

**Authority:** 12 U.S.C. 248(i), 375a(10), 375b(9) and (10), 1817(k)(3) and 1972(2)(G)(ii); Pub. L. 102-242, 105 Stat. 2236.

2. Section 215.2 is amended as follows:

a. The last sentence of paragraph (i) introductory text is revised;

b. Paragraphs (i)(1) and (i)(2) are revised; and

c. Paragraph (i)(3) is removed.

The revisions read as follows:

**§ 215.2 Definitions.**

\* \* \* \* \*

(i) \* \* \* A member bank's unimpaired capital and unimpaired surplus equals:

(1) A bank's Tier 1 and Tier 2 capital included in the bank's risk-based capital under the capital guidelines of the appropriate Federal banking agency, based on the bank's most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3); and

(2) The balance of a bank's allowance for loan and lease losses not included in the bank's Tier 2 capital for purposes of the calculation of risk-based capital by the appropriate Federal banking agency, based on the bank's most recent consolidated report of condition filed under 12 U.S.C. 1817(a)(3).

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, April 14, 1995.

**William W. Wiles,**

*Secretary of the Board.*

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**NATIONAL CREDIT UNION ADMINISTRATION**

**12 CFR Part 701**

**Organization and Operations of Federal Credit Unions**

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Proposed rule.

**SUMMARY:** National Credit Union Administration (NCUA) Rules and Regulations prohibit officials and certain employees of federally insured credit unions from receiving either incentive pay or outside compensation for certain activities related to credit union lending. The regulations are ambiguous in places and have proved difficult to interpret. Further, the regulations may be too restrictive in some instances and too broad in others. The NCUA Board is proposing to amend the regulations to make them clearer, to authorize lending-related compensation in certain situations where it is

currently prohibited, and to prohibit it in other situations. If amended as proposed, it should be easier for credit unions to determine when incentives may be paid and easier for officials and employees to determine whether they may accept compensation for outside activities.

**DATES:** Comments must be postmarked or posted on NCUA's electronic bulletin board by June 19, 1995.

**ADDRESSES:** Mail comments to Becky Baker, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314-3428. Send comments to Ms. Baker via the bulletin board by dialing 703-518-6480.

**FOR FURTHER INFORMATION CONTACT:** Lisa Henderson, Staff Attorney, (703) 518-6561, at the above address.

**SUPPLEMENTARY INFORMATION:**

**Background**

Section 701.21(c)(8) of the NCUA Rules and Regulations, 12 CFR 701.21(c)(8), prohibits federal credit unions from making a loan if, either directly or indirectly, any commission, fee, or other compensation is to be received by the credit union's directors, committee members, senior management employees, loan officers, or any immediate family members of such individuals, in connection with underwriting, insuring, servicing, or collecting the loan. However, non-commission salary may be paid to employees. As a condition of federal insurance pursuant to Section 741.3(a) of the Regulations, 12 CFR 741.3(a), the prohibition applies to federally insured state-chartered credit unions. The purpose of Section 701.21(c)(8) is to ensure that an individual who is in a position of authority in a credit union does not put self-interest ahead of the credit union's interest in making good loans and providing good service to its members. The provision prohibits compensation from third parties and from the credit union itself, in the form of commissions, incentive pay, or bonuses.

Under the current regulation, a "loan officer" is an individual who has the authority to approve a loan. A loan officer may or may not be involved in taking and processing loan applications. "Underwriting the loan" means approving or disapproving it. Thus, an individual who has any part in approving a loan is prohibited for receiving incentive pay in connection with that loan. An individual who is involved in processing a loan, but who has no role in its approval or

disapproval, may receive incentive pay in connection with the loan.

The prohibition against making a loan if a commission or fee is to be received by a loan officer in connection with insuring the loan means, for example, that the individual who has the authority to approve a loan may not receive an incentive for selling credit life or disability insurance on it.

Noting that credit union management had become increasingly interested in implementing lending-related incentive pay programs, the NCUA Board, on March 9, 1994, issued a Request for Comment on whether § 701.21(c)(8) should be amended to permit loan officers and/or senior management to receive incentive pay for underwriting and insuring loans, 59 FR 11937 (March 15, 1994). A total of 252 comments was received, 177 of which expressed support for allowing incentive pay for loan officers. Most of the latter suggested that incentive pay be permitted only with controls in place.

