NASCUS

National Association of State Credit Union Supervisors

May 31, 2011

Mary Rupp
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: NASCUS Comments on Proposed Rulemaking – Parts 741 and 751, Incentive-Based Compensation Arrangements

Dear Ms. Rupp:

The National Association of State Credit Union Supervisors (NASCUS)[1] appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) concerning the proposed rulemaking Parts 741 and 751, Incentive-Based Compensation Arrangements. The proposed rule implements §956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requiring the federal banking agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation arrangements at certain financial institutions. Pub. L. 111-203, §956, 124 Stat. 1376, 2011-2018 (2010). Under Dodd-Frank, the agencies are to promulgate regulations that prohibit incentive-based compensation that encourage inappropriate risk taking as well as regulations that require covered institutions to report certain incentive-based compensation arrangements to their federal regulator.

NCUA's proposed rule is similar to the rules proposed by the other banking regulators with several exceptions, including a lower asset threshold for a credit union to be a "larger covered institution" under the proposed rules than for retail banks. Regarding this proposed rule, NASCUS recommends NCUA address the need for consultation with state regulators; increase the asset threshold for a credit union to be considered a large institution under the rule; establish a "material incentive-based compensation" threshold for reporting; and consider other refinements and clarifications of the proposed rules.

Consultation with State Regulators and Consideration of State Law

1) Consultation with state regulators

Footnote 19 to the supplemental information accompanying the proposed rule states that "NCUA would ***likely*** consult with the appropriate state regulator in cases involving a state-chartered credit union." 76 Federal Register 72 (April 14, 2011) p. 21177 [emphasis added]. The Dodd-Frank Act vested rulemaking authority in NCUA for implementation of § 956 for all credit unions while splitting enforcement authority between NCUA (for federally insured credit unions) and the Federal Trade Commission (non-federally insured credit unions).[2] As a result NCUA has rulemaking, but no examination or enforcement authority over non-federally insured credit unions. The consultation with, and cooperation of, state regulators, will be necessary for effective implementation of the proposed rule. Furthermore, state regulators are more

[1] NASCUS is the professional association of the nation's state credit union regulatory agencies.
[2] Dodd-Frank §956(d) delegating enforcement pursuant to §505 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (November 12, 1999).

NASCUS • 1655 North Fort Myer Drive, Suite 300. Arlington, Virginia 22209 • P: (703) 528-8351 • F: (703) 528-3248 • www.nascus.org • offices@nascus.org

likely to be familiar with local standards, circumstance and prevailing trends in compensation not just in credit unions, but across the financial services industry.

The final rule should contain a clear statement that NCUA will consult and cooperate with state regulators in the implementation and administration of the rule. Such a provision is particularly critical in the administration of proposed §751.5 and the determinations made regarding the incentive-based compensation plans of state-chartered credit unions.

2) Compensation as defined by state law

Proposed §751.3(b) defines compensation under the rule to exclude from coverage certain benefits such as reimbursement, insurance and indemnification that are consistent with existing §701.33 of NCUA's rules. This exclusion is too narrow. The proposed rule applies to all credit unions, however NCUA's §701.33 applies only to federal credit unions (FCUs). State laws may allow similar insurance or reimbursement benefits related to a director's credit union duties.

NCUA should amend proposed §751.3(b) to exclude compensation consistent with NCUA's rules as well as similar state rules, or delete the reference altogether. We note that the Federal Deposit Insurance Corporation's (FDIC) proposal lacks any similar reference. If NCUA seeks a credit union specific carve out, it should do so in a manner equitably deferential to state law, and not solely in deference to existing FCU standards.

The supplemental material contains references to limitations on compensation that are inapplicable to state-chartered credit unions. Footnote 7 of the material explicitly references NCUA prohibitions on compensating directors, §701 of NCUA's rules and to FCU bylaws.[3] These references should likewise be deleted from supplemental material in the final rule, or be amended to clarify that permissible compensation under state law meeting the spirit of the rule is acceptable.

Proposed §751.4 and §751.5 – Credit Unions Over $10 Billion in Assets

1) The asset size determination for a large covered institution should be the same for credit unions and retail banks.

The federal banking agency rules proposed pursuant to §956 of Dodd-Frank contain additional requirements for "large covered institutions." These requirements include additional reporting and mandatory deferment of 50 percent of annual incentive-based compensation over a period of no less than three (3) years.[4] For retail banking institutions, federal bank regulators define a large covered institution as an institution with assets of $50 billion or more. See OCC proposed § 42.4(b)(3) and §42.5(b)(3); FRB proposed § 236.4(b)(3) and § 236.5(b)(3); and FDIC proposed §372.4(b)(3) and 372.5(b)(3). However, with no supporting discussion in the supplemental information, NCUA defines a "large covered institution" as a credit union with assets of only $10 billion or more. See NCUA proposed §751.4(c)(3) and §751.5(c)(3).

