April 30, 2019

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

Dear Mr. Poliquin,

Thank you for providing the opportunity to comment on the topic of incentive compensation as it relates to current regulation. I will address three items in this comment letter – my qualifications to provide comments, reference to guidance currently in place that would be useful for NCUA to consider, and characteristics of a well-designed incentive arrangement.

Qualifications

I have personally implemented and monitored incentive plans in credit unions and banks for over 20 years. My firm has been implementing plans since 1988. We have a lot of expertise in this area, having successfully guided clients through the financial crisis that started in 2007. Not only did they survive the crisis, them came out stronger, able to capitalize on the weakness of others who were crippled by it. I am a founding investor in a 2007 de nova bank. My perspective and experience with balanced incentive compensation arrangements is real, with my personal resources directly invested in the industry. Finally, I have authored three Filene research papers on credit union performance.

Existing Interagency Guidance

I would like to direct the attention of the NCUA to the Interagency Guidance (OCC, Federal Reserve, FDIC, OTS) on Sound Incentive Compensation Policies in the Federal Register. A link is provided below:

https://www.govinfo.gov/content/pkg/FR-2010-06-25/html/2010-15435.htm

The Agencies agreed that incentive compensation arrangements are beneficial, stating:

“Compensation arrangements are critical tools in the successful management of financial institutions. These arrangements serve several important and worthy objectives, including attracting skilled staff, promoting better organization-wide and employee performance, promoting employee retention, providing retirement security to employees, and allowing an organization's personnel costs to vary along with revenues.”

The Agencies also agreed that poorly designed and implemented incentive compensation arrangements, that lead to unmitigated risk-taking, adversely impact that safety and soundness of financial institutions. Rather than providing specific or formulaic guidance, the Agencies agreed that a principles-based approach was best. The principles adopted are:

1. Incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk.

2. Incentive compensation should be compatible with effective controls and risk-management.

3. Incentive compensation arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

I would encourage the NCUA to consider adopting similar guidance in order to provide regulatory parity as it relates to this topic.

Characteristics of Well-Designed Incentive Arrangements

I would like to share specific characteristics of well-designed incentive plans, that NCUA could use as reference points, when evaluating incentive compensation plans.

Directors' Rationale. A well-designed plan will include a transparent cost-benefit analysis, that shows the impact of the incentive program upon earnings, in order to allow for oversight by the board of directors. This business case should be provided to the board of directors, before the start of the plan year, for review and approval.

Balanced Measures. A well-designed plan includes simultaneous elements of growth, pricing, asset quality and productivity. It is easy to exploit one area, but a balanced approach includes consequences for doing so.

Periodic Updates. This allows the board, management team, and plan participants to monitor progress of the incentive plan, and the cost to the organization, during the year, not just when the year is over.

Back-Test. This allows the board and management team to verify the incentive plan arrangement produced the desired outcome without unintended consequences.

Triggers. Triggers serve as a pass-fail test that must be met before any incentive is awarded. Examples include, but are not limited to, a minimum threshold return on assets or net income, minimum amount of net worth, interest rate risk within policy, satisfactory CAMEL rating, etc.

Extraordinary Exclusion. Items that are deemed extraordinary or non-operational in nature may be excluded. For example, share insurance distributions, gain on sale of

certain assets, accrual accounting reversals, etc. In addition, certain risky or "fringe" activities, as defined by the board or its management team, could be excluded.

Discretionary Provision. At the determination of the board, the size of the incentive reward can be reduced or eliminated if unintended or unanticipated circumstances should arise.

In closing, I would ask NCUA to avoid narrowly defining incentive criteria. The current language "based upon overall financial performance" provides latitude for boards to govern such plans.

Narrowly defining criteria such as "based upon ROA" has shortcomings. For example, in an attempt to maximize ROA, in order to increase the size of the reward, an unintended incentive is created to under-reserve for loan losses, avoid investment in operations to maintain marketplace relevance, engage in elevated levels of interest rate risk, and over-leverage capital, just to name a few.

At the conclusion of the comment window, should the NCUA have additional questions or concerns, please consider me a resource that you can draw upon; I would be happy to share my experiences with you.

Respectfully submitted,

Mike Higgins, Jr.
Partner
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