



August 3, 2009

VIA EMAIL TO [REGCOMMENTS@FHFA.GOV](mailto:REGCOMMENTS@FHFA.GOV):

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Fourth Floor  
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Washington, D.C. 20552  
Attention: Comments/RIN 2590-AA12

Re: Proposed Rule on Executive Compensation, RIN 2590-AA12

Dear Mr. Pollard:

On behalf of the board of directors of the Federal Home Loan Bank of Cincinnati (“FHLBank Cincinnati”), we are writing to comment on the Federal Housing Finance Agency’s (“FHFA”) proposed rule on Executive Compensation (the “Proposal”), which was published on June 5, 2009.<sup>1</sup> The Proposal contains proposed executive compensation regulations that would implement sections 1113 and 1117 of the Housing and Economic Recovery Act of 2008 (“HERA”) with respect to the Federal Home Loan Banks (collectively, the “FHLBanks”, and individually, an “FHLBank”). We welcome this opportunity to comment on the Proposal.

I. Summary of Principal Concerns Regarding the Proposal

A. Implications of a Member-Controlled Cooperative Structure for FHLBank Executive Compensation

The principal thrust of the Proposal, which is to in effect substitute the FHFA’s formula regarding compensation of FHLBank executives for the business judgment of the boards of directors of individual FHLBanks, is not consistent with applicable law and is not based on supportable legal, economic or business factors. The Proposal’s approach fails to recognize that the unique cooperative structure of the FHLBanks, as well as their disclosure obligations under

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<sup>1</sup> 74 Fed. Reg. 26989 (2009) (to be codified at 12 C.F.R. pt. 1230).

the Securities Exchange Act of 1934 (“Exchange Act”), combine to ensure that the member-controlled boards of directors of the FHLBanks consistently set executive compensation at a market-driven level. This compensation balances (1) the need to attract and retain talented individuals to manage large, complex financial institutions that have a statutorily-mandated mission to support the financing of housing and associated community development in local markets across the United States along with (2) the need to minimize operating expenses in order to permit the FHLBanks to provide the best combination of product rates and dividends to their member institutions. No government should seek to impose its compensation judgments in a system where the co-op owners who gain or lose from their decisions about executive compensation have legally mandated majority representation on each FHLBank’s board of directors.

The FHLBanks all have similar attributes. As a general matter, the FHLBanks’ principal focus is on meeting their housing and community development mission by servicing the financing needs of their member commercial banks, thrifts, credit unions and insurance companies by making advances to their member institutions, maintaining mission-consistent investment portfolios and holding acquired member assets. The assets of the FHLBanks today stand at approximately \$1.2 trillion. The principal financing of the FHLBanks’ operations is provided by the issuance of consolidated obligations through the Office of Finance of the FHLBanks, for which the individual FHLBanks are each jointly and severally liable. The FHLBanks currently have approximately \$1.1 trillion of consolidated obligations outstanding. The funding of the FHLBanks is an exceptionally active process with over \$43.6 billion in consolidated obligations being issued during the week of July 6, 2009. The management of such large and complex balance sheets presents a very significant challenge.

In addition to providing a stable low-cost funding source for member institutions involved in housing finance and community development lending, the FHLBanks also serve an important public mission. The FHLBanks operate an Affordable Housing Program (“AHP”) under which they provide grants and interest rate subsidies to their member institutions to support affordable housing projects. The FHLBanks also operate a Community Investment Program (“CIP”) through which member institutions have access to funding for lending to lower income borrowers. These programs provide significant support for member institutions in their efforts to meet community needs throughout the country.

By law, each FHLBank is operated independently of the other eleven FHLBanks. Each FHLBank is owned by member institutions in its specified geographic area. Each FHLBank is overseen by an independent board of directors elected by the members of the FHLBank. A majority of the board is comprised of “member” directors – i.e., persons who are directors or officers of member institutions. The remainder of the directors are referred to as “independent” directors. These independent directors (who cannot be an officer of any FHLBank or a director, officer or employee of any member of the FHLBank) are either public interest directors who have experience in representing consumer or community interests in financial services or housing, or directors who have knowledge of specified areas including accounting, financial

management or risk management. Each board of directors is subject to normal fiduciary obligations to protect the interests of the shareholders of the FHLBank.