NASCUS believes the threshold for a "large covered credit union" should be similar to that for a "large covered retail bank."

The asset threshold for a "large covered credit union" was not mandated by Dodd-Frank and is therefore entirely within NCUA's discretion. It is difficult to support the conclusion that an incentive-based

[3] 76 Federal Register 72 (April 14, 2011) p. 21173.
[4] 76 Federal Register 72 (April 14, 2011) p. 21173.

compensation arrangement at a $10 billion credit union poses any greater risk *to that credit union* than the identical incentive-based compensation arrangement at a $10 billion retail bank. Establishing a significantly lower threshold for credit unions disadvantages, and diminishes, the overall credit union charter with little regulatory, or safety and soundness benefit.[5]

Furthermore, NASCUS notes that credit unions in general, and particularly credit unions with assets in excess of $10 billion, are already subject to numerous state and federal regulations that mitigate many of the risks the proposed rule seeks to address. For example, credit unions are subject to restrictions on commercial lending, investments, and (in most cases) director compensation. Furthermore, credit unions that would meet the $10 billion threshold already draw substantial regulatory scrutiny. The state-chartered credit unions that would likely meet (or will meet in the near term) the threshold are examined annually by both state regulators and NCUA. Finally, with respect to disclosure of compensation in general, we note that all state-chartered credit unions are required to annually disclose the compensation of certain high level officials by Internal Revenue Service (IRS) regulations on IRS Form 990. While these disclosures do not identify incentive-based compensation per se, if the overall amount of compensation is inordinate, whether incentive based or not, its amount is a matter of public record and easily discernable.

2) Effect of mandatory deferment on existing contracts

Under the proposed rule, the requirement to defer 50 percent of incentive-based compensation over a period of three years would take effect six (6) months after publication in the *Federal Register*.[6] However, the proposal is silent as to what NCUA expects for incentive-based compensation arrangements already in existence. Many of these arrangements constitute contracts between the credit union and employee.

NASCUS recommends the rule provide a grandfather clause for such arrangements.

Such an approach would be consistent with NCUA's approach in its recent final rule Part 750, Golden Parachute and Indemnification Payments. Failure to provide an exception for existing contracts would likely require all such contracts to be renegotiated, which in turn could trigger application of the aforementioned new final Part 750. The same disruptive factors NCUA sought to avoid by providing the exception under its golden parachute rule are presented by this proposed rule.

3) Comparable incentive-based compensation arrangements

Proposed §751.5 prohibits excessive incentive-based compensation. Among factors to be considered by NCUA in making a determination as to whether a particular incentive based compensation arrangement is excessive is "comparable compensation practices at comparable institutions, based upon such factors as asset size…" <u>See proposed §751.5(a)(2)(iv)</u>. Should NCUA retain a "large credit union" threshold of $10 billion in assets under the rule, than it should make clear in supplemental information that for

---

[5] While retail banks are, on average, larger than their credit union counterparts, a review of the asset size of bank and credit union failures from 2010 indicate that overwhelmingly, the losses to the insurance funds derive from failures of institutions well under the respective asset thresholds proposed in the rules. In 2010, there were no failures of natural person credit unions with assets of even $1 billion or more. On the bank side, of 157 FDIC insured institution failures, the largest was $10.8 billion in assets and only 11 were between $2 billion and $10 billion in assets. See http://finance.yahoo.com/news/Bank-Failures-2010-More-dg-2030232555.html?x=0

[6] 76 Federal Register 72 (April 14, 2011) p. 21174.

purposes of proposed §751.5, a comparable institution would be a large (per the rule definition) $50 billion asset bank.[7]

Meaningful Application of Intent of Dodd-Frank §956

The intent of Dodd-Frank was to provide federal regulators the ability to identify, and to prohibit, incentive-based compensation that is excessive or could lead to material loss by encouraging excessive and unwarranted risk taking. Dodd-Frank §956(a)(1)(A) and (B).[8] NASCUS believes the proposed rule could be narrowed in a manner compliant with Dodd-Frank while not burdening credit unions, and regulators, with disclosures of non-material incentive-based compensation.

As proposed, the rule would require disclosure of all incentive-based compensation of all employees. It seems likely that covered credit unions provide small bonuses to a wide range of employees for performance on terms that are prima facie not excessive, or to employees not in a position to expose the credit union to the risks contemplated by Dodd-Frank. The final rule should amend the scope of coverage to address only material incentive-based compensation, such as compensation that is more than some level of base pay. The final rule should also refine the definitions of covered persons to include only those individuals in a position to expose the credit union to material risk of a nature contemplated by Dodd-Frank.