A number of commenters described the success their credit unions had had with incentive programs involving employees other than loan officers; they argued that even greater benefits would accrue from paying incentives to loan officers. Most of these programs seem to have been implemented in the past few years, however, and some of the information submitted to the Board raises questions about whether they will be successful in the long run.

For example, information submitted by one commenter cites research which has shown that incentive programs can fail in the long term because employees become preoccupied with meeting goals and fail to carry out their normal routines. When management sets a specific goal, and offers a reward for meeting it, work or problems that do not relate to that goal are ignored. Cooperative spirit between people often diminishes because each has different goals and becomes wrapped up in his or her own work. Incentive pay can actually work to undermine an employee's internal motivation to perform well, as employees end up working for the incentive rather than the satisfaction of the work itself. Employees can also be demoralized by the underlying assumption that they are not working hard and need incentives to perform.

One credit union commenter learned about the risks of incentive programs the hard way. He reported that his credit union's incentive program for loan officers was unsuccessful for the following reasons: (1) Despite controls being in place, some loan officers exceed their authority in approving

loans. The commenter noted that even if a loan officer can be disciplined for poor judgment, "once a loan is made, you can't take it back."; (2) Incentives caused disputes among loan officers, each of whom thought the others were receiving more favorable treatment from management by having more creditworthy loans routed to them; and (3) Incentives caused some animosity between employees who were eligible for incentive pay, such as those in the loan department, and those who were not.

Other commenters argued that incentives are not necessary for successful loan programs. One commenter provided details of how his credit union had dramatically improved productivity after *eliminating* all incentives. He reported that the credit union's consumer loan approval ratio had increased from 62% to 84% as a result of centralizing the origination function and implementing a credit scoring system. The credit union also improved service to members by providing loan decisions within 24 hours and making the terms and pricing of its products more competitive. In two years, the consumer loan portfolio increased by 38% while loan delinquencies and charge-off ratios remained better than the credit union's peer group. As a result of improved terms and pricing of mortgage products, originations increased from \$62 million in 1991 to \$161 million in 1993.

Despite misgivings about incentive pay, the Board recognizes the strong arguments made by many commenters that if incentive pay can be offered in a manner that protects against abuses, the decision whether to do so should be a management decision, not one that is precluded by an overly restrictive regulation. Therefore, the Board is proposing to allow credit unions to provide incentive pay to some employees, including loan officers, in certain circumstances, as described below.

### Proposed Regulation

The proposed rule changes the structure of the regulation to a broad prohibition, with specific exceptions, against an official or employee receiving compensation in connection with any loan made by the credit union. The Board believes that this structure will be easier to interpret and administer. It has proved difficult to determine, in the current regulation, whether certain activities are part of "underwriting, insuring, servicing, or collecting" a loan, particularly "underwriting" and "insuring." Proposed paragraph 8(i) only requires that an activity be

determined to be "in connection with" a loan. NCUA would take a reasonableness approach to that determination.

For example, suppose an official owns a company that manufactures forms. In this example, a credit union could purchase loan application forms from the company, even if it resulted in compensation to the official, since the purchase of loan application forms is not reasonably "in connection with" making a loan.<sup>1</sup> On the other hand, if an official owned a credit bureau, a credit union could not obtain credit reports from the company, resulting in compensation to the official, because providing credit reports is reasonably "in connection with" making a loan.

Similarly, a credit union could finance a home built by a construction company owned by an official, as long as the credit union was not financing the construction of the home, as building a home is not reasonably in connection with making a loan. However, a credit union would be prohibited from referring a member to the construction company to have a home built, as in that case, the construction would be in connection with making a loan.

In the context of incentive pay, rather than outside compensation, loan processing and making credit decisions on loans are clearly activities in connection with making loans. Thus, an employee would be prohibited from receiving incentive pay for performing those activities unless covered by an exception.

