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National Association of Federally-Insured Credit Unions

June 21, 2019

Mr. Gerard Poliquin
Office of General Counsel
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: Compensation in Connection with Loans to Members and Lines of Credit to Members (RIN: 3133-AE97)

Dear Mr. Poliquin:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the National Credit Union Administration's (NCUA) advanced notice of proposed rulemaking (ANPR) on the NCUA's regulations limiting a credit union official's and employee's compensation in connection with lending. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 117 million consumers with personal and small business financial service products. NAFCU and its members appreciate the NCUA's leadership and commitment to updating, clarifying and modernizing regulations covering compensation in connection with loans to members and lines of credit to members. Compensation regulation is essential in ensuring credit unions operate prudently and can continue to grow and offer provident credit to their members. NAFCU proposes several amendments to carry out the NCUA's intent while allowing credit unions the flexibility necessary to implement compensation plans that work best for their unique business models, including redefining "overall financial performance" to include loan growth as part of the calculation. Modernizing these regulations is critical for credit unions' governance because it will allow them to build well-balanced incentive plans that attract and retain talented employees and executives to help credit unions grow and better serve their communities.

General Comments

NAFCU continues to advocate for modernizations to the NCUA's regulations so that credit unions may create comprehensive incentive plans that include loan metrics without encouraging inappropriate risks, incentivizing bad loans, or creating conflicts of interest. Flexibility in compensation regulations is essential to credit unions' ability to attract and promote skilled employees and cultivate better organization-wide employee performance. Credit unions need competitive compensation plans so that they may continue to grow—unfortunately, the current regulations do not allow credit unions operational flexibility. The current regulations contain NAFCU-supported protections against conflicts of interest and establish a framework to prevent bad practices that could plague credit unions and pose a risk to the National Credit Union Share

Insurance Fund (NCUSIF). However, the compensation rule could be substantially improved by the recommendations below to incorporate lending as part of a broad and balanced set of organizational goals and performance measures.

Over the past 20 years, credit unions have sought clarity on the NCUA's regulations related to compensation in connection with lending. As a result, the NCUA Regulatory Reform Task Force's (Task Force) December 2018 report correctly recommended the NCUA Board modify its regulations to "provide flexibility with respect to senior executive compensation plans that incorporate lending as part of a broad and balanced set of organizational goals and performance measures." Based on the Task Force's recommendations, the Board noted the NCUA's regulations in this area are likely outdated, burdensome, and at odds with industry standards for senior executive compensation plans. However, as the ANPR notes, in addition to providing flexibility to senior executive compensation plans, the NCUA should modernize regulations governing compensation associated with lending generally.

In this comment letter, NAFCU outlines the recommended changes provided by its member credit unions regarding some of the important questions raised in the ANPR. First, the current structure of section 701.21(c)(8) should be modernized to include loan metrics in setting compensation plans to ensure consistency and clarity across the industry. In addition, the NCUA should provide flexibility in these regulations so that credit unions can develop compensation plans that are unique to their respective business models and in line with the objectives their boards of directors have identified as necessary for their credit unions to grow.

Modernizing Section 701.21(C)(8)

The NCUA should provide a clear, updated standard within its regulations regarding compensation in relation to lending incentives. Generally, section 701.21(c)(8) prohibits most credit union employees and officials from receiving compensation made "in connection with any loan" a credit union makes, with some enumerated exceptions. One important exception is that an employee, including senior management, may receive an incentive or bonus based on the credit union's "overall financial performance." However, despite the general exceptions to section 701.21(c)(8), NAFCU member credit unions have reported issues with NCUA examinations where examiners questioned compensation programs that appear to comply with the requirements of the regulation. Accordingly, NAFCU recommends the term "overall financial performance" in section 701.21(c)(8)(iii) be defined as:

> "A quantifiable metric, set by the board of directors of the credit union, used for the purposes of measuring a credit union's achievement of targeted performance goals. This metric may include, but not be limited to, total asset growth, overall loan growth, return on assets, efficiency ratio, net-worth ratio, loan-to-value ratio, and delinquency ratios."

The above definition appropriately reflects current industry practices while discouraging bad practices and perverse incentives. In addition, a quantifiable metric allows the boards of credit unions to tailor their compensation plans to meet the needs of their specific credit union.

Importantly, this standard would ensure consistency in examination because both examiners and credit unions would have a clear guideline on compensation associated with lending.

Flexibility to Develop Methodology for Compensation Plans

Section 701.21(c)(8) should be structured in a way that permits a credit union to develop a compensation plan based on its business model and the objectives its board has acknowledged as necessary for the credit union to grow. A 2018 survey on executive compensation, jointly conducted by NAFCU and BFB Gallagher, shows that the methodologies credit unions use to develop compensation plans vary, depending on whether it is for credit union officials or employees.[1] The survey found 61 percent of executive officers have a bonus plan and 26 percent have a bonus plan with a formal structure.

