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June 21, 2019

VIA E-MAIL ONLY: regcomments@ncua.gov

Gerard Poliquin, Secretary of the Board
NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: SW&M—Comments on Advance Notice of Proposed Rulemaking: Compensation in Connection with Loans to Members and Lines of Credit to Members

Dear Mr. Poliquin:

This letter is written on behalf of Styskal, Wiese & Melchione, L.L.P., a law firm located in Southern California which represents hundreds of credit unions, both state and federal. The firm began representing credit unions in all aspects of their operations on an almost exclusive basis in 1987. Our experience includes advising Boards of Directors as to compensation plans, drafting executive compensation plan documents, and assisting credit unions in navigating discussions with the NCUA and state regulators regarding compensation plans. As counsel to institutions, but not to executives (we do not represent individuals), we offer a unique perspective. We offer the following discussion as a comment on the Advance Notice of Proposed Rulemaking.

Background and General Comments

The topic of compensation has been an issue in the regulatory conversation since the 2008 financial crisis. We believe this is an area where the NCUA should take into account its holistic positions regarding compensation, including the potential future viability of any incentive compensation rule as required to be implemented under Dodd-Frank. We believe this is an area where change is necessary to keep the credit union industry competitive for talent and spur beneficial innovation. The NCUA should reconsider older rules in 12 C.F.R. § 721.7 and § 701.23(g), and other interpretations and references to compensation throughout its rules, as they far predate Dodd-Frank and more modern ways of regulating compensation. By hewing closer to Dodd-Frank principles, rather than absolute limits like § 701.21(c)(8), the NCUA would be furthering Congress's policy directives While imperfect, we believe there are beneficial perspectives in the Interagency Proposed Rule regarding Incentive Compensation Arrangements (the "Incentive Compensation Proposed Rule"), including an general approach which would be preferable to the absolute rules in existing NCUA regulations.

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Specifically regarding § 701.21(c)(8), the NCUA's interpretations in NCUA OGC Legal Opinion Letters amend the wording of the rule to more closely mean that compensation in connection with a credit union's lending function is not permitted. Indeed, NCUA Office of General Counsel Legal Opinion Letters have extended this rule to additionally cover compensation in connection with loans not made by the credit union.[1] If no other changes are made to this regulation, it should be amended to clarify the NCUA's interpretation of its scope.

Two exceptions to the rule have to do with incentive pay: § 701.21(c)(8)(iii)(C) (permitting non-senior management bonuses or incentives, subject to policies and internal controls) and § 701.21(c)(8)(iii)(B) (permitting payment of incentives or bonuses based on "overall financial performance").

Incentive compensation arrangements are commonplace among financial institutions, including for senior management officials. Those incentives, to be effective, should be based on financial performance that has a real effect on the success of the institution. One of the major drivers of overall financial performance at credit unions is the lending function. Accordingly, in the development of targeted and balanced incentives for overall financial performance, many institutions include in senior management incentive programs loan growth goals (in conjunction with goals in other areas of operations and loan quality goals). Just as net income is a measure of overall financial performance that includes lending functions, a list of multiple measures in various key areas, including loan growth and loan quality, similarly represents overall financial performance.

In recent years, we have seen examiners in various areas of the country (not concentrated with any single Region or examiner) criticize credit unions for including lending as a line item in executive incentive compensation arrangements, even though the institutions are not tying any individual executive's compensation to a single loan transaction or specific group of transactions, and aggregate loan growth is only one element in the overall evaluation. The criticisms have not been based on the arrangement leading to excessive risk, but rather a reading of § 701.21(c)(8) to prohibit incentives based on the lending function (even when balanced against and with other functions and internal controls).

We believe that high level incentives of this nature should be permissible because "overall financial performance" need not be a single measure. Lists of overall financial performance drivers should not need to omit references to the lending function. Overall financial performance can be a balance of financial performance measures, including lending or incidental powers measures, provided that they are relatively in balance with the activity's impact on the institution as a whole.

[1] If the scope of § 701.21(c)(8)'s prohibition is to remain as it has been interpreted in Legal Opinion Letters and in the preambles to the NCUA's regulations, we believe its wording should be changed to reflect that the regulation actually prohibits compensation in connection with the credit union's lending function.