The locally based board of directors of each FHLBank oversees the cooperative with a direct appreciation of the unique circumstances facing its individual institution. This, of course, includes an understanding of strategic goals of the FHLBank and the qualifications of the executives that are most important to the particular institution. It also involves an understanding of the competitive compensation environment that exists in the unique geographic markets in which each of the twelve FHLBanks operates across the full breadth of the nation.

Compensation decisions have been and will continue to be a critical aspect of the function of the FHLBanks' boards of directors. The ability to provide compensation arrangements that allow an FHLBank to attract and retain highly qualified executives, especially during a period of extraordinary financial turmoil, is a tool that is essential to the board's ability to ensure the effective operation of the FHLBank. At the same time, board members are acutely aware of the need to operate an FHLBank in the most efficient manner possible and the need to be effective at fulfilling the FHLBank's missions for its members and the public, since all costs come out of the pockets of the members, and a majority of directors must be either an officer or director of a member. Moreover, from a public perspective, efficient operation of an FHLBank enhances the ability of an FHLBank to support its AHP and CIP initiatives. Since compensation is a major element of FHLBank non-interest expenses, ensuring that executive compensation levels do not exceed the amounts necessary to meet an FHLBank's requirements is a key focus of board attention. The balancing of these competing considerations is a quintessential example of the business judgment that is exercised by the boards of directors of the FHLBanks and the best form of market discipline.

#### B. Transparency of the FHLBanks Executive Compensation Process

The FHLBank executive compensation process is conducted in a very transparent manner. Each FHLBank is registered with the Securities and Exchange Commission ("SEC") under the Exchange Act. As Exchange Act registrants, the FHLBanks are required to provide, among other information, a detailed annual description of their compensation practices. This typically includes a discussion of an FHLBank's compensation philosophy, the roles played by its board and board compensation committee, their use of independent consultants or outside compensation survey information, the peer or comparator institutions that they look to, and the results of the operation of these processes with respect to certain key executives. This discussion, which is referred to as the Compensation Discussion and Analysis ("CD&A"), is included in each FHLBank's annual Form 10-K. As may be required, additional compensation information is also provided periodically in Forms 8-K filed by the individual FHLBanks. As a result of these requirements, members of the FHLBanks and the public in general are fully informed as to the FHLBanks' executive compensation process as well as to the amounts and elements of compensation.

C. Consideration of the Impact of the FHLBanks' Cooperative Structure Under 12 U.S.C. § 4513(f)

Under 12 U.S.C. § 4513(f), prior to promulgating any regulation that applies to the FHLBanks, the FHFA Director is required to consider the differences between the FHLBanks and Freddie Mac and Fannie Mae (“Enterprises”) with respect to, among other things, the FHLBanks’ cooperative structure. The Proposal requested comments on the application of section 4513(f). As discussed above, because the member-controlled cooperative structure of the FHLBanks (which is not present at the Enterprises) directly and dramatically mitigates against the possibility that an FHLBank’s board of directors will compensate the FHLBank’s executive officers in excess of compensation comparable with other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities, it is particularly inappropriate to impose a regulatory structure on the FHLBanks that effectively shifts the principal responsibility for establishing FHLBank executive compensation from each FHLBank’s compensation committee or board of directors to the FHFA.

II. The Proposal Violates the Statutory Prohibition on the FHFA Setting FHLBank Executive Compensation and Unwarrantedly Usurps the Authority and Responsibility of the FHLBanks Boards of Directors

We believe that the Proposal violates the prohibition in 12 U.S.C. § 4518(d) that prohibits the FHFA Director from prescribing or setting “*a specific level or range of compensation.*” Two elements of the Proposal lead to this conclusion.

