NASCUS

The National Voice of the State Credit Union System

June 24, 2019

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

Re: NASCUS - Comments on Advance Notice of Proposed Rulemaking: Compensation in Connection with Loans to Members and Lines of Credit to Members

Dear Mr. Poliquin:

The National Association of State Credit Union Supervisors (NASCUS)[1] submits the following comments in response to the National Credit Union Administration's (NCUA's) public notice and request for comments on modernizing § 701.21(c)(8) concerning compensation in connection with loans to members. Incentive-based compensation tied to loan production is a complicated matter requiring nuance to balance a financial institution's need to offer competitive compensation packages for key staff on par and in line with prevailing industry standards and practices against the risk of incentivizing bad loans or encouraging inappropriate risk taking.

NASCUS commends NCUA for issuing this Advance Notice of Proposed Rulemaking (ANPR) soliciting stakeholder input for modernizing the National Credit Union Share Insurance Fund's (NCUSIF) approach to mitigating risk posed by inappropriate loan-based incentive compensation programs.[2] We recommend NCUA consider an approach combining a general regulatory framework supported by guidance, relying on the supervisory process to identify and curb bad actors. We also recommend NCUA clearly identify, in separate provisions, the various credit union staff to which the rules apply. We also urge NCUA to consolidate the provisions applicable to state-chartered credit unions in §741 (NCUA's share insurance rules for state credit unions).

That poorly designed and implemented loan-based incentive compensation programs can have disastrous effects on a financial institution is well documented.[3] However, trying to use an all-encompassing prescriptive regulation to address the risks posed by poorly designed, implemented, or overseen programs can be a complicated undertaking. Imprecise or overbroad wording in a regulation can confuse stakeholders as to when compensation may be paid to staff or officials.[4] Further complicating matters, state credit union practices in

[1] NASCUS is the professional association of the nation's 45 state credit union regulatory agencies that charter and supervise over 2,100 credit unions.
[2] 84 FR 16796, (April 23, 2019).
[3] See United States Senate report, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (April 13, 2011). Available at https://www.hsgac.senate.gov/subcommittees/investigations/media/senate-investigations-subcommittee-releases-levin-coburn-report-on-the-financial-crisis.
[4] See NCUA Legal Opinion 961010 (December 2, 1996) in response to a credit union questioning whether it may pay the legal invoice submitted by a board member who represented the credit union in litigation related to a loan. Available at https://www.ncua.gov/files/legal-opinions/OL1996-1010.pdf.

developing and structuring incentive-based compensation varies widely. Many credit unions, particularly larger credit unions, might use third party vendors and compensation data from like-sized organizations outside of the credit union space to ensure competitive salary. Other credit unions develop their compensation plans internally or based on credit union specific salary studies. Differences in credit union staffing levels and organizational charts further complicates matters as some credit unions have multiple layers of staffing and oversight between the loan officer and the executive suite while others have much more limited staffing and overlapping responsibilities.

For these reasons, we do not believe a prescriptive one-size fits all approach is effective for supervising loan-based incentive compensation programs. Given the differences in credit union practices regarding loan-based incentive compensation, and the inherent nuances that distinguish a well-managed incentive compensation program from one that incentivizes inappropriate risk-taking, this is a subject better suited to guidance and supervisory review than to prescriptive rules.

NCUA Should Adopt General Rules Supported by Guidance

In its notice for comment, NCUA questions whether loan-based incentive compensation should be governed by a bright line rule.[5] While some aspects of regulating this type of compensation might lend itself to bright line rules, such as prohibiting classes of employees from receiving such compensation, such as underwriters, in many other regards a bright line rule is impractical.

Prohibiting incentive compensation based on loan volume is illustrative of the nuances involved in supervising such arrangements. Ultimately, its is not "loan volume" alone that leads to imprudent risk taking, but rather "loan volume" absent any other controls, parameters, or other mitigating qualifications. In other words, a loan-based incentive compensation program tied to loan volume, where the loans to be generated were required to have pre-determined high credit scores and predetermined low loan-to-value ratios would not on its face be problematic.