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Suggested Revisions

As noted above, we would recommend amendment of § 701.21(c)(8) and similar regulations to exempt all employees (including senior management), and replacing the paradigm with regulations based on the Dodd-Frank principles of Reasonableness, Comparability, and Affordability. This is particularly true for credit unions with sufficient internal controls and board review, as they would not pose an excessive risk to the credit union or NCUSIF. We believe repeal of § 701.21(c)(8) and replacing it with a risk-based paradigm would be in line with other regulatory changes recently implemented by the NCUA Board and would lead to a modernization of compensation regulations generally.

If § 701.21(c)(8) is to be retained in a substantially similar form, we believe that such interpretation should be memorialized in the rule in one of two ways:

- Amending § 701.21(c)(8)(iii)(B) to read: "payment, by a Federal credit union, of an incentive or bonus to an employee based on the credit union's overall financial performance, including metrics based on aggregate lending performance;" or

- Issuing guidance to credit unions and examiners emphasizing that § 701.21(c)(8)(iii)(B) permits incentive compensation plans that include line items based on the overall lending function, provided that lending line items are in a context reasonably able to be interpreted as their place in the overall picture of the credit union.

However, we do not believe that § 701.21(c)(8), § 721.7, or § 701.23(g) should be eliminated entirely as concepts in the non-employee arena. We agree that credit union volunteers should not be permitted to benefit from loans made by their credit union pursuant to general conflict of interest rules.[2] However, we believe that employees, including senior management employees (especially if an incentive compensation rule applies or if a credit union agrees to be governed by the reporting requirements of such a rule) should be excluded from the application of the restrictions of these subsections.[3]

Specific Questions from the ANPR

As the NCUA raises a number of specific questions in the ANPR, we wish to address each of these questions to help assist the NCUA in examining the appropriate level of and content of regulation in this area.

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[2] Indeed, these prohibitions could be wrapped into general conflicts rules rather than being individual line items in individual regulations.

[3] In our comments to the 2011 Proposed Rule Regarding Incentive Compensation Arrangements, we suggested proposed language which would effectuate such an exception.

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- *Is there a single industry standard or methodology for developing executive compensation plans? Are there multiple standards or methodologies for credit unions of different asset sizes?*

From our experience with hundreds of credit unions and numerous benefits consultants, there are many different methodologies, but there are certain prevailing methodologies. From looking at them, one could boil down the overall goals of executive compensation as being to (1) compensate for work now (base salary); (2) provide incentives to perform well; (3) provide some element of deferred pay to retain talent; (4) provide enough deferred pay or current pay to allow for sufficient retirement savings to replace income during retirement at a target level. The pay presented under each of these elements serves to attract talent. Naturally, as the asset sizes of institutions grow, the complexity of operations grows, and the competition for talent grows. With competition (demand), price increases and expectation for more nuanced incentives grows. Accordingly, credit unions with over $500 million in assets will have higher compensation and more complex compensation arrangements; credit unions with over $1 billion in assets are more likely to need to compete in a limited talent pool and so have yet higher degrees of complexity (as well as balance sheets that can support such plans).

For short and medium term incentive compensation, many institutions use a formula based approach, with a target payout being established contingent on meeting both individual and organizational goals. The target can be exceeded, up to reasonable thresholds, if individual performance exceeds target expectations (and sometimes if overall goals are also exceeded).

For retirement planning, payments are often based on a formula related to total compensation levels (or base salary levels) in the years prior to retirement, as projected to occur during the plan design. As noted above, these formulas are generally designed not to reflect variations in performance, but rather to provide for retirement income. When not formula based, a calculation is still performed to come to a reasonable absolute dollar value based on similar formulas. The vehicles to get to that number (e.g., 457(f) SERPs, Collateral Assignment Split Dollar plans, 457(b) plans, etc.) depend on various aspects of the economics of the situation, including age of the executive, size of the institution, interest rates, and the Board and executives' feelings about complexity. Three hallmarks of compensation planning—Reasonableness, Comparability, and Affordability—are a key part of board due diligence and planning in this area.

