PENNSYLVANIA CREDIT UNION ASSOCIATION

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

***Incentive Based Compensation Arrangements, RIN 3133-AE48***

Dear Mr. Poliquin:

The Pennsylvania Credit Union Association (PCUA) appreciates this opportunity to comment on a proposed rule, opened for comment by the NCUA and the other federal financial institution regulators, addressing incentive-based compensation. PCUA is a statewide advocacy organization representing a majority of credit unions located in the Commonwealth of Pennsylvania.

Section 956 of the Dodd-Frank Act requires federal regulators to jointly prescribe regulations or guidelines to require each covered financial institution to disclose the structures of all incentive-based compensation offered by such institution. The disclosure enables a determination whether the compensation structure provides and executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or could lead to a material financial loss to the financial institution. 12 U.S.C. § 5641. Section 956 further requires the federal regulators to adopt regulations or guidelines that prohibit arrangements that encourage inappropriate risks by providing executive officers, employees, directors or principal shareholders excessive compensation, fees or benefits or that could lead to a material loss in the financial institution.

Once again, credit unions are at the precipice of another Dodd-Frank mandate that imposes inordinate compliance burdens driven by an unduly complicated proposed rule. Whether the issue is consumer protection or safety and soundness, the reach of the Dodd-Frank Act is overbroad when applied to credit unions. Credit unions have been routinely subject to compliance schemes for activities in which they do not engage or for practices they do not commit. In the case of incentive-based compensation, there is nothing in the record of the proposed rule that even hints of credit union compensation practices being excessive, contributing to material losses or threatening the National Credit Union Share Insurance Fund.

Also, the entire structure of the proposed rule defies compliance efforts. It fails to articulate a clear standard of what constitutes excessive compensation. The proposal recites factor after factor, attributes of plans, and risk management controls. However, there is no objective way for a credit union board and management team to determine whether or when a plan achieves compliance or violates the rule. Accordingly, the rule, unless it is substantially revised, will have a chilling effect on incentive plans for credit unions.

We appreciate that the Dodd-Frank Act requires the federal regulators to adopt the regulations or guidelines jointly. However, Dodd-Frank does not limit NCUAǿs discretion to adopt regulations or guidelines that are appropriate for credit unions. Therefore, it is imperative that the final rule address risk in a realistic manner as opposed to a one-size-fits-all approach which occurs too frequently when all of the financial institution regulatory bodies adopt concurrent regulations. The structure of credit unions is substantially different from that of banks and other financial service providers. Credit unions are non-profit cooperatives owned by their members. As such, credit unions have a built-in fiduciary obligation to act in the best interests of their members. Credit unions create compensation packages suitable to attract and retain executive management and employees with the interests of the membership in mind.

Credit unions are currently subject to limitations on compensation and incentives which should be the starting point of the effort to satisfy Section 956 of the Dodd-Frank Act. There are at least three rules in place regulating the manner in which federal credit unions address compensation.[1] The NCUAǿs direct authority to regulate compensation is bolstered by its enforcement authority in the Federal Credit Union Act.

1. NCUA Regulation 701.21(c)(8) prohibits officials or employees of federal credit unions from receiving any commission, fee or other compensation in connection with any loan. 12 C.F.R. 701.21(c)(8). The rule does permit incentives or bonuses for employees, other than senior management, provided the board of directors adopts a policy and internal controls for such incentives and monitors the plan annually.

2. NCUA Regulation 701.19 regulates benefits for employees of federal credit unions. Benefits must be reasonable given the federal credit unionǿs size, financial condition and duties of the employee. 12 C.F.R 701.19.

3. Part 750 of the NCUA Rules and Regulations prohibit golden parachute payments and indemnification payments to institution affiliated parties. The scope of Part 750 reaches federally insured credit unions. See 12 C.F.R. 750.

4. Section 206 of the Federal Credit Union Act confers broad authority on the NCUA to impose orders requiring a federally insured credit union to cease and desist from violations of law or unsafe or unsound practices. 12 U.S.C. § 1786. Accordingly, the NCUA can intervene in the operation of an insured credit union and stop compensation practices that it deems to be unsafe or unsound.

NCUA has sufficient tools to address compensation issues that present a safety and soundness threat to federal credit unions and insured credit unions. Further, NCUA can apply, where appropriate, its enforcement powers precisely in situations where there is actual risk. With such mechanisms in place, NCUA can adopt a much less complicated rule or guidance on ñexcessive compensationò that is better suited for credit unions. In the end, NCUA can meet the requirements of the Dodd-Frank Act without imposing an unduly complicated rule on federally insured credit unions.

Recommendations, Simplification of the Proposed Rule

[1] By adopting regulations or guidelines, NCUA can apply the rules discussed above to federally insured credit unions.

Deferral & Forfeiture

Prospoesd section 751.7(a) imposes minimum required deferral amounts and time periods for Level 1 and Level 2 credit unions. 81 Fed.Reg. 112 (June 10, 2016) at 37822. The deferral is mandated in order for a compensation plan to qualify under the regulation. The mandatory nature of the amount of a deferral is inappropriate. It's automatic. There is no finding of wrong doing. It requires no finding that the incentive plan jeopardizes the safety and soundness of the credit union. In short, the requirement is a naked presumption on the part of the federal financial institution regulators concerning what might be excessive compensation. In addition, this construct is at odds with the factors for determining excessive compensation under proposed section 751.4(b).