These refinements could substantially reduce the compliance burden for credit unions while allowing regulators to focus on the material incentive-based compensation arrangements that concerned Congress.

While the supplementary information contains a brief discussion of the limited nature of incentive-based compensation for the purposes of the proposed rule, those disclaimers do not seem to carry through to the proposed regulatory definition. For example, the supplementary information cites behaviors not related to risk taking such as achieving a level of certification, but is silent as to a non risk performance metric such as compensation tied to positive feedback on member satisfaction surveys.[9]

Form of Required Reporting

Proposed §751.4 requires annual reporting of credit union incentive-based compensation plans in a format directed by NCUA. However, the proposed rule is silent as to what that format will be. Given the sensitivity of the information to be submitted, and the effort required for its aggregation and submission, the format of the reporting is important. See footnote 20, p. 21177 [discussing two exemptions to FOIA requests that would shield the information].

In addition, the final rule will apply to a subset of credit unions that are not federally insured and therefore may not be in NCUA's normal reporting and communications channels. NASCUS encourages NCUA to work with state regulators and covered institutions to develop the appropriate form of disclosure and reporting.

---

[7] Given the limited number of credit unions of the asset size in question, it is likely NCUA would have to include bank comparisons for any meaningful comparisons.

[8] See also the supplementary information stating it is the purpose of the rule to cover only incentive-based compensation that encourage inappropriate risk or present risk of material loss. 76 Federal Register 72 (April 14, 2011) p. 21175.

[9] 76 Federal Register 72 (April 14, 2011) p. 21175.

Proposed §751.5 Prohibitions

1) Inconsistent standards

NASCUS is concerned that the rule as proposed is inherently conflicted. Proposed §751.4 contains the requirements for reporting including a provision that specifically states that a credit union "is not required to report the actual compensation of particular covered persons as part of the report [required by the provision]." See proposed §751.4(b). Section 956 of Dodd-Frank specifically states that individual specific compensation disclosure will not be required. See Dodd-Frank §956(a)(2). Yet proposed §751.5(a)(2)(i) and §751.5(a)(2)(ii) state that in determining if compensation is excessive NCUA will consider "the combined value of all cash and non-cash benefits provided the covered person as well as the compensation history of the covered person [and possibly other non-covered persons with similar expertise]. Although credit union Call Reports (and other mandated reporting) capture compensation of certain high level officials, it is possible that other covered persons' compensation is not currently captured, suggesting that specific individual compensation may have to be reported.

NCUA should explain how these provisions will operate in practice, and what confidence covered credit unions and persons will have that disclosure of individual salaries will not become common place.[10]

2) Identifiable standards

Proposed §751.5(a)(2)(vii) states that in evaluating whether an incentive-based compensation arrangement is excessive NCUA may also rely on "any other factors [it] determines to be relevant." Given the fairly comprehensive list of enumerated factors, it is uncertain what this provision entails. As proposed, it is too open ended to provide reasonable guidance to credit unions, or their state regulators, as to what standards NCUA would apply in a specific circumstance.

NASCUS recommends that proposed §751.5(a)(2)(vii) be amended to reflect that additional factors determined by NCUA be published as standards in regulation or guidance so that all parties can fairly understand the criteria by which the compensation is being evaluated.

3) Balancing risk and financial rewards

Proposed §751.5(b)(2) requires covered credit unions to balance risk and financial reward in incentive-based compensation arrangements. Specifically, proposed §751.5(b)(2)(i) lists examples of acceptable balancing such as the use of deferral of payment, risk adjustment of rewards, reduced sensitivity to short term performance or longer performance periods.

We recommend NCUA amend this provision to make clear there are other acceptable methods beyond those listed. Furthermore, we note that deferral of compensation potential may raise complex tax issues, and NCUA should alert credit unions to those issues before strongly recommending such an approach.

The additional requirement for "larger covered credit unions" under proposed §751.5(b)(3)(i)(B) should be amended. Specifically, the requirement that deferred compensation of an executive officer be adjusted to reflect actual losses or other aspects of performance that become known in the deferral period should be amended by deleting the reference to actual losses and retaining a reference to elements of performance. The reference to actual losses is confusing, implying that a plan ***must*** deduct for ***any*** loss occurring during the deferral period. That is an unreasonable standard.

---

[10] As noted above, state-chartered credit unions already disclose the compensation of certain officials pursuant to IRS Form 990. However, the proposed rule could significantly broaden the disclosure of salaries, and adds an additional regulatory burden.

NASCUS and state regulators remain committed to working with NCUA to mitigate material risk throughout the credit union system, and appreciate the opportunity to submit comments on this proposed rule.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
SVP Regulatory Affairs & General Counsel