Exception (A) would allow credit unions to pay salary to employees who perform activities in connection with making loans. This is in the current regulation and needs no discussion.

Exception (B) would clarify that an incentive may be paid to an employee based on the overall financial performance of the credit union, which of course depends in part on its lending activities. While it could be argued that such an incentive is not truly "in connection with" a loan made by the credit union, the Board has included the exemption to avoid confusion. The Board believes that this type of incentive presents fewer problems than does an incentive based on the performance of a single individual, as it is focused on the interests of the credit union as a whole. However, incentives

based on an organization's overall performance must still be monitored closely to avoid the problems discussed above. NCUA of course reserves the right to take exception to overall performance related incentive plans for safety and soundness reasons, for example, and plans where incentive pay is based on asset growth with no consideration of factors such as capital and asset quality.

Despite the concerns raised about incentives based on an individual's performance, the Board is proposing to allow credit unions to develop incentive programs with that feature. The Board is responsive to the significant interest on the part of credit unions to implement such programs. Proposed exceptions (C), (D), and (E) would allow credit unions to make incentive payments to employees for processing loans, making recommended or final decisions to approve or disapprove loans, and collecting loans, respectively. In order for an employee to be eligible for an incentive, there must be a supervisory level above the employee that does not receive incentive pay for the activity in question. Furthermore, a senior management employee may not receive incentive pay for any of the activities. Supervisors and senior management employees are excluded from direct incentive pay in the interests of sound internal control. However, the proposed rule would allow such employees to receive bonuses based on broad measures of management skill, such as profitability.

Credit unions already have the authority to provide incentive pay for processing and collecting loans. The real change is the proposal to allow loan officers to receive incentive pay. To address the concern regarding loan quality, the proposed rule provides that incentives for making recommended or final decisions to approve or disapprove loans may not be based on the number or dollar amount of loans approved. The Board requests comment on this restriction. Commenters who believe that it is not necessary should provide evidence to that effect.

The proposed rule also requires that there be sufficient controls in place to prevent an increase in problem loans. A credit union would have the responsibility of structuring its incentive pay program to meet this requirement.

Finally, proposed paragraph (8)(iv) of the regulation would require that the board of directors establish written policies and controls for any incentive plan and monitor compliance on at least a quarterly basis.

<sup>1</sup> Other legal restrictions would apply, however. For example, common law principles would require that the transaction be at arms length and in the credit union's best interest, and the standard FCU Bylaws would require that the interested director recuse himself or herself from the decision to purchase the forms.

### Policy Changes

In addition to allowing incentive pay for loan officers under certain circumstances, the proposed rule would make additional policy changes. The current regulation has been interpreted to permit a credit union official or employee to receive compensation for acting as an agent in the sale of property securing a loan made by a credit union, on the rationale that listing or selling a property on which a loan is granted is not included in underwriting, insuring, servicing, or collecting the loan. Under this interpretation, an official or employee not only could receive a commission from an outside party for selling property financed by the credit union, he or she could also act as listing agent for the credit union's sale of foreclosed properties financed by the credit union. While listing or selling property financed by a credit union is not included in underwriting, insuring, etc., it is reasonably "in connection with" a loan made by the credit union. Thus, compensation for such activity would be prohibited unless the activity is covered by an exception. Since compensating an official or employee for listing or selling property financed by the credit union presents potential conflicts of interest, no exception is provided.

The current regulation also permits employees who are not senior managers or loan officers to receive incentives, from either the credit union or an insurance company, for selling credit life and disability insurance. Senior managers and loan officers may not receive such incentives because of the prohibition against compensation for "insuring" a loan. Since selling credit insurance is an activity reasonably "in connection with" a loan, the proposed rule prohibits all employees from receiving compensation for the activity, unless it is covered by an exception. The Board believes members should be allowed to make their own informed decisions about credit insurance and should not be pressured into purchasing it by employees who are motivated by incentive pay. Accordingly, no exception is provided. Lest there be any misunderstanding, however, credit unions are allowed to sell credit insurance and to generate income for the credit union from the activity.