- First, the preamble to the Proposal contains the following statement:

in order to take into account the Banks’ size and structure, FHFA may consider the Federal Reserve Bank and the Farm Credit Banks as examples of appropriate comparators to assess the reasonableness and comparability of executive compensation provided by the Banks.<sup>2</sup> (emphasis added).
- Second, proposed section 1230.2, which, among other things, establishes a definition of “comparable”, provides that:

FHFA generally considers comparable to be at or below the median compensation for a given position at similar institutions. In particular circumstances, consideration as described in paragraph (1) of this definition, may indicate the

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<sup>2</sup> 74 Fed. Reg. at 26990.

appropriateness of higher or lower benefit amounts to which FHFA would not object. (emphasis added).

There can be no dispute that the practical effect of the FHFA (i) appearing to designate particular comparator institutions to determine compliance with the regulation, and (ii) imposing a presumptive cap of “at or below the median” on compensation by reference to those particular institutions, would be to prescribe or set a specific level or range of compensation. This is precisely what Congress prohibited the FHFA Director from doing in 12 U.S.C. § 4518(d), which provides as follows:

**(d) Prohibition of setting compensation**

In carrying out subsection (a) of this section, the Director may not prescribe or set a specific level or range of compensation.<sup>3</sup>

However, under the FHFA’s intended approach, as reflected in the preamble and the text of the proposed rule, the FHFA would effectively take control of the compensation process, thereby displacing the business judgment of the twelve individual FHLBanks’ boards of directors and compensation committees. This result is neither legally permissible under 12 U.S.C. § 4518(d), as enacted by section 1113 of HERA,<sup>4</sup> nor warranted as a matter of appropriate corporate governance or regulation of the FHLBanks.

We do not believe that Congress intended for section 1113 of HERA to be applied in a manner that so dramatically strips the boards of directors of the FHLBanks of their authority and proper incentives in making sound executive compensation decisions. Section 12 of the Federal Home Loan Bank Act authorizes the FHLBanks to hire and set the compensation of FHLBank executives. While HERA authorizes the FHFA to review FHLBank compensation, it did not alter the fundamental authority of the board of directors of each FHLBank to set executive compensation.

The Federal Housing Finance Board (“FHFB”), the predecessor to the FHFA with respect to the FHLBanks, made it clear that a key responsibility of an FHLBank board of directors was to “hire and retain competent management.”<sup>5</sup> In that regard, the FHFB indicated that an

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<sup>3</sup> The same provision initially was enacted as part of the Federal Housing Enterprises Financial Safety and Soundness Act (“1992 Act”) and provided that: “In carrying out subsection (a) of this section, the Director may not prescribe or set a specific level or range of compensation.” Subsection (a) of 12 U.S.C. § 4518 requires the Director to prohibit the FHLBanks from paying executive compensation that is not reasonable and comparable with compensation for employment in other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities.

<sup>4</sup> Nor is the FHFA’s intended approach permitted under proposed section 1230.3(d), which repeats the compensation setting prohibition contained in 12 U.S.C. § 4518(d).

<sup>5</sup> FHFB Office of Supervision Examination Manual April 2007 at 6.2.

FHLBank's board of directors would be evaluated based on, among other things, its oversight of management's performance and compensation, including "the establishment and periodic review of compensation which is reasonable in view of an officer's performance and the condition, operating performance and risk profile of the FHLBank."<sup>6</sup>

The FHFA's approach would impose uniform FHFA-mandated compensation outcomes on a widely divergent set of FHLBanks that operate in different circumstances, under different strategies, and in different markets. Instead of **reviewing** the reasonableness of the outcome of an individual FHLBank's compensation committee's or board of directors' compensation process against the statutory standard of reasonableness and comparability with "other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities,"<sup>7</sup> the FHFA effectively would be dictating an outcome to the FHLBanks' boards of directors, thereby assigning to the FHFA the role that is properly assigned to the FHLBanks' boards of directors.

The FHFA's intention is made clear in proposed section 1230.3(a), which provides that:

No regulated entity or the Office of Finance shall pay compensation to an executive officer that is not reasonable and comparable with compensation paid by such similar businesses involving similar duties and responsibilities. (emphasis added.)