Credit unions should have the flexibility to develop their own compensation philosophies and choose appropriate compensation tools and levels within those philosophies to their risk appetites, their geographies, and their economic situations.

- *Are the terms and conditions of executive compensation plans developed by credit unions themselves or are the plans crafted by third-party vendors?*

  Both. In this area, certain types of arrangements, such as retirement plans, are frequently crafted by third parties because the third parties have the core competency of performing income replacement calculations and determining what investments and plan vehicles are specifically targeted to retirement-horizon returns. This is an activity that is highly specialized.

  By contrast, many institutions craft salary and bonus plans in-house. Many plans do follow typical structures,[4] but details vary. Other bonus plans are purely discretionary, based on supervisors' views of performance. There is significant variability in style between institutions.

- *What do these plans look like? Are there specific formulas employed to determine terms and conditions? If so, what are the formulas?*

  This question is quite broad. Types of executive compensation plans can include retirement plans and salary. Based on context, we assume that this question specifically relates to formulas to determine bonuses based on performance (whether individual or institutional).

  There are not uniform formulas, but a methodology that is often repeated takes multiple factors and weights each to determine a point system. For example, we have distilled a number of different plans to show the NCUA the following generalized example of one type of plan:

[4] See https://www.shrm.org/ResourcesAndTools/hr-topics/compensation/Pages/annual-incentive-metrics.aspx.

Category	Expectation levels/ Goals	Result	Maximum score	Weighting	Max weighted score	Total Points
1	0 to 5		5	5	25	
2	0 to 3		3	8.33	25	
3	0 to 5		5	10	50	
Total					100	

Each "Category" and "Expectation Level" is defined with metrics. Categories could be ROA, net income per employee, net worth levels, specific operational goals, such as adoption of new electronic channels, or individual productivity goals. For executives, the goals and targets are generally a mixture of overall business performance (including specific measures which are important to that institution), departmental performance, and individual performance. The specific goals should not be dictated by regulation, as they must necessarily differ based on position and institution.

Performance against the expectation levels or goals feeds into an incentive payment grid (the below grid being provided as an example only):

Points	Percentage of Target Payment to be Paid
100	125%
90 to 99	100%
75 to 89	75%
60 to 74	50%
< 60	Zero

The "Target" is often defined as a dollar amount or as a percentage of base salary, and there is often a maximum.

Numerous different ways of performing a similar type of calculation exist. Because of this variability, we do not believe that encapsulating this methodology in a regulation would be beneficial.

To generalize, though, the Society of Human Resource Management has noted,[5]

> "Typically, plans include a:

[5] https://www.shrm.org/ResourcesAndTools/hr-topics/compensation/Pages/annual-incentive-metrics.aspx

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> Threshold or minimum level of performance achievement (i.e., paying 50 percent of the reward if 80 percent of the goal is met).
> Target business goal (i.e., paying 100 percent of the reward if the target is 100 percent met).
> Maximum level of performance achievement above target, setting the upper limits of the payout (i.e., a 150 percent payout if 120 percent of the target is achieved)."

- *Is the current structure of § 701.21(c)(8), namely a broad prohibition with specific exceptions, the best format for regulating this area?*

  We do not believe this is the appropriate format, particularly for larger, more sophisticated operations.

- *Do commenters prefer a bright line test for permissible compensation to regulations that make a more holistic evaluation of individual compensation plans and the incentives they provide? Is a bright line test even possible in this highly fact determinative area? If so, where is that line?*

  We do not believe that a bright line test is possible or appropriate in this area. As we have previously commented, we believe that a paradigm more akin to the Interagency Proposed Rule regarding Incentive Compensation is more appropriate for credit union executive compensation plans, rather than bright line tests. This is particularly true for larger organizations.

- *Are current credit union compensation plans similar to, and competitive with, those provided at other financial institutions? If not, how do they differ and what, if anything, in the NCUA's regulations contributes to those differences?*

  Credit union compensation plans are steadily growing to resemble those possible at other financial institutions. However, credit unions cannot offer stock options or similar types of compensation. Credit unions also cannot offer retirement plans that would have payouts over a number of years—Internal Revenue Code § 457(f) makes it so that entire amounts are taxable as soon as they vest. This tax code creates the large payouts for executives upon retirement. The Tax Cuts and Jobs Act makes worse this division by creating an excise tax for payments over $1 million. The combination of these laws creates an inherently uncompetitive situation for credit unions. It is important that the NCUA not create further roadblocks to competitive pay.

