's *future performance of services* to the employer. (The plan typically provides that the executive will forfeit future unpaid benefits if she/he voluntarily leaves the credit union before distribution.) Such plans seem outside the regulators' vision for the scope of "incentive-based compensation." But what's the risk that a court might someday blur any intended distinction between compensation that rewards an executive's performance *of agreed-upon employment services* vs. the *institution's financial* performance vs. the performance *of the loans* the executive made? The definition's reliance on the single word "performance" is inadequate. If the regulators intend to carve out exceptions for compensation tied to continued employment, for retirement plans, for pensions, and so on, then they should adopt exceptions to say so specifically.

<u>The Proposed Rules Are Intrusive</u>

These proposed rules are an example of regulatory overreach. As we've said, America's credit unions are not guilty of the risky compensation practices that crippled our economy several years ago. And yet credit unions once again find themselves caught in scattershot regulatory reform. This proposal is just the latest volley in a seemingly endless barrage of onerous regulations, which have made it more and more difficult for credit unions to do their jobs – providing responsible financial services to members.

We believe that this level of government intrusion is unwarranted. Member-elected boards can adequately oversee their CEOs, and management can adequately assess the risks of credit unions' compensation plans, without the need for a regulator's scrutiny. Compensation and performance evaluations are intensely personal for any institution's employees. If a credit union's CAMEL rating is adequate, if it meets safety and soundness standards, and if it satisfies the new risk-based capital requirements, then the NCUA has no business micro-managing the compensation of its employees. This proposal gives the NCUA far too much supervisory authority over how credit unions pay staff. None of the agencies, including the NCUA, have historically regulated compensation in such a direct manner.

What is more, the harm to credit unions would outweigh any potential benefit from such government intrusion. Credit unions, like any financial institutions, compete to attract and retain talented staff. Human capital drives their growth and success. As the NCUA and other agencies acknowledge in the proposal, "incentive-based compensation arrangements are critical tools in the management of financial institutions." However, credit unions, unlike banks, cannot offer exorbitant salaries and stock options to the most qualified candidates. Credit unions need latitude to devise effective compensation plans, accounting for local employment conditions, the cost of living, and other relevant factors. If the regulators stifle the ability of credit unions to offer reasonable, common-sense compensation packages to reward staff and attract qualified new hires, they will be at a significant competitive disadvantage in the labor market.

Other foreseeable consequences would undermine the effectiveness of these rules. For example, employees are likely to want more compensation paid as fixed compensation and base salaries, not on an incentive basis. In addition, executives may well push to have their compensation packages restructured before final rules become effective.

<u>Conclusion</u>

We appreciate that Congress and the regulators are taking steps to control the imprudent incentives paid by some big banks and mortgage companies. Americans rightly consider such programs a moral hazard, encouraging excessive risks for short-term gains at the expense of long-term institutional stability. However, credit unions are not the problem. The NCUA is not required to participate (nor should it) in this ambiguous and intrusive joint proposal. For credit unions, these rules are not needed. NCUA guidance could better serve our industry by establishing best practices in a format that allows the NCUA to expand on and fully explain its expectations.

Sincerely,

Paul Guttormsson
Regulatory Counsel & Director of Compliance Services
The Wisconsin Credit Union League