

LEGAL UPDATES AND NEWS

NCUA Proposes Rules on Dodd-Frank Sound Incentive Compensation Arrangements

In April 2011, the National Credit Union Administration (NCUA) proposed regulations regarding new limitations on incentive compensation under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), which was signed into law on July 21, 2010. Under the proposed regulations, the NCUA will expect the boards of directors of larger credit unions to routinely undertake a new, periodic “top to bottom” review of the credit union’s incentive compensation arrangements. The NCUA will expect to see evidence of such board oversight as part of regularly scheduled “safety and soundness” reviews of larger credit unions. In addition, credit unions that are subject to the rules would be required to report annually to NCUA with respect to their compliance with these “safety and soundness” rules. Although the rules are directed at institutions with more than \$1 billion in assets, credit unions of lesser size may receive such scrutiny, if only on informal basis through the examination process.

Incentive compensation arrangements include everything from commissions paid to loan officers or mortgage originators to bonuses paid to any employee, including top executives and entry level employees.

Specifically, the proposed rules look at “risk adjusted rewards.” For example, commissions based solely on volume are traditionally typical pay structures for lenders. However, such pay structure does not assess risks like credit quality. Under the proposed rules, for loans to be held in the credit union’s portfolio, commissions should consider credit quality in addition to loan volume. The credit quality measure could evaluate either the individual lender’s portfolio or the credit union’s entire loan portfolio, or both. Credit unions may want to consider adding a clawback on loans for sale in the secondary market that adjusts the commissions paid on any loan that is returned within 12 months (for example, due to documentation errors).

The proposed rules expect credit union boards to limit or control employees’ current focus on immediate results and develop more of a long-term focus to assess performance over a time period that is commensurate with the length of the credit risk of the loan to the credit union. However, keep in mind that Code Sections 457 and 409A generally apply to credit union’s deferred compensation arrangements.

These proposed rules were jointly issued by the NCUA and the federal bank regulatory agencies under Section 956 of Dodd-Frank that imposes broad (and often vague) rules regarding incentive-based compensation arrangements maintained by certain financial institutions for their executive officers and certain other covered persons. The proposed rules are similar to final rules published on June 25, 2010 that already apply to FDIC-regulated banks.

General Rule

The proposed rules generally would:

- **Prohibit** “covered financial institutions” (those with more than \$1 billion in total assets, **including credit unions**) from maintaining incentive-based compensation for “covered persons” (any executive officer, employee, director or principal shareholder of a covered financial institution) that involve “excessive” compensation (amounts that are unreasonable or disproportionate to the amount, nature, quality and scope of services performed, and requires peer group analysis) or encourage inappropriate risks;
- Impose additional stringent requirements on “larger covered financial institutions” (**including credit unions with \$10 billion or more in total consolidated assets**), including a requirement that at least half of the annual

incentive compensation for covered persons must be deferred for at least three years;

- The amounts deferred are subject to adjustment to reflect actual losses or other measures of performance that are realized during the deferral period;
- Require covered financial institutions to adopt policies and procedures regarding “incentive-based arrangements” (i.e., any variable compensation that serves as an incentive to performance). It is unclear whether a discretionary bonus would be included; and
- Impose reporting obligations on covered financial institutions regarding incentive compensation arrangements.

Policies and Procedures Required

Under the proposed rules, incentive compensation arrangements would be *prohibited* unless they are adopted pursuant to policies and procedures developed and maintained by the covered financial institution and approved by its board (or compensation committee of the board) that are reasonably designed to ensure and monitor compliance with the requirements of the proposed rules.

The proposed rules describe minimum standards for such policies and procedures. For example, the procedures must ensure that risk management, risk oversight and internal control personnel have an appropriate role in the credit union’s processes for designing incentive compensation and for assessing their effectiveness in restraining inappropriate risk taking. Accordingly, the proposed rules focus on new measures for strong corporate governance that call for direct board oversight of “top to bottom” incentive compensation arrangements within the credit union in order to effectively balance the financial rewards to the covered person and the range and time horizon of risks to the credit union that are associated with the covered person’s activities.

Annual Report

In addition, the proposed rules require that every covered financial institution must submit an annual report to its primary regulator within 90 days after the end of the institution’s fiscal year describing the structure of its incentive compensation for covered persons, including a narrative description of the components of the institution’s incentive compensation, a description of the policies and procedures that govern such arrangements and an explanation of why that structure does not expose the institution to material financial loss by providing excessive compensation to covered persons. The report would also require disclosure of any changes made to the incentive compensation arrangements since the previous filing. The information would be kept confidential by the regulators and is not subject to Freedom of Information Act (FOIA) disclosure.

If you have any questions regarding the NCUA proposed regulations on sound incentive compensation arrangements, please do not hesitate to contact any of our partners below.

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