

credit union Directors newsletter

TRENDS, EVENTS, & ANALYSIS FOR POLICY MAKERS

SEPTEMBER 2009 • Volume 33 Issue 9

cuna.org

Executive Pay Plans Are Under the Microscope

Change is in the air for executive compensation plans. One reason is the Obama administration's call for legislation on "say on pay."

The House Financial Services Committee introduced H.R. 3269 this summer. Portions of the bill, known as the Corporate and Financial Institution Compensation Fairness Act, direct the National Credit Union Administration (NCUA) and federal bank and thrift regulators to jointly issue regulations requiring all financial institutions to disclose

information related to the structure of incentive-based compensation.

The Credit Union National Association (CUNA) requested credit unions be exempt from the provisions. The final House measure, passed before legislators' summer recess, exempts financial institutions with less than \$1 billion in assets. The bill now resides in the Senate.

Another cause for change: the recession. About 63% of directors who serve on corporate boards believe U.S. companies should modify their executive compensation programs to adapt to the

new economic realities, a Watson Wyatt survey points out.

This likely will include more emphasis on performance-based awards and changes to performance metrics. But 54% of directors said legislation and public pressure would have little or no effect on improving pay for performance.

Among credit unions, bonus and/or incentive awards and base salary account for 92% of a CEO's total compensation, according to CUNA's 2009-2010 CEO Total Compensation Survey Report for credit unions with more than \$100 million in assets.

continued ►

QUICK TAKE

For your next board meeting

The Youth Potential

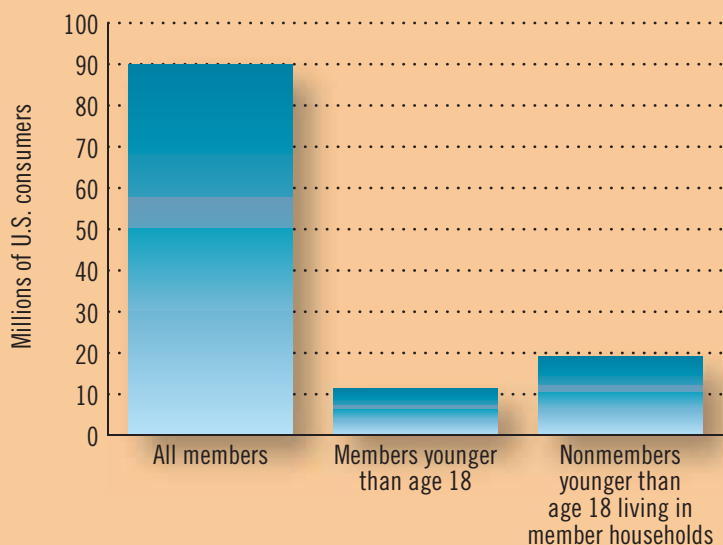
Young adults have been difficult to draw into the credit union family, CUNA research shows. That's primarily because they have so many options for financial services, both traditional and online.

But a huge growth opportunity is at the doorstep. An estimated 19 million children under age 18 currently reside in member households but don't belong to credit unions.

Consider these outreach strategies:

- **Use** blogs, social networks, and online videos for promotions;
- **Focus** on online money-management services; and
- **Feature** money-saving loan solutions.

Young Members and Nonmembers



Source: CUNA's 2009-2010 National Member Survey Report (buy.cuna.org, enter 28532 in the product finder)



Overall, 73% of these CEOs received a bonus and/or incentive reward in 2008. That's similar to 2007's figure. Median variable pay—bonus and/or incentive payments—was \$26,000, or 14% of base salary.

For performance-based CEO pay, loan growth and earnings were the top criteria boards used to determine bonuses and incentives.

Other survey trends:
► **Base salary**, on average, represents 84% of a CEO's total compensation among credit unions with \$100 million or more in assets. The median salary this year is \$192,491, up 10% from 2008. The

median CEO salary for all credit unions this year is \$72,000.

► **CEOs at credit unions with \$100 million or more in assets** received a median \$204,924 in total cash compensation in 2008—base pay plus variable pay—an increase of 6.4% over the previous year.
► **Among credit unions offering them**, 47% of CEOs received bonuses in 2008, up from 41% in 2007. The median bonus award among this group rose 7.5% from about \$14,000 in 2007 to about \$15,000 in 2008.

► **Fewer credit unions** offered incentive pay in 2008—42%

compared with 49% in 2007. But 61% of those CEOs received an incentive payment, up from 45% in 2007. The median incentive payment was \$23,000, 18% higher than the median incentive received in 2007.

There's a strong tie between CEO compensation, especially base salary, and credit union size. As assets increase, so does the complexity of the operations. CEOs are compensated accordingly. "Therefore, when evaluating and comparing the base salary of an individual credit union CEO, it's important to look at institutions with comparable assets," the survey recommends.

To learn more, visit buy.cuna.org, and enter 28814 in the product finder. ■

Loan growth and earnings are top criteria in performance-based CEO pay.