Rather than a bright line rule, NCUA should focus on ensuring credit unions mitigate the riskier elements of the incentive compensation program, implement oversight of the program by the credit union's board of directors, and using the supervisory assessment of the culture of safety and soundness within the institution. We recommend NCUA consider the guidance approach utilized by the Federal Deposit Insurance Corporation (FDIC) for banks.[6] Using guidance and the supervisory process to curb unsafe and unsound incentive compensation practices allows for a more nuanced and adaptable response by regulators.

Guidance related to effectively administered loan-based incentive compensation programs should be associated with a general rule prohibiting unsafe and unsound practices with

[5] 84 FR 16797, (April 23, 2019).
[6] FDIC Statement of Policy, Guidance on Sound Incentive Compensation Policies. Available at https://www.fdic.gov/regulations/laws/rules/5000-5350.html.

respect to incentive-based compensation. For example, the general rule could prohibit incentive-based compensation or fees paid to employees directly related to underwriting loans. Greater clarity could also be provided by specifying, and segregating, regulatory limitations that might apply to executive level staff as opposed to those that might apply to general management staff. Regulatory limitations could also be distinguished based on the lending portfolio, recognizing that residential real estate, auto, and commercial lending present different underwriting vulnerabilities that might be exacerbated by an affiliated incentive-based compensation program.

We anticipate that NASCUS's preference for guidance will be met with trepidation by some within the credit union movement. We understand the unease with which some view broad discretionary authority for the regulator: state or federal. However, in this instance we firmly believe a case-by-case analysis within a framework of guidance, is the best approach for risk mitigation. A bright line prescriptive regulatory approach will, almost by necessity, hinder many credit unions in their ability to develop competitive incentive-based compensation programs. To allay concerns with regulatory discretion, we recommend that NCUA:

- publish the guidance and solicit comments before finalizing it
- explicitly clarify that supervisory findings related to incentive-based compensation are appealable under Part 746
- require NCUA to obtain concurrence of the state regulator before taking a supervisory action related to incentive-based compensation with a state credit union

Applicability to Federally Insured State Credit Unions (FISCUs)

NCUA applies its federal credit union prohibition on prohibited fees and incentive compensation income to FISCUs by reference in §741.203(a), which reads in relevant part:

> "[a]ny credit union which is insured pursuant to title II of the Act must… [a]dhere to the requirements stated in part 723 of this chapter concerning commercial lending and member business loans, §701.21(c)(8) of this chapter concerning prohibited fees, and §701.21(d)(5) of this chapter concerning non-preferential loans…"
>
> \- 12 C.F.R. 741.203(a)

Should NCUA continue to apply provisions of §701.21 to FISCUs, those provisions should be incorporated in full in §741. The current practice of incorporation by reference creates confusion among stakeholders. Incorporation by reference also creates an additional, and wholly unnecessary regulatory burden for FISCUs and examiners seeking to understand NCUSIF related compliance obligations.

The Ability of States to Obtain Exemption from the Rule

Part 741.203(a) provides an exemption from §701.21(c)(8) prohibitions for FISCUs "in a given state…if the state supervisory authority…adopts substantially equivalent regulations as determined by the NCUA Board…" NCUA should retain a state exemption provision related to the application of §701.21(c)(8) to FISCUs.

NCUA should exempt from this rule all FISCUs in a state that has state-specific limitations, regulations, or supervisory policies that address incentive-based compensation. Many states have comparable rules intended to curb abuses in incentive-based compensation programs. NCUA's rule should defer to state rules with NCUA's prohibitions acting as a default in the event a state has not addressed incentive-based compensation.

At a minimum, NCUA should modernize the "substantially equivalent" standard for exempting FISCUs to a "comparability" standard or a "sufficient risk mitigation" standard. That NCUA now acknowledges the current rule is confusing and outdated highlights the inherent problem with a "substantially equivalent" standard: it stymies supervisory innovation and regulatory progress. Broadening the standard for states to seek an exemption will allow for a diversity of approaches to curb materially risky practices.

NASCUS supports NCUA's review of its existing rules regarding loan related incentive-based compensation. Currently §701.21(c)(8) is confusing and in need of substantial refinement to more precisely curb bad behavior while allowing credit unions to appropriately incentivize employees. We urge NCUA to proceed to proposed rulemaking utilizing recommendations submit herein, and to publish proposed guidance in conjunction with the rulemaking. We would be pleased to discuss these recommendations in detail at your convenience.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
General Counsel