This provision does not appear in 12 U.S.C. § 4518(a). When read in the context of the FHFA's suggested comparable entities and the use of a median compensation level, the Proposal appears to be an effort by the FHFA to compel the individual FHLBank boards of directors to acquiesce to the FHFA's usurpation of their authority and responsibility to determine executive compensation. Instead of undertaking an independent evaluation and determination process, the compensation committee and board of directors could be presented with a *fait accompli* by the FHFA.

As a practical matter, under the Proposal, the FHFA would be able to impose on FHLBank boards of directors the determination of which entities are relevant comparator institutions and the FHFA would also be able to impose a median comparator compensation level as a *de facto* compensation cap. Thus, it appears that the legal framework and limitations specified by Congress are being ignored by the FHFA in the Proposal.

Section 1113 of HERA has assigned to the FHFA an important oversight role in ensuring that executive compensation decisions made by the FHLBanks are reasonable and comparable, but has prohibited the regulator from setting caps, limits or ranges on such executive

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<sup>6</sup> Id. at 6.29.

<sup>7</sup> 12 U.S.C. § 4518(a).

compensation decisions. We believe that this careful balance reflects a recognition by Congress that each participant in the executive compensation process, both directors and the regulator, benefit from the proper involvement of the other. Directors are best positioned to engage in the highly-individualized process of determining comparator institutions and specific percentile ranges for executive compensation, while the regulator is intended to review these decisions carefully and objectively to ensure that they are reasonable and comparable.

There is no indication in the Proposal that the FHFA considered, in any respect, the extensive independent compensation setting process that each FHLBank's compensation committee or board of directors followed as set forth in great detail in the CD&A section of each FHLBank's Form 10-K for 2006, 2007 and 2008. We believe that a fair evaluation of the description in the Form 10-Ks of the FHLBanks' independent board controlled compensation processes, which typically have made use of outside compensation experts, would confirm that those processes establish a firm foundation for the FHFA's review of an individual FHLBank's determination of reasonable compensation for its executive officers that is intended by 12 U.S.C. § 4518(a).<sup>8</sup>

The current executive compensation regulations governing the Enterprises<sup>9</sup> promulgated by the Office of Federal Housing Enterprise Oversight in 2001 ("OFHEO Compensation Rule") under substantively similar statutory requirements do not include a specific presumptive percentage cap relative to comparator institution compensation that would apply to the Enterprises' executive compensation determinations. Nor does the OFHEO Compensation Rule or its preamble specify particular comparator institutions for the Enterprises. We believe that the approach taken in the OFHEO Compensation Rule in these respects is correct and that the FHFA should use this approach in any final rule applying to the FHLBanks.

We note that the FHFA in the preamble to the Proposal indicated particular institutions that it might consider to be appropriate comparators for the FHLBanks as a whole, but did not offer any indication of which institutions it would consider to be appropriate comparators for Freddie Mac and Fannie Mae. On the surface, it would appear to be easier for the FHFA to make such identification in regard to the Enterprises. All of their principal operations are located in a single metropolitan area, rather than being scattered across twelve cities of dramatically varying levels of size and business and financial activity. Moreover, while the twelve FHLBanks each operate under their own independent member-controlled board of directors, Freddie Mac and Fannie Mae both operate under the direction of the FHFA as their conservator.

It is widely recognized that it is difficult for a government agency to both regulate and operate a financial institution simultaneously. These conflicts are compounded when the government agency also is responsible for regulating other entities that it does not operate under conservatorship -- and where such other entities are in actual or potential competition with

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<sup>8</sup> The FHLBanks' general compensation practices are described in detail in Section III below.

<sup>9</sup> 12 C.F.R. pt. 1770.

businesses the FHFA is operating. In this regard, the FHLBanks currently are competing for funding with the Enterprises. Furthermore, there is the potential for full-scale mortgage securitization competition between the FHLBank and the Enterprises.<sup>10</sup> Under these circumstances it is essential that the FHFA avoid any indication that it is treating entities in which it has a direct operational role as conservator in a manner that seems more favorable than the treatment it is giving to other non-conservatorship entities.

