outside the credit union in areas such as insurance or real estate, where customers of the outside business choose to obtain loans from the credit union

The Board wishes to make clear that this action is not intended to encourage lending-related incentives. In the preamble to the proposed rule, the Board expressed some of its concerns regarding incentive pay, particularly for lending activities. However, this liberalization and deregulation reflects the recognition that there are good arguments and strongly held beliefs on both sides of the incentive pay issue. It is the Board's determination, in light of those considerations and the comments received, that NCUA should structure a rule that involves basic controls and safety and soundness standards and that, beyond that, allows a memberelected board of directors to decide whether to use incentives. Of course, NCUA reserves the right to take exception to any compensation plan for safety and soundness reasons.

Analysis

The supplementary information section of the preamble stated that the structure of the regulation had been changed to make it easier to interpret and administer. The preamble noted that it had been difficult to determine, in the current regulation, whether an activity was part of "underwriting, insuring, servicing, or collecting" a loan. The proposed regulation only required that an activity be "in connection with" a loan. The preamble stated that NCUA would take a reasonableness approach to that determination.

In an effort to illustrate the distinction between activities in connection and not in connection with lending, the preamble provided examples. The following were presented as being not in connection with lending: (1) Purchasing loan application forms from a company owned by an official; and (2) Financing a home (already) built by a construction company owned by an official. In contrast, the following were presented as being in connection with lending: (1) Obtaining a credit report from a credit bureau owned by an official; and (2) Referring a member to a construction company owned by an official to have a home built and financing the construction of the home.

Eleven commenters stated that the phrase "in connection with" was too broad or too vague. Two commenters stated that the examples provided did little to clarify the scope of coverage of the regulation.

The Board continues to believe that the proposed prohibition would be easier to administer than the current regulation and has therefore retained it in the final rule. The Board acknowledges, however, that the examples provided were not helpful. Rather than trying to determine whether an activity is significant enough to be considered "in connection with" a loan, the Board has concluded that any activity that is directly linked to lending should be considered to be "in connection with" a loan. Under that analysis, each of the four examples discussed above involves an activity that is in connection with a loan.

Proposed paragraph (8)(ii) set forth definitions, only three of which elicited comment. The proposed regulation defined "compensation" as including non monetary items, and a few commenters stated that items of nominal value should be excluded. The Board agrees, and has changed the definition accordingly. Items of nominal value are those with a value so small as to make accounting for them unreasonable or administratively impracticable. The board of directors of a credit union may look to Internal Revenue Service law regarding income and de minimus fringe benefits, 26 USC 132, for guidance in this area.

The proposed regulation defined "employee" to include independent contractor. The intent was to prevent credit unions from evading the rule by calling an individual who is essentially an employee an independent contractor. Several commenters objected to including independent contractors in the definition of employee. They said that it would have the effect of prohibiting any lending-related compensation to any independent contractors or third parties. The Board agrees and has deleted the term 'independent contractor'' from the final rule. The Board notes, however, that NCUA will treat an individual functioning as an employee as such for the purposes of § 701.21(c)(8).

The proposed regulation defined 'senior management employee'' as it is defined elsewhere in the NCUA regulations (the chief executive officer, any assistant chief executive officers, and the chief financial officer) but added the phrase, "and any other employee who sets policy for the credit union." Several commenters objected to this addition, arguing that it was too broad and muddied the distinction between senior management and other employees. The Board agrees and has deleted the phrase from the final rule.

Finally, in the final rule the Board has deleted the definition of "workout loan"

as unnecessary and added a definition for "volunteer official." A volunteer official is a director or committee member who is not compensated as such. Federal credit unions are permitted to compensate one director solely for his or her service on the board, and many state-chartered credit unions are permitted by state law to compensate one or more directors for such service. Under the final rule, a director so compensated would not be considered a volunteer official.

Paragraph (8)(iii) of the proposed regulation set forth five exceptions to the prohibition against lending-related compensation. Exception (A), salary for employees, was met with universal approval from the commenters. Exception (B) was an incentive or bonus to an employee, including a senior management employee, based on the credit unions overall financial performance. This codified a position that had been taken in an opinion letter from NCUA and also was supported by the commenters. Accordingly, exceptions (A) and (B) have been retained in the final rule.

Exceptions (C), (D), and (E) authorized payment of an incentive to an employee in connection with processing a loan, making a decision to approve or disapprove a loan, and collecting a loan, respectively, provided that no incentive or bonus was paid to a supervisor of the employee, a senior management employee, or an immediate family member of a supervisor or senior management employee. Exception (D) additionally required that an incentive paid in connection with making a loan decision not be based on the number or dollar amount of loans approved and be structured in a manner that demonstrably protected against an increase in problem loans.

Sixteen commenters said that non senior management should be permitted to receive incentives. Many said that the prohibition against payment of incentives to supervisors would disproportionately affect large credit unions. They argued that lower level supervisors would be caught between senior management, who receive bonuses based on overall performance, and front-line employees, who are eligible for incentive pay. In response to the comments, the Board has removed the prohibition against supervisors receiving incentive pay from the final rule.

Thirty-eight commenters objected to the prohibition against basing incentives on the number or dollar amount of loans approved. Most said there were no other reasonable measures on which to base incentives for loan officers. As