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CU COUNSEL, Pllc

202 508 3795 1629 K Street, NW Washington, DC 20006 cucounsel.net

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Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Advance Notice of Proposed Rulemaking, 84 FR 16796, on Compensation in Connection with Loans and Lines of Credit (12 CFR 701.21(c)(8))

Dear Mr. Poliquin:

CU Counsel, Pllc, appreciates the opportunity to file comments on behalf of client credit unions regarding the National Credit Union Administration Board's Advance Notice of Proposed Rulemaking on how to address weaknesses in the agency's current rule on compensation in connection with lending.

The ANPR acknowledges that the rule, last revisited in 1995, is "likely outdated, burdensome, and at odds with industry standards." In response to credit union concerns and a recommendation in the agency's December 2018 Regulatory Reform Task Force Report that the rule be modified to provide flexibility to compensation plans "that incorporate lending" in their performance metrics, the agency has initiated a process that many are hopeful will result in a better regulatory and supervisory approach to compensation for officials and personnel involved with credit union lending.

Responses to NCUA Questions

Our comments correspond to the questions the agency included in the ANPR.

- 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?

  Many of the same metrics, such as return on assets, are used by credit unions of different asset sizes, but there is not a single standard employed within the credit union system. Based on the results of several recent surveys regarding credit union executive bonus and compensation practices, a number of credit unions report they use loan metrics such as loan growth, loan/share ratios, loan market share, and loan delinquencies as components with other factors to determine the amount of compensation and incentives they provide to senior management.

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

Credit unions use third party vendors in some cases, but they may modify the vendor's plan to suit their operations. Credit unions also develop and implement their own plans.

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

  Formulas are used, but they vary throughout the credit union system. Measurements include but may not be limited to return on assets, net worth, membership growth, member satisfaction, asset growth, comparison to peers, share growth, products and services per member, and even supervisory ratings, in addition to loan-related metrics mentioned in response to the first question.

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

The agency should not retain the present structure of the rule. The regulation is confusing and can be presented in a more useful way. Rather than using an outright prohibition followed by exceptions, the agency should address what is permitted and what is not allowed in concise terms.

The language of the rule is also an issue, not just its structure. The ANPR notes that the phrase "overall financial performance" for which a bonus, for example, may be permissible for an executive is murky, and we agree it should be clarified. The Supplementary Information to the proposed rule changes in April 1995 (60 FR 19690) stated that "overall financial performance" of a credit union would "of course depends (sic) in part on its lending activities."

Using lending activity as a factor in assessing the financial condition of an individual credit union and the credit union system is exactly what the agency does in its financial performance reports and reports on the financial condition of the credit union system. Yet the inclusion of lending activity in "overall financial performance" was not formalized with the final rule and in implementing the regulation, some examiners have taken the exact opposite position, that a credit union's financial performance may not include lending-related metrics such as loan growth for compensation purposes.

Another example of unclear language is found in (c)(8)(i) which prohibits direct or indirect compensation in connection with any loan. The general objective of this provision is to prevent a loan officer from being paid to make loans he or she would not make without the payment. However, the broad language sweeps in loan activities that might otherwise reasonably occasion a bonus, such as a senior executive undertaking considerable effort to work with delinquent borrowers to achieve performing loans.

Two agency legal opinions letters, one dated January 11, 1994 and the other dated December 18, 1997 on incentives for loan officers are noteworthy. The earlier letter states that the use of ratios of loans to assets and delinquencies is not permissible in determining incentives, which we believe should be revised. However, we agree with the letter's conclusion that a credit union's board has flexibility to base bonuses on net returns on average assets. The later letter reinforces that compensation from third parties to loan officers is impermissible. While the analysis of the letter is correct, the agency may want to seek comments on this issue to obtain feedback on whether any exceptions could be reasonable, legal and appropriate.

We also think that the agency should consider the extent to which guidelines may be utilized, rather than regulatory directives that limit credit unions' ability to tailor their compensation plans. Such an approach could augment the rule, if not supplant it, and would provide the agency more flexibility to raise issues of concern while affording latitude to credit unions to design loan-associated compensation plans that meet their board's objectives. The federal bank regulators' "Guidance on Sound Incentive Compensation Policies" (75 FR 36395) focuses on the material risks presented by personnel and is principles-based, centering on three standards that should be reflected in incentive programs, which are:

- Incentives should appropriately balance risk and reward;
- They should be compatible with effective controls and risk-management; and
- They should by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles provide a foundation that allows institutions to have considerable flexibility to manage their incentive programs while satisfying safety and soundness objectives. The guidance also differentiates supervisory priorities for the largest banks compared to smaller ones, which are not expected to have the same level of detail in their policies or be subject to the same level of examiner scrutiny as the big banks. Credit unions, with their lower level of risk and less complex activities, should be afforded similar treatment as the smaller banks in terms of examiner expectations. Guidance for credit unions should be developed that reflects their particular issues and concerns but the bank regulators' guidelines could be an important reference in that process.

- Do commenters prefer a bright line test for permissible compensation to 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?

Without seeing the language of the test the agency envisions, it is hard to respond. However, whether the agency proceeds with proposed rule changes, guidelines, or both, what is authorized should be clear, and the permissibility of the use of loan metrics in assessing overall financial performance spelled out. How credit unions comply operationally, such as which metrics they select to assess performance, should be left to the credit unions' boards. NCUA's current approach focuses on what credit unions cannot do, while the bank regulators through guidelines have chosen a more flexible approach that nonetheless addresses risk management in providing incentive programs. NCUA should consider a less intrusive model that reinforces safety and soundness without undue intrusion into the structure of credit unions' incentive programs.

- 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?

In reading the Supplementary Information accompanying the ANPR as well as the 1995 proposed and final rule changes, the necessity for a regulation on incentive compensation to address problems throughout the credit union system has not been demonstrated. Well-managed credit unions are aware of the risks involved with providing incentive compensation but should be allowed to manage and mitigate the risks as they do other with other potential concerns associated with running a credit union. The boards of credit unions under the Federal Credit Union Act are ultimately responsible for lending at their institutions and that should include designing loan-related compensation that meets their risk management capabilities.

- 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?

As credit union system surveys show, credit unions are already using loan metrics, and the ANPR acknowledges its rule may be out of step with current credit union practices. The agency should recognize the reasonableness of using loan metrics but leave it to credit unions to determine which loan-related measures are appropriate and how they should manage risks associated with providing incentives to personnel involved with lending.

- Should the NCUA provide additional requirements for compensation related to a line of business that is new for the credit union?

It is not clear why additional requirements would be needed. Compensation related to a new line of business is one of the risks a credit union should identify and manage but additional regulatory directives are not necessary to accomplish this since a credit union's risk mitigation efforts should take this into account.

Conclusion

The ANPR has provided a reasonable framework for the agency to begin the process of reviewing how it addresses incentive compensation in connection with lending. We appreciate the agency's efforts to consider the deficiencies in the current regulation and how its approach may be improved. Guidance as opposed to intrusive regulatory directives could be an effective way to help achieve safety and soundness objectives, but regardless of the approach the NCUA pursues, it should result in balancing risk mitigation with sufficient flexibility for credit unions to tailor their compensation incentives in line with their board's objectives.

Thank you for the opportunity to comment on this important issue. Please feel free to contact me if you have any questions about the views expressed in this letter.

Sincerely,

Mary Mitchell Dunn
Partner
CU Counsel, Pllc