The proposed regulation also clarifies another issue related to insuring loans. The current regulation has always been interpreted to prohibit, for example, a credit union official from owning an insurance company that sells car insurance to members who finance their cars at the credit union. Recently, it has

been argued that the regulatory language prohibits compensation in connection with insuring the loan but not in connection with insuring collateral securing the loan. Under this argument, the regulation clearly would apply to credit life and disability insurance but would not appear to apply to ordinary car or homeowners insurance. NCUA is concerned about the inherent conflict that arises if an owner of an insurance agency that insures collateral securing loans made by a credit union serves as a credit union official, because of the opportunity to "steer" members to the official's agency. Since insuring collateral is reasonably "in connection with" a loan, the proposed regulation continues the prohibition against a director receiving compensation for such activity.

The Board also notes that "insuring the loan" recently has been interpreted to include the sale of vehicle warranties (also called insured vehicle service contracts and mechanical breakdown insurance) in states in which such products are considered insurance. Thus, credit union employees have been prohibited from receiving incentive pay for selling vehicle warranties in those states. Since such products generally are sold at the time a loan is made, they are reasonably "in connection with" a loan. Therefore, the proposed regulation would prohibit the payment of incentives to employees for the sale of these products, regardless of whether they are considered insurance in a particular state.

### Regulatory Procedures

#### *Regulatory Flexibility Act*

The NCUA Board certifies that this final rule will not have a significant impact on a substantial number of small credit unions (those under \$1 million in assets). Accordingly, a Regulatory Flexibility Analysis is not required.

#### *Paperwork Reduction Act*

This proposed rule, if adopted, will impose no additional collection requirements and, therefore, need not be sent to the Office of Management and Budget for approval.

#### *Executive Order 12612*

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. It states that: "Federal action limiting the policy-making discretion of the states should be taken only where constitutional authority for the action is clear and certain, and the national activity is necessitated by the presence of a problem of national scope." The risks to

federally insured credit unions are concerns of national scope. The NCUA Board believes that the protection of the NCUSIF warrants this rule. It will not unduly burden federally insured state-chartered credit unions. This rule does not impose additional costs or burdens on the state, nor does it affect the states' ability to discharge traditional state government functions.

The benefits provided and protection afforded by the NCUSIF are the same for federally insured state-chartered credit unions as for federally chartered credit unions. It is protection afforded through a federal system. The responsibility for administering that system lies with the NCUA Board. The NCUA Board believes that all federally insured credit unions should continue to be subject to the same conflict provisions in the area of lending. The NCUA Board, pursuant to Executive Order 12612, has determined that this rule may have an occasional direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. However, the potential risk to the NCUSIF without these changes justifies them.

### List of Subjects in 12 CFR Part 701

Credit unions.

By the National Credit Union Administration Board on April 13, 1995.

**Becky Baker,**

*Secretary of the Board.*

For the reasons set forth in the preamble, NCUA proposes to amend 12 CFR part 701 as follows:

### **PART 701—ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS**

1. The authority citation for part 701 continues to read as follows:

**Authority:** 12 USC 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787, 1789, and Public Law 101-73. Section 701.6 is also authorized by 31 USC 3717. Section 701.31 is also authorized by 15 USC 1601, et seq., 42 USC 1981, and 42 USC 3601-3610. Section 701.35 is also authorized by 12 USC 4311-4312.

2. Section 701.21(c)(8) is revised to read as follows:

#### **§ 701.21 Loans to members and lines of credit to members.**

\* \* \* \* \*

(c) \* \* \*

(8) Prohibited fees; exceptions.

(i) Except as otherwise provided in this section, no official or employee of a Federal credit union, or immediate family member of an official or

employee of a Federal credit union, may receive, directly or indirectly, from an outside party or the credit union, any commission, fee, or other compensation in connection with any loan made by the credit union.

(ii) For the purposes of this section:

(A) *Compensation* includes non monetary items.

(B) *Employee* includes an independent contractor.

(C) *Immediate family member* means a spouse or other family member living in the same household.

(D) *Loan* includes line of credit and workout loan.

(E) *Official* means any member of the board of directors or a volunteer committee.