III. The FHFA Should Not Select Comparator Institutions or Establish Presumptive Compensation Caps Either Formally or Informally in Connection with the Executive Compensation Rule

A. Current FHLBank Compensation Practices

The FHLBanks take executive compensation very seriously. Compensation decisions at the FHLBanks are made by the individual FHLBanks boards of directors, and particularly their compensation committees. Under the terms of the Federal Home Loan Bank Act (“Bank Act”), FHLBank boards may not include any representatives of FHLBank management, but rather are composed of representatives of the FHLBank’s member institutions and independent board members. Under the Bank Act, the majority of each of the FHLBank’s boards is comprised of representatives of member institutions who would have no incentive to provide excessive compensation to FHLBank executive officers, since such payments would drive down earnings available for distribution to their member institutions. In addition, each FHLBank uses (and discloses the use of) independent, third party compensation consultants and/or independent market data sources in reviewing and establishing compensation.

The CD&A sections from the FHLBanks’ Form 10-Ks for each of the last three years demonstrate the executive compensation process undertaken by the FHLBanks. We believe that a review of each of these FHLBanks’ compensation practices will enable the FHFA to make the judgment that executive compensation at the FHLBanks is reasonable and comparable as required under HERA.

There is no single formula for setting compensation among the FHLBanks. A review of the FHLBanks’ descriptions of their compensation processes demonstrates that the peer groups and benchmarking percentages differ for each FHLBank.<sup>11</sup> This reflects the differences in the competitive employment environment confronting each individual FHLBank and the individualized strategic approaches and analysis that each FHLBank’s compensation committee and board of directors undertakes in determining the FHLBank’s compensation levels. For the FHFA to select one peer group for the entire FHLBank System and to establish a presumptive

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<sup>10</sup> FHFA Study of Securitization of Acquired Member Assets, 74 Fed. Reg. 8955 (2009).

<sup>11</sup> See Appendix A which sets forth information on compensation peer groups from the CD&As of each FHLBank for the 2008 fiscal year.



benchmarking percentage for all the FHLBanks would violate 12 U.S.C. § 4518(d), and indeed the proposed rule itself, by effectively setting *de facto* compensation levels.

The FHFA should not seek to substitute its judgment for that of compensation committees or boards of directors in determining comparables. The compensation committees and boards of directors, should, with the outside advice and assistance that they deem appropriate, determine the appropriate comparables and adjust them, as they deem appropriate. The FHFA should only intervene in this process if the determinations of an FHLBank compensation committee or board of directors are manifestly unreasonable or proper procedures are not followed.

In addition, the approach the FHFA is suggesting is significantly at odds with the FHLBanks' current disclosures required under Item 402(b) of the SEC's Regulation S-K. Each FHLBank is required to include in its CD&A a discussion of its compensation philosophy and how compensation actually paid to executive officers fits into that philosophy. Specially, each FHLBank must discuss whether it has engaged in any benchmarking and if so, identify and explain the rationale for the relevant comparables as well as specific benchmarking targets. Therefore, if the proposed rule were adopted in its present form, the CD&As for the FHLBanks would likely have to include a statement that the peer groups and benchmarking percentages are set by the FHFA rather than at the discretion of the FHLBanks boards of directors.

#### B. Similar Institutions and Peer Groups

In selecting peer groups, a task that is performed typically with the assistance of compensation consultants, the FHLBanks focus on competitors from both business and labor market perspectives. Factors considered include (i) operations in similar geographic markets, (ii) company size by assets, revenues, and employee population, and (iii) complexity and similarity of business functions. FHLBanks also consider firms from which the FHLBank historically has hired employees, firms to which the FHLBank has lost employees, and firms that regularly are identified as having qualified candidates by internal and external recruiters. The FHLBanks focus on the realistic employment opportunities for their executives in assessing comparability, since their key compensation objectives include attracting and retaining executives.

