League of Southeastern
Credit Unions & Affiliates

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Re: Compensation in Connection With Loans to Members and Lines of Credit to Members - 12 CFR 701 [RIN 3133-AE97]

06/24/2019

To Mr. Poliquin,

The League of Southeastern Credit Unions & Affiliates (LSCU) appreciates the opportunity to comment on potential changes to the Compensation in Connection With Loans to Members rule. We support the effort to clarify or update this rule for the betterment of credit union operations. The LSCU is a trade association that represents 244 credit unions in Alabama and Florida. Our mission is "to create an environment that enables credit unions to grow and succeed." We think the goal of improving this regulation should be to balance a minimalization of risk to the industry of defaulted loans with enough incentive to promote loan growth and effective monitoring for our credit unions by establishing clear guidelines to compensation in connection with loans. We stress the importance of providing incentives for our employees while staying competitive, not only with banks, but also with other unregulated lending entities.

We have the following input:

1. *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?*

We are unfamiliar with a single industry standard for policies on executive compensation, but it should be apparent that with the diversity of credit unions operating in the variety of marketplaces throughout the country, there should be flexibility in the ability of a board to develop a policy because not all credit unions are the same, therefore their risks and incentives will be unique to their circumstances.

2. *Are the terms and conditions of executive compensation plans developed by credit unions themselves or are the plans crafted by third-party vendors? What do these plans look like? Are there specific formulas employed to determine terms and conditions? If so, what are the formulas?*

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

   We think it would better to change this regulation by giving specific guidance on acceptable policies or programs, meaning setting strict parameters connected with loans rather than the present form of a broad prohibition with the specific exceptions. We also think that the NCUA should affirm any associated past guidance, letters to credit unions or legal opinion letters, perhaps as reference in a commentary or appendix that would lay out specific examples of acceptable vs. unacceptable incentive plans.

4. *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?*

   Yes, we support a bright-line rule, though one that has some flexibility to accommodate credit unions of different asset sizes or unique portfolio compositions. It is important to give boards the flexibility to innovate and stay competitive with other financial institutions whether by asset size or geographical market. Essentially, NCUA could create some basic parameters in the rule that

the credit union board will use to develop appropriate policies (to manage risk) while being unique (to promote incentives and monitoring) to that credit union's circumstances.[1]

One study we reviewed analyzed compensation structure and loan officer behavior regarding their three duties of monitoring loans, originating loans, and screening loan applications at a large international bank as it changed its compensation policy, from a variable compensation model to one of fixed salary.[2] The conclusions of this analysis offer insight into the issues NCUA should consider when reviewing this rule. Here are some of the findings from this study:

- Loan officers dedicate more time to monitoring their loan portfolio, reducing originations, and approving a larger proportion of those loans when their bonus is threatened because their portfolio has underperformed.[3] This leads to greater repayment and higher quality of those loans.[4]
- Compensation in connection with loans improves loan quality.[5]
- Compensation in connection with loans may lead loan officers to focus more attention to some activities over others, which may result in undesirable outcomes for the bank, like focusing on the probability rather than the magnitude of the loan loss, for instance.[6]
- Loan officers over scrutinize customers in their lending, meaning that only the highest quality borrowers will get loans, rather than other applicants that pose an acceptable risk to the bank.[7]
- Compensation in connection with loans motivate loan officers to adjust their attention to their three primary duties discussed above, but that adjustment is done after, rather than before they reach whatever default threshold is set to suspend their bonus.[8]

[1] Justin Mims, *The Wells Fargo Scandal and Efforts to Reform Incentive-Based Compensation in Financial Institutions*, 21 N.C. Banking Inst. 429, 461 (2017).
[2] Patrick Behr et al., *Financial Incentives and Loan Officer Behavior: Multitasking and Allocation of Effort under an Incomplete Contract*, Journal of Financial and Quantitative Analysis, Oct. 2014, at 1.
[3] *Id*. at 28.
[4] *Id.*
[5] *Id.*
[6] *Id.*at 28-29.
[7] *Id*. at 29.
[8] *Id.*

5. *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?*

   Many credit union officials have worked previously in the bank sector, and we have solicited input from them. There were common factors in our discussions with credit unions to include in compensation plans, which are: production goals, growth goals, and some consideration for delinquency and charge offs that would negatively modify the positive growth benchmarks. A credit union's compensation policy should be "to maximize … (net worth for the members) … while promoting a proper balance between risk taking and risk management.[9]"

6. *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?*

   It is important to continue the emphasis on conflicts of interest that appear in various letters to credit unions. It seems clear that when there is a conflict of interest, there is a distortion in the risk tolerance of otherwise well-reasoned lending. This ties in with the growing importance of board oversight and governance issues as the industry evolves along with the technological and economic changes in recent years. There should be a limit as to how much of a loan officer's salary will be dependent on their loan portfolio performance. We don't have a specific percentage to recommend; it should simply be large enough to motivate loan growth and loan without exposing the credit union to too much risk, while providing credit to our members, particularly those who need credit most, but tend to pose a higher risk of default.

7. *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?*

[9] Mims, *supra*, at 433.

Many credit unions we spoke with did not offer incentives for individual loan production, rather they included incentives for aggregate credit union growth and production. This seems to be the best practice when there is some evidence that compensation associated with loan volume increases that volume but decreases the quality of the loans.[10] We would encourage NCUA to revisit the prohibition[11] of Federal credit unions for compensation by third parties offering products associated with loans, such as GAP insurance. These products help minimize risk of a loan default to the credit union (and therefore the Share Insurance Fund) and to the consumer who chooses to purchase these types of products. Furthermore, this compensation is provided by the insurance provider, not the credit union, so the credit union can minimize risk while producing a small revenue steam that benefits all parties.

8. *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 think that credit union boards should intensely scrutinize compensation policies for new lines of business. This seems to be reasonable guidance when a credit union starts offering products or services that are new.

We appreciate the opportunity to comment on proposed rulemaking and hope our thoughts are useful in NCUA's considerations for this rule. We look forward to NCUA's other efforts to modernize the regulatory environment that credit unions operate in.

Sincerely,

Mike Lee

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[10] Sumit Agarwal and Itzhak Ben-Davis, *The Effects of Loan Officers' Compensations on Loan Approval and Performance: Direct Evidence from a Corporate Experiment*, at 21-22 (2011).

[11] Letter from Shelia Albin, Associate General Counsel, NCUA, to Mary Issacs, Trane Federal Credit Union, Re: Third Party Incentives for Selling Mechanical Breakdown Insurance, (Nov. 4, 1998).