

Open Board Meeting

April 21, 2016

**NCUA Board Member J. Mark McWatters
Statement on Section 956 of the Dodd-Frank Act
Interagency Proposed Rule
Incentive-Based Compensation Arrangements**

I would like to offer a few observations regarding the proposal before us today on incentive-based compensation arrangements. I appreciate that Section 956 of the Dodd-Frank Act requires the National Credit Union Administration (NCUA), federal banking regulators, and others to issue a rule or guidelines to address certain executive compensation arrangements that provide financial institution officials with incentives to take undue risk. Almost six years after the passage of the Act, we are now considering a second proposal to implement Section 956.

The NCUA Should Improve the Processing of Proposals

Yet, despite the slow progress in developing this proposal, my office received the new version on April 6, while we were away speaking at a credit union conference. In addition, we received no interim reports or analysis on how the proposal was changing. Going forward, I urge the agency to afford Board members with more time and additional briefings, particularly on lengthy proposals such as this one.

More Time Is Needed to Analyze the Proposal Before the Board Votes To Issue It For Comment

Because the executive compensation proposal is complex and lengthy, more time is warranted for its consideration. I do not think we should rush to vote on this rule today but rather afford the proposal thoughtful review and bring it back to the Board next month or the month after. I am not suggesting that we delay the proposal for an inordinate amount of time, just long enough for us to analyze it as carefully as we should.

I realize the proposed rule only applies to credit unions with assets of \$1 billion or more—258 credit unions under Paperwork Reduction Act analysis¹—if their incentive-based compensation arrangements meet the criteria laid out in the proposal. Yet, even if very few credit unions are subject to the proposal, I do not think we should respond hastily in our assessment, nor do I accept that a pressing safety and soundness need exists to issue a proposal for credit unions at our meeting today.

¹ These credit unions comprise slightly less than 60-percent of the assets of the entire credit union community (excluding Corporate credit unions).

That said, based upon my tenure as a member of the TARP Congressional Oversight Panel, I appreciate that executive compensation arrangements at some banking institutions were a factor in contributing to the recent financial crisis. I also appreciate that even though credit unions are neither the focus nor the culprit, the Dodd-Frank Act requires the NCUA to address covered, incentive-based compensation arrangements in a joint rulemaking with the other regulators. Specifically, the Act directs the regulators to prescribe the rule within nine months of its enactment, so I recognize we are behind in this effort. In light of these factors, if the Board determines to move forward with the proposal, I will concur, albeit reluctantly.

Issues with Proposed Incentive-Based Compensation Provisions that the NCUA will Implement

However, I would like to identify some concerns that we have noted in the abbreviated period of time we have had to review the proposal.² I urge commenters to address these matters in their letters to the NCUA. Undoubtedly, there are other issues the agency should address, but these are the matters we identified during our initial review.

- Section 956 of the Act provides that regulators may address incentive-based compensation arrangements through “regulations or guidelines.” Would the use of guidelines, instead of rules, offer a feasible approach to the implementation of Section 956? Could the NCUA issue guidelines if any of the other agencies adopt a rulemaking?
- I am not aware that credit unions extensively engage in the types of compensation practices that Section 956 seeks to address. Moreover, if examiners implement this rule too broadly, I would have real concerns. How may the agency modify the proposal so as to minimize opportunities for examiners to micromanage the compensation practices of credit unions? As applied to the credit union community, would the proposed rule survive an objective, transparent cost-benefit analysis?
- What do commenters think of the design of the proposed rule? Are there changes that the agency should make to reduce its complexity so as to facilitate compliance for boards and management in a more efficient and cost effective manner?
- Does the proposal sufficiently articulate what constitutes permissible incentive-based compensation arrangements? Is it clear that the proposed rule does not apply to an individual’s salary and bonus, even if the person is a senior executive official or other covered individual, unless the compensation is

² It is possible that some of these issues are addressed in the proposed rule. Unfortunately, we were not afforded sufficient time to conduct a thoughtful review of the over 500-page proposal.

provided as an incentive for the credit union to take inappropriate risk? In my view, the proposed rule should not apply to salaries and bonuses offered in the ordinary course of business unless the compensation arrangement unambiguously encourages inappropriate risk taking by the granting credit union.