The FHFA should not dictate which entities are similar institutions for compensation purposes. Rather, it should review the reasonableness of the determinations of comparable institutions made by the FHLBanks. The problem with having the FHFA take on the unwarranted authority to make compensation comparator determinations is illustrated by the suggestion in the Proposal that the Federal Reserve Banks and Farm Credit Banks are appropriate comparators. Section 1113 of HERA directs the FHFA to look to compensation levels at similar businesses, including other publicly traded financial institutions or major financial services companies. Using this approach, we believe the FHFA would, in assessing appropriate comparators, have identified the types of institutions that generally have been cited by FHLBanks in their compensation setting processes – namely, generally publicly traded regional and national bank holding companies and other large publicly traded financial services firms and other FHLBanks.

In contrast, the FHFA cited in the preamble to the proposed rule the Federal Reserve Banks and the Farm Credit Banks as examples of possible comparators. However, the FHFA gives no indication that it analyzed actual comparative compensation among the executive officers of the Federal Reserve Banks, the Farm Credit Banks, and the FHLBanks.<sup>12</sup> Nor does it give any indication as to whether it has evidence that the FHLBanks are in actual or potential competition for current or prospective employees with the Federal Reserve Banks or the Farm Credit Banks, a fact that would appear to be critical to any assertion that these are appropriate comparators for purposes of assessing the reasonableness and comparability of FHLBank executive compensation. We also note that these institutions are neither publicly traded nor registered with the SEC under the Exchange Act.

C. Federal Reserve Banks and Farm Credit Banks

We believe that the Federal Reserve Banks and Farm Credit Banks are not appropriate comparators, and as such the final rule should make it clear that the FHLBanks are expected to make their own individual determinations regarding comparator institutions and that the FHFA will not purport to engage in this function. The final rule should also make it clear that the FHFA's function in this regard will be limited to reviewing the comparator decision made by an FHLBank. Such a review will appropriately consider the process that the FHLBank undertook in reaching a comparator decision; however, the regulator will not substitute its views for the business judgment of an FHLBank's compensation committee or board of directors.

The FHLBanks do not generally compete for talent with the Federal Reserve Banks. Historically, employees of the Federal Reserve Banks generally do not move to the FHLBanks or vice versa. The last time the FHLBank Cincinnati looked at the Federal Reserve for potential employees was in 1980 when it began its NOW account processing services for the thrift industry. This business was subsequently sold to a private firm in 1995. The reality of employment competitors as it relates to the FHLBanks and the lack of relevance of the Federal Reserve Banks is described in a paper by McLagan Partners, an executive compensation consulting firm that provides consulting services to a majority of the FHLBanks, which is attached hereto as Appendix B ("McLagan Paper").

Nor are the Federal Reserve Banks appropriate comparators from a business perspective. The Federal Reserve Banks fundamentally are engaged in very different lines of activity than the FHLBanks. The Federal Reserve Banks are the front-line component of the regulatory, supervisory and enforcement operations of the Board of Governors of the Federal Reserve System. Included among their regulatory responsibilities are the examination and supervision of state member banks and bank holding companies and their affiliates. The Federal Reserve Banks

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<sup>12</sup> In that regard, we are not aware that the Federal Reserve Banks publicly disclose the individual compensation of their executive officers. The Board of Governors of the Federal Reserve System in its annual report discloses information regarding the salary (and not any other forms of compensation) of the President of each Federal Reserve Bank and does not provide any compensation information regarding other executive officers of the Federal Reserve Banks. The five Farm Credit Banks disclose individual level compensation information only for their chief executive officers.

also play a major role in the payments system and currency system. Historically, Federal Reserve Banks have been engaged in lending activities to depository institutions only on a short-term basis. Furthermore, financing of Federal Reserve Bank operations is fundamentally intertwined with the issuance of U.S. currency.

In contrast to the Federal Reserve Banks, the FHLBanks have not had any regulatory responsibilities for almost two decades. Nor are they engaged in the payment and currency system activities of the Federal Reserve Banks. Instead, they focus on providing a full range of short-, medium-, and long-term lending products to member institutions. This activity is far different than the very limited short-term lending activity of the Federal Reserve Banks. Unlike the Federal Reserve Banks, the FHLBanks must fund their operations through market borrowings for which the FHLBanks do not have any statutory or explicit U.S. government guarantee. As a result, FHLBanks, as is evidenced by the significant regulatory and examination structure that applies to them, are subject to market and credit risk considerations far different from those facing Federal Reserve Banks. In short, Federal Reserve Banks are not appropriate comparator institutions for FHLBanks.