Discuss Examiner's Document of Resolution

Credit union boards of directors should thoroughly analyze any formal agreement entered into with NCUA or state regulators.

A document of resolution (DOR), sometimes called the record of action, is the most important section of the examination report. The DOR details agreements with your board to correct major concerns, which the NCUA Examiner's Guide says are problems "that could affect the credit union's safety and soundness or interfere with the normal daily operations" of the credit union.

Concerns can include: capital levels, inadequate allowances for loan losses, lending policies, collections procedures, asset-liability management, internal controls, field-of-membership violations, reporting deficiencies, and Bank Secrecy Act compliance.

Your board should thoroughly discuss the issues the DOR raises, not only with the examiner at the exit meeting, but also with man-

agement prior to that meeting.

The board chairman, or the CEO on the board's behalf, should request a copy of the exam report before the exit meeting. This gives management and the board time to address the examiner's questions and put unresolved issues to rest.

The document's action plan typically specifies:

- **Corrective** actions expected;
- **Who** will take those actions;
- **Start** and completion dates; and
- **Official** or group of officials overseeing the actions.

If you don't agree on a course of action or timetable, push back. Don't agree just to appease the examiner or just to finish the exam. Failure to accomplish the action by the deadline could result in a Letter of Understanding and Agreement (LUA) if the issue is serious enough.

What's an LUA?

NCUA's Examiner's Guide says an LUA "is essentially a contract between NCUA and a credit

union." State regulators might call it by another name, such as a "memorandum of understanding and agreement," which it typically prepares jointly with NCUA for state-chartered, federally insured credit unions. NCUA regional directors enter into LUAs on behalf of the NCUA Board.

An LUA is "voluntary" in name only. If the credit union won't agree to take actions the regulator considers essential, the regulator will move on to formal enforcement actions, usually by issuing a cease-and-desist order or imposing civil money penalties on the credit union or managers.

Negotiating an LUA

Typically, every director on a credit union's board is required to sign the LUA. But boards *never* should sign one when the examiner first presents it.

Just as you seek legal advice when a vendor presents a contract, it's essential to seek legal advice *before* signing the LUA. And it's critical to conduct the same

due diligence when selecting an attorney as when choosing other providers.

While examiners typically present LUAs when a credit union has

been unable or unwilling to comply with the DOR plan of action, that's not always the case. Sometimes the examiner presents an LUA at the end of an examination

or even after a special supervisory contact following a review of quarterly call report data. It's especially important when the board and management team first learn of the regulator's concerns that the board not sign a letter when it's presented. Such action could be the death knell for the credit union if it's incapable of complying with the LUA's provisions.

Many attorneys have lamented the situation where the credit union signs the LUA and *then* contacts counsel. After the examiner presents the *draft* LUA to your board, it's entirely appropriate to advise the examiner the board will discuss the provisions internally and follow up within a few days. LUAs are an urgent matter, so a period of days—not weeks—is the appropriate response.

Don't let anyone say this is a stall tactic. It's a reasoned response by a board fulfilling its fiduciary responsibility to members and exercising good due diligence. ■

CHRISTOPHER PIPPETT is a partner with the law firm of Saul Ewing LLP, Wayne, Pa. Reach him at 610-251-5084 or cpippett@saul.com.

Take Note of These LUA Actions

Boards should treat a Letter of Understanding and Agreement (LUA) as a proposal, subject to negotiation. Consider these actions, according to Christopher Pippett, partner with the law firm of Saul Ewing LLP, Wayne, Pa.:

- ▶ **Discuss**, first internally and then with the examiner, if there are reasonable alternatives for addressing the examiner's concerns;
- ▶ **Evaluate** the timeline for accomplishing each expected action. Often it's the timetable, not the required action, that makes it difficult to comply with the LUA;
- ▶ **Document** in the agreement the steps your credit union already has taken to address the examiner's concerns. If the regulator subsequently modifies the LUA, have the revised agreement reflect the degree of compliance to date;
- ▶ **Insist** on citations to authority for specified actions;
- ▶ **Expect** the LUA's language to be factual and objective, avoiding unnecessary adjectives and adverbs;
- ▶ **Insist** the LUA not be made public. NCUA rarely does so, but if the agency wants to directly enforce the agreement's provisions, the Federal Credit Union Act requires NCUA to publish it (typically on its Web site). If published, NCUA must show (for enforcement purposes only) that the LUA provisions weren't followed;
- ▶ **Make sure** the LUA includes a termination date, rather than remaining in effect indefinitely;
- ▶ **Keep** the lines of communication open between the examiner and the credit union; and
- ▶ **Continue** communicating with the examiner after the LUA is executed, especially if the credit union encounters trouble with any of its terms. Calling to discuss progress or problems demonstrates your credit union is taking the LUA seriously.

Consider All Options Before Modifying Loans

Loan modifications are yet another effect of the Great Recession. The number of modified real estate loans is increasing among all credit unions, according to CUNA's economics and statistics department.