At a minimum the deferral amounts and deferral periods should be reduced by 50%. Further, a deferral amount or deferral period should be triggered only by a tangible event or change in the credit union's financial condition, not mandated. That event should be a readily recognizable material change that exposes the credit union to significant risk such that deferring compensation is reasonable to protect the financial condition of the credit union. Credit unions have not been adjudicated as institutions that engage in risky compensation practices. More precisely, the events that trigger forfeiture and downward adjustment of compensation in proposed section 751.7(b), 81 Fed. Reg. 112 (June 10, 2016) at 37823, should logically be the events that trigger deferral. That is, deferral, forfeiture or downward adjustment should only come into play where the criteria listed in section 751.7(b)(2) are present. The final rule should address actual risk. The proposed rule makes assumptions about compensation that are not supportable by the administrative record, at least in the case of credit unions.

Clawback

The clawback provision of 751.7(c) raises difficult public policy questions. On one hand, it mandates that a credit union include clawback provisions in its compensation or incentive plans or agreements. To that extent, government is dictating the terms and conditions of agreements between private parties and that is inappropriate. We understand that a clawback could be an effective incentive for senior executive officers and significant risk-takers to discharge their responsibilities prudently. On balance, we think section 751.7 should be removed from the credit union rule. It sets an unwise precedent for government dictating terms and conditions in contracts. NCUA has adequate policing authority to impose cease and desist orders to repair unsafe and unsound conditions. And, a credit union could pursue a remedy for damages or in restitution against officials who fail to perform. Because other adequate remedies exist, the clawback provision should be removed.

Appeals

The very nature and structure of the proposed incentive-based compensation regulation dramatically illustrates the need for a robust and independent appeals process. The compensation or incentives earned by executive management or another employee are often determined by contract. When the contractual conditions are met, the management official or employee may have a property right in the compensation or incentive. Contractual or property rights should not be disturbed absent some appropriate adjudication or review. To the extent that any finding of fact, deferral, forfeiture, downward adjustment or clawback is the result of any action by NCUA, formal or informal, the credit union, the senior executive officer or significant risk taker should have a right to appeal NCUA's findings or determination. The adjudication or review should be conducted pursuant to the federal Rules of Evidence and must result in a final, written order supported by findings of fact and conclusions of law. In short, a full agency record should be developed in the event judicial review is required.

Additional Disclosures

Section 751.5 requires an inventory of records, maintained for seven years, of senior executive management, the compensation arrangements, any forfeiture, downward adjustment or clawback; and any material changes in the plan. This is not required by the Dodd-Frank Act and represents an overreach.

The rule should be stripped down to the language of 751.5(b) which simply requires the maintenance of records in a manner that allows for independent audit.

Prohibitions, Risk Management, Governance Requirements

Sections 751.8, 9, and 10 read in tandem reveal a policy preference against incentive-based compensation. The provisions prohibit hedging, require detailed risk management controls and require extensive reviews of the plan by directors and independent parties. In sum, the risk management and governance requirements will render incentive-based compensation arrangement unduly expensive. Further despite all of the controls and review, the NCUA will have significant discretion to question a credit unionôs program. Accordingly, the final regulation should include a safe harbor consisting of a simple provision that states that an incentive program based on the overall financial performance of the credit union is not excessive compensation.

Material Financial Loss

The rule states that an incentive-based compensation arrangement encourages inappropriate risk that could lead to a material financial loss unless it balances risk and reward, is compatible with effective risk management and controls; and is supported by effective governance. Id. at 37822. The very structure of the rule presumes that incentive-based compensation plans encourage risk. This approach to regulation is improper. The federal regulators should be able to define, more precisely when and where incentive-based compensation represents undue risk.

Excessive Compensation

We understand that the definition of excessive compensation should be a factor-oriented analysis and based on some comparison of peer institutions. The administrative record is not clear on the extent to which credit unions adopt intricate, incentive-based compensation plans for senior executive officials. In order to tailor the rule in an appropriate manner for credit unions, the term excessive compensation should include a safe harbor. For example, plans that are not tied to volume, but based on the overall performance of the credit union, should be deemed to be not excessive.

Significant Risk-Taker

The proposed definition of the term, ñsignificant risk-taker,ò in section 751.2(hh), Id. at 37821, is a dragnet, attempting to capture employees other than senior executive officials, who receive some type of incentive payment. Any credit union employee, other than a senior executive official, would be supervised or controlled by senior executives. Further, any incentive paid to such an employee is regulated by other provisions of the NCUA Rules and Regulations. Therefore, the definition of significant risk taker should be removed from the final rule that applies to credit unions.

Conclusion

Regulations on incentive-based compensation have been mandated by the Dodd-Frank Act. As such, NCUA has a duty to coordinate its efforts with other financial institution regulators and craft a rule. The Dodd-Frank Act does not limit NCUAós discretion to adopt a regulation or guideline that is more appropriate for credit unions. The Act does not address credit union structure or risk profile. However, given the difficulty of complying with the proposal, NCUA could improve the final rule by adopting specific changes discussed in this letter.

The most significant amendment would be the adoption of a safe harbor. Again, an incentive plan that addresses the factors stated in section 751.4(b), and is not based on volume, should be deemed to be not excessive. This would enable credit unions to adopt reasonable plans and manage compliance with the rule. In addition, the provisions for deferrals, downward adjustments and clawbacks should be amended consistent with these comments. A plan that satisfies our suggested safe harbor should not be required to undergo a third-party evaluation. Finally, the definition of significant risk taker should not be included in the final rule for credit unions because other regulatory mechanisms are in place protecting credit unions and the share insurance fund from undue risk.

We would be happy to address any questions about our comments at your convenience.

Sincerely,

PENNSYLVANIA CREDIT UNION ASSOCIATION

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RTW:llb

cc: P. Conway
Association Board
Regulatory Review Committee
State Credit Union Advisory Committee