(F) *Senior management employee* means the credit union's chief executive officer (typically, this individual holds the title of President or Treasurer/Manager), any assistant chief executive officers (e.g., Assistant President, Vice President, or Assistant Treasurer/Manager), the chief financial officer (Comptroller), and any other employee who sets policy for the credit union.

(G) *Workout loan* means a loan which has had its original terms changed due to nonperformance or anticipated nonperformance.

(iii) This section does not prohibit a Federal credit union from paying:

(A) Salary to employees;

(B) An incentive or bonus to an employee based on the credit union's overall financial performance;

(C) An incentive or bonus to an employee in connection with processing loans, provided that no such incentive or bonus is paid to a supervisor of the employee, a senior management employee, or an immediate family member of a supervisor or senior management employee;

(D) An incentive or bonus to an employee in connection with making recommended or final decisions to approve or disapprove loans, provided that:

(1) No such incentive or bonus is paid to a supervisor of the employee, a senior management employee, or an immediate family member of a supervisor or senior management employee; and

(2) The incentive or bonus may not be based on the number or dollar amount of loans approved and must be structured in a manner that demonstrably protects against an increase in problem loans;

(E) An incentive or bonus to an employee in connection with collecting loans, provided that no such incentive or bonus is paid to a supervisor of the employee, a senior management employee, or an immediate family

member of a supervisor or senior management employee.

(iv) The board of directors of a Federal credit union shall establish and implement written policies, procedures, and internal controls for any payment of incentives or bonuses to employees in connection with loans made by the credit union. At least quarterly, the board shall monitor compliance with such policies, procedures, and controls. Documentation of such monitoring shall be made available to the supervisory committee and NCUA.

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BILLING CODE 7535-01-U

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 39

[Docket No. 94-NM-131-AD]

#### Airworthiness Directives; British Aerospace Model BAe 146-100A, -200A, and -300A Airplanes

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Notice of proposed rulemaking (NPRM).

**SUMMARY:** This document proposes the adoption of a new airworthiness directive (AD) that is applicable to all British Aerospace Model BAe 146-100A, -200A, and -300A airplanes. This proposal would require repetitive inspections for cracking of fuselage frame 29, and repair, if necessary. This proposal is prompted by testing that revealed fatigue cracking in the web and inboard flange of frame 29. The actions specified by the proposed AD are intended to prevent reduced structural integrity of the fuselage, due to fatigue cracking in frame 29.

**DATES:** Comments must be received by May 31, 1995.

**ADDRESSES:** Submit comments in triplicate to the Federal Aviation Administration (FAA), Transport Airplane Directorate, ANM-103, Attention: Rules Docket No. 94-NM-131-AD, 1601 Lind Avenue, SW., Renton, Washington 98055-4056. Comments may be inspected at this location between 9:00 a.m. and 3:00 p.m., Monday through Friday, except Federal holidays.

The service information referenced in the proposed rule may be obtained from Avro International Aerospace, Inc., 22111 Pacific Blvd., Sterling, Virginia 20166. This information may be

examined at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington.

**FOR FURTHER INFORMATION CONTACT:** William Schroeder, Aerospace Engineer, Standardization Branch, ANM-113, FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington 98055-4056; telephone (206) 227-2148; fax (206) 227-1320.

#### SUPPLEMENTARY INFORMATION:

##### Comments Invited

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications shall identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this notice may be changed in light of the comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report summarizing each FAA-public contact concerned with the substance of this proposal will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: "Comments to Docket Number 94-NM-131-AD." The postcard will be date stamped and returned to the commenter.

##### Availability of NPRMs

Any person may obtain a copy of this NPRM by submitting a request to the FAA, Transport Airplane Directorate, ANM-103, Attention: Rules Docket No. 94-NM-131-AD, 1601 Lind Avenue SW., Renton, Washington 98055-4056.

##### Discussion

The Civil Aviation Authority (CAA), which is the airworthiness authority for the United Kingdom, recently notified the FAA that an unsafe condition may exist on all British Aerospace Model BAe 146-100A, -200A, and -300A airplanes. The CAA advises that, during fatigue testing of the fuselage, cracking was discovered in the web and inboard flange of frame 29 between stringers 12