  The NCUA does currently contribute to some of the uncompetitive nature of credit union pay, as § 701.21(c)(8) prevents credit unions from pursuing pay for loan producers or innovators on an incentive basis. Senior managers who are highly involved in creating channels for the secondary market or other highly lucrative fields expect incentive pay to be a major part of their package. This tool is not available to credit unions.

We highlight this in particular because we have witnessed executives choose bank or non-bank lender jobs over credit union jobs for lack of expected incentives. The uncompetitive nature of these prohibitions is not speculative and has a very real impact on the talent pool for credit unions.

- *What limitations, if any, are necessary to prevent individuals from being incentivized to take inappropriate risks that endanger their credit unions? What authorities do credit unions need to enable them to compete for talented executives?*

  We are keenly aware of the bad incentives that came out of executive and employee level incentive compensation before (and after) the Great Recession. Certainly plans should be drafted to avoid such issues; however, we believe there is a limit to the extent to which regulators should hard-wire specific limitations into regulations or even guidance. Rather, limitations should be a part of a holistic view of risk management. Indeed, in practice, management teams avoid/mitigate such risks through internal controls, checks and balances, and audits. Accordingly, regulations that require policies and board-level review of certain plans would not be inappropriate. Regulations that require internal controls would not be inappropriate. Requirements for qualitative factors to be included for senior management are certainly a part of those considerations.[6] However, credit unions should have the ability to design and innovate in order to compete for talented executives.

  To the extent that limitations are seen as necessary in this area by the Board, the NCUA should look to the Interagency Proposed Rule regarding Incentive Compensation for ideas of limits, rather than subject-matter based bright line rules.

- *To what extent should the NCUA permit loan metrics, such as loan volume, to be a part of compensation plans? How would those metrics be incorporated into the overall plan?*

  The NCUA should permit metrics, including loan volume, to be parts of compensation plans in line with the above comments. When incorporated into a larger risk management framework, loan volume can be an appropriate bonus trigger. That can even be the case if loan volume is the only trigger noted in the plan itself. For example, if loan volume is a trigger, but the executive subject to the plan is not a part of the credit union's ALCO or subject to significant checks on quality, then the bonus trigger may not actually

[6] Plan designers do often leave in overall subjective review of payments based on safety and soundness criteria to avoid payments that would be detrimental to the organization's health.

expose the institution to the risk that might be present without those controls. We have in the past observed examiners ignore the gestalt situation and focus only on the words in a plan documents; we believe that hard-wired limitations can create tunnel vision on the contents of the four corners of documents, rather than more broadly at situations surrounding the plans.

- *Should the NCUA provide additional requirements for compensation related to a line of business that is new for the credit union or one in which the credit union lacks substantial experience or expertise?*

  We do not believe that new line of business limitations are appropriate. New lines of business are the types of areas where institutions may most need to improve upon their executive team, and may not yet have developed the profits to support the pay wanted by the talent they need. A promise of pay based on success can create the possibility of future compensation without locking the institution into pay without results. Without the possibility of incentive pay for new lines of business, credit unions may be stifled in their ability to innovate. Stifling innovation carries its own risks, including the potential that the credit union industry will cease to be relevant.

  While the NCUA could institute procedural requirements for "new" business lines (such as review by the institution's board of directors), such requirements would require definitions of "new" that would likely be as awkward to apply in real-world scenarios as subject-matter related bans (like § 701.21(c)(8)). The NCUA could as easily place procedural requirements on senior executive plans as a whole without creating these types of limits.

In all, we believe that by hewing closer to Dodd-Frank principles, rather than absolute limits like § 701.21(c)(8), the NCUA would be furthering Congress's policy directives. We hope that these comments are helpful as the Board considers what it believes is appropriate in the field of executive compensation. We would be pleased to provide further feedback to the NCUA upon request.

Sincerely,

STYSKAL, WIESE & MELCHIONE, LLP

Timothy I. Oppelt

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