Likewise, the Farm Credit Banks are not appropriate comparators. The FHLBanks do not compete for talent with the Farm Credit Banks. Historically, employees of the Farm Credit Banks generally do not move to FHLBanks, nor do employees of the FHLBanks generally move to the Farm Credit Banks. As discussed in the McLagan Paper, the FHLBanks do not view the Farm Credit Banks as comparator institutions. Moreover, the nature of the respective businesses within each FHLBank is very different from that of the Farm Credit Banks, which service the agricultural sector. The FHFA should not impose a determination that the Farm Credit Banks are appropriate comparator institutions for the FHLBanks.

#### D. Benchmarking Percentages

The FHFA may not mandate that “comparable [compensation] ... be at or below the median compensation for a given position at a similar institution.”<sup>13</sup> Such prescription violates the language in the 1992 Act which was effectively unchanged in HERA; further, section 1230.3(d) of the Proposal states that the FHFA Director may not prescribe or set a specific level or range of compensation. OFHEO did not make any effort to mandate a particular benchmark percentage in the OFHEO Compensation Rule. By purporting to delineate the appropriate comparator group and providing that each FHLBank must presumptively pay compensation at or below the median compensation of the comparator institutions, the FHFA effectively mandates compensation at a certain level in violation of the prohibition in 12 U.S.C. § 4518(d) and proposed section 1230.3(d).

Under 12 U.S.C. § 4518, the FHFA may not mandate a specified benchmarking level for compensation by establishing a presumption that FHLBanks must pay compensation at or below the median compensation. Again, a review of the Form 10-Ks filed by the FHLBanks indicates

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<sup>13</sup> Proposed section 1230.2.

that, although many of the FHLBanks' boards of directors have chosen to utilize the median level, others look to the 65<sup>th</sup> percentile or the 75<sup>th</sup> percentile. The critical point is that this choice, consistent with 12 U.S.C. § 4518 and corporate governance principles under the Bank Act, should be made by the individual FHLBank's compensation committee or board of directors utilizing their own business judgment and not dictated by the FHFA. The FHFA should only intervene in this process if the determinations of an FHLBank compensation committee or board of directors are manifestly unreasonable or proper procedures are not followed.

In addition, the FHFA ignores the reality that benchmarking is not done in isolation but is related to (i) the entity chosen as comparable, (ii) the position chosen at the "comparable" entity, (iii) individual performance or other factors, and (iv) a review of the total employment proposition. Benchmarking positioning will vary depending on the peer group. For example, many CD&As disclose that the benchmarking percentage is different when looking at (i) other FHLBanks and (ii) other comparators. Second, benchmarked jobs typically are selected based on division, role, and level of responsibilities, considering only "realistic employment opportunities" for each executive. Third, the benchmarking target at some FHLBanks may increase or decrease depending on individual performance or other factors. Finally, benchmarking takes into account all aspects of compensation to ensure that total compensation is appropriate.

A general description of the benchmarking process used at the FHLBanks is described in the McLagan Paper and in the CD&As of the respective FHLBanks filed as part of their Form 10-Ks. As with the selection of comparator institutions, each FHLBank undertakes this process in a manner that allows it to address its particular allocation of functions and personnel strength and weaknesses. The Proposal sweeps past this highly nuanced individualized process and seeks to apply a 'one size fits all' presumptive compensation cap to the FHLBanks. We therefore urge the FHFA to delete the provision in proposed section 1230.2 that establishes a presumptive compensation cap, and instead follow the approach in the OFHEO Compensation Rule which avoids any specific regulatory statement regarding appropriate comparative compensation levels.<sup>14</sup>

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<sup>14</sup> We further request that the FHFA delete the reference in clauses (1) and (2) of the definition of "reasonable and comparable" compensation