- Another perspective on this issue—under the proposal, no credit union may establish or maintain any type of incentive-based compensation arrangement, or any feature of any such arrangement, that encourages inappropriate risks by the credit union (i) by providing a covered person with “excessive compensation,” fees, or benefits, or (ii) that could lead to “material financial loss” to the credit union. Does the proposal sufficiently clarify what these provisions mean and what is specifically expected of credit unions? Do the definitions of “excessive compensation” and “material financial loss” vest excessive discretion with examiners and regulators? How should the NCUA undertake to implement such broad based and arguably ambiguous authority in a fair, accountable, and transparent manner? Will the agency issue additional guidance to examiners and the credit union community regarding the day-to-day implementation of the proposed rule?
- The proposal would grandfather existing plans. Should it also clarify that credit unions may add new employees or officials to existing plans without triggering compliance requirements?
- The proposal addresses performance measures by credit union employees. Should the proposal reserve these issues to the discretion of credit union boards and management?
- The proposed rule would require covered credit union boards to approve incentive-based compensation arrangements, subjecting them, even though they are generally volunteers, to even more professional responsibility and examiner scrutiny. Is this necessary for credit unions? Do viable alternatives exist? By what standards will the NCUA assess such board action or inaction? Will the agency offer safe-harbor guidance?
- The proposal has three categories of compliance, with Level 1 and 2 credit unions subject to enhanced requirements. Under the proposal, the NCUA may subject certain Level 3 credit unions to the more stringent requirements of Level 1 or 2, even if a Level 3 credit union does not otherwise meet the criteria. Is this necessary and appropriate? Should credit unions possess the right to appeal such determination if the NCUA concludes a compensation arrangement is covered under the rule and the credit union disagrees? If not, what due process rights apply to aggrieved credit unions? Further, what due process rights are

credit unions afforded under the proposed rule regarding other potential areas of dispute with the agency?

- The proposal requires Level 1, 2, and 3 credit unions to create records annually and maintain them for seven years, subject to review by the NCUA. Level 1 and 2 credit unions would have additional requirements. Is it possible to simplify this document maintenance and retention requirement for certain credit unions?
- It is my understanding that the proposal would require a Level 1 or 2 institution to reclaim, defer, reduce, or withhold an employee's covered compensation for the poor financial performance of the credit union that is due to deviation from the credit union's risk parameters, or if the credit union must correct a financial statement for a material error, among other items. Should the rule, instead, directly link the operation of the clawback to the actions of the specific credit union employee or official? Is it appropriate for a non-culpable recipient to forfeit an incentive-based compensation award due to the actions of other persons?
- Level 1 and 2 institutions would have specific caps on the amount of incentive based compensation they may provide individuals. Are such caps appropriate and, if so, should each covered credit union set the cap?
- The proposal contains a number of provisions that address governance, policy requirements, and risk controls as they relate to incentive-based compensation arrangements at Level 1 and 2 credit unions. By what standards will the NCUA implement these requirements?
- Should the proposal prohibit volume based covered compensation?
- Should the tax equalization provision between credit unions and banks also consider bracket creep resulting from the acceleration of credit union incentive-based compensation awards into taxable income in the year the award is granted by the credit union to the covered person?
- How does the clawback provision operate if a recipient has previously paid tax on the incentive-based compensation award?
- Does the NCUA have the discretion to change the \$1 billion total consolidated asset threshold for Level 3 credit unions?
- What authority does the NCUA possess to waive or grant narrow or broad based exceptions to the proposed rule?

- The proposal includes unique provisions for the FHFA and the NCUA regarding institutions in conservatorship and liquidation. To what extent could the NCUA or any of the other covered regulators include or exclude other provisions to tailor the proposal better for their institutions?

Conclusion

I am confident that I have not identified all of the issues presented by the proposed rule to the credit union community and the safety and soundness of the Share Insurance Fund, which reflect my most significant concerns in proceeding with the rule today. I respectfully request that we defer consideration until all Board offices have had a sufficient opportunity to analyze the proposed rule. If the Board determines to proceed this morning, I will not dissent, given we are required by law to act at some point, we are far behind schedule in developing a rule, it is a joint rulemaking, and—most importantly—the rule constitutes a mere proposal. My consent to the proposed rule, however, does not in any manner reflect my view of a final rule unless the agency satisfactorily addresses the above noted observations as well as the comments of the credit union community.

I urge credit unions to study the proposed rule in detail, let us know of your concerns, and discuss in your comment letters the range of issues that the proposed rule presents. In reviewing the proposal it is critical to recall that credit unions were neither a perpetrator nor an aider and abettor of the recent financial crisis and, as I have stated on many occasions, it seems entirely inappropriate to hold the community to the same regulatory standards that may more appropriately fit the large money center or too-big-to-fail institutions.

Thank you.