The percentage of modified first mortgages outstanding grew from 0.53% at year-end 2008 to 0.92% as of March 2009. The same holds true during this time-frame for modified second mortgages (from 0.33% to 0.38%) and modified real estate loans reported as business loans (from 0.74% to 1.4%).

About 10% of credit unions

offering first mortgages made modifications, CUNA reports. In the category of "other mortgages," 7.1% were modified. And 2.2% of real estate loans reported as business loans were modified.

More than one-third (37%) of all mortgages that were modified during first-quarter 2008 were in default within six months, according to a 2009 Office of the Comptroller of the Currency report.

The report reveals the number of new loan modifications rose 55% during first-quarter 2009. Foreclosures in process grew to about 2.5% of serviced loans—a 22% increase from the previous

quarter and a 73% jump from the first-quarter 2008.

A new white paper—"TDR Financial Flash"—published by the CUNA Chief Financial Officer (CFO) Council closely examines loan modifications and troubled debt restructuring (TDR).

TDRs aren't a new tool, but "current economic conditions have amplified the importance, necessity, and complexity of determining when TDRs are appropriate, how to account for them, and how to track them," according to Dan Green, executive vice president of strategy for Prime Alliance Solutions, Tukwila, Wash., and

report author.

All TDRs are modified loans, though not all loans are TDRs, Green notes. When a loan with a similar risk is extended at its current interest rate or replaced with new debt at the existing debt's current interest rate, it's a modified loan.

TDRs share the traits of modified loans but have two additional features, he points out:

1. The modification is due to economic or legal reasons related

to the debtor's financial difficulties; and

2. The modification provides for a reduction in interest or principal.

Is TDR the right option for your credit union? Often a repossession or foreclosure may be the best business decision.

The paper suggests credit unions ask the following questions:

► **Is TDR** too generous in a particular situation?

► **What's the likelihood** the credit union will consistently collect payments based on these loan revisions?

► **What's in the best interests** of the member and the credit union?

In addition, Green writes, credit unions must consider accounting and regulatory complexities based on restructuring scenarios.

For information on the paper, visit cunacouncil.org. ■

Where NCUA Sees Risk, Some See Opportunity

Dale Rutt describes a "flight to safety" phenomenon during the current economic turmoil as members "pull their money from equity investments.

"We're having a hard time finding appropriate investment vehicles for this new money,"



'If we manage our

business prudently in this

environment, we'll see

plenty of opportunities for

the long term.'

Dale Rutt
Chairman

says Rutt, chairman of \$239 million asset Sooper Credit Union, Arvada, Colo. "We've dropped interest rates, but the risk is still there."

With recently passed legislation, corporate stabilization program expenses will have a lesser effect on financials and strategic plans, for the time being, CEO Dan Kester notes (*Credit Union Directors Newsletter*, 7/09). Rather, examiners have highlighted

other credit union initiatives—branch expansions and mergers—and their impacts on financials, says Rutt.

Regarding how examiners have approached corporate stabilization program expenses, "they're taking it out of all the ratios," Kester says. "It has affected our capital [now at 12.8%], but we're still very well-capitalized and need to remember that we have a strong foundation."

Staying focused is key. Operating expense control "was always a part of [our strategic] plan," Kester says, "although that has become a higher priority in the wake of this crisis."

Rutt and Kester agree events of the past year have demonstrated nobody can look into the future and predict what might affect a business plan. The board has held extra board meetings, Rutt says, "and we've been under the microscope of both state and federal examiners."

The board also has been deal-

ing with expenses, delinquencies, and achieving balance between deposits and loans.

"There's plenty of stress to go around," Rutt declares, "for both directors and senior managers. But if we manage our business prudently in this environment, we'll see plenty of opportunities for the long term."

When NCUA looks at the financial landscape, Kester explains, it sees insurance fund risks. But "we look for opportunities. We want to be prudent, but we want to thrive, too. There's market share to be gained."

Maintain your capital and control your operating expenses, Rutt and Kester advise. "Being lean and robust is the best position from which to move forward and serve members with the best possible products and services," they say. ■

DICK RADTKE is a partner with *Fourth Lake Communications LLP* in *Madison, Wis.*



CREDIT UNION DIRECTORS NEWSLETTER (ISSN 1058-1561) is published monthly for \$107 per year by the Credit Union National Association, 5710 Mineral Point Road, Madison, WI 53705-4454. (Multiple-copy discounts available.) Also available as a downloadable PDF for an annual subscription rate of \$535. Periodical postage paid at Madison, Wis.

POSTMASTER: Send address changes to CREDIT UNION DIRECTORS NEWSLETTER, P.O. Box 461, Annapolis Junction, MD 20701-0461. Advertising is accepted only from reputable firms, but inclusion of advertising does not imply endorsement by the newsletter or CUNA Inc.

Publisher: Doug Benzine, dbenzine@cuna.com. Editorial staff: Steve Rodgers, editor in chief, srodgers@cuna.com; Ann Hayes Peterson, managing editor, apeterson@cuna.com.

Editorial: 608-231-4211 ■ Subscriptions: 800-348-3646, fax 301-206-9789, or cuna.org

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