Importantly, credit unions rely on over 21 different components in structuring their compensation plans. These components include: membership growth, net income growth, net worth, delinquency measures, discretionary board evaluation, strategic initiatives, asset growth, membership satisfaction, expense ratios, efficiency ratios, and savings/checking growth. As reflected in the survey result and based on feedback from our members, including lending in compensation plans does not pose a threat of concentration risk or conflict of interest because loan growth is one of the many variables used in compensation incentive plans.

However, it is important to note that among the executives with structured bonus plans, the survey identified return on assets and loan growth as most commonly included in compensation incentive plans. Specifically, 47 percent of credit unions surveyed use loan growth as one of the many bonus plan components. Based on this data, it is evident that the current blanket prohibition in section 701.21(c)(8) is not feasible in practice. Instead of a black and white limitation on compensation in connection to lending, the NCUA should modernize its regulation to offer credit unions clarity on how to build sound incentive compensation policies.

The above data and other industry evidence demonstrate that loan growth is widely used as a metric in bonus plans. When this issue comes up in examinations, the NCUA considers various factors to analyze how the use of loan growth in the bonus plan affects risk levels for the credit union, including the health of the loan portfolio, loan concentration issues, and the level of liquidity in the loan portfolio. Credit unions already conduct this type of review when considering the use of lending in connection to compensation. Credit unions are aware that they need to strike a fair balance between their desire to reward senior executives and employees on proper loan growth through bonus compensation to spur continued growth of the credit union, and the NCUA's mission to ensure safe and sound practices.

Such incentive-based compensations plans are commonly used across the financial services industry to attract and retain talent. Banks use loan growth as one of the many incentive metrics to attract and retain employees and as a tool for encouraging and rewarding high performance. This does not pose a risk to the safety and soundness of the industry because both banks and credit

[1] NAFCU/BFB Gallagher 2018 Executive Compensation and Benefits Survey Report.

unions are subject to a variety of other regulatory requirements to prevent perverse incentives in lending practices and to protect consumers. For example, the *Truth in Lending Act* (Regulation Z) prohibits basing a loan originator's compensation on "any of the transaction's terms or conditions."[2] Under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, the Bureau of Consumer Financial Protection (CFPB) has enhanced this rule to prohibit steering incentives. The CFPB's Loan Originator Rule prohibits compensation that varies with the loan terms and "dual compensation" so that a loan originator cannot get paid by both the consumer and another person such as the creditor.[3] In addition, the rules set qualification and screening standards.[4]

Credit unions follow this rule and other regulations to prevent consumer harm and avoid unsound and unsafe practices. Therefore, additional requirements in this area are unnecessary and would serve to inhibit credit unions' ability to attract talent, grow their credit union, and better serve their members. With more tools available to help credit unions grow, the entire credit union system will be safer and pose less of a risk to the NCUSIF. Maintaining the current prohibition on loan growth as a metric in compensation plans or increasing requirements for the structuring of compensation plans would stifle credit union growth without enhancing safety and soundness.

Increased regulation in this area is also not appropriate given credit unions' unique cooperative structure. As member-owned, non-for-profit financial institutions, credit unions and their volunteer boards have the best interest of their members in mind and do not seek to maximize profits at the expense their members. Therefore, the regulations necessary to monitor a credit union's compensation arrangement should be focused on preventing bad practices while permitting credit unions to do what they do best – provide access to credit to those consumers who need it most. Moreover, the member-owned nature of credit unions equips their executives and boards to establish an appropriate compensation plan tailored to their individual credit unions without compromising safety and soundness.

Considering that loan growth is already widely used as a metric in bonus plans, the NCUA's regulation should be updated to reflect this current practice and the best interest of credit unions. Including loan growth as a metric in compensation plans is essential to attracting and retaining the best and brightest employees and executives. Although, at the onset, these individuals have the talent necessary to help the credit union grow, with time, the credit union, like any organization, must incentivize its top employees and executives to stay on board and continue to help the credit union achieve its mission. Explicitly including loan growth as a permitted metric in compensation plans is a simple and noncontroversial way to achieve this end. As a result, credit unions will be able to provide more services to their members and expand their reach to serve more members in their communities.

As such, the NCUA should clarify its regulations to include loan metrics in setting compensation plans. This would not only enhance credit unions' ability to design and administer bonus plans that attract and retain talented employees and executives, but also encourage more prudent lending at

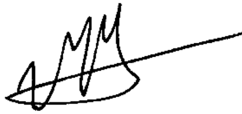
[2] 12 C.F.R. § 1026.
[3] 12 C.F.R. § 1026.36.
[4] 12 C.F.R. § 1026.36.

credit unions. Increased lending would improve the overall health of the credit union industry and preserve a strong NCUSIF.

Conclusion

NAFCU appreciates the opportunity to provide comments on this ANPR and looks forward to the NCUA clarifying this regulation. NAFCU continues to emphasize the importance of allowing credit unions flexibility to set compensation programs tailored to their unique business plans so that credit unions can grow and increase the safety and soundness of the entire industry. If you have questions, please contact me at mmakonnen@nafcu.org or (703) 842-2222.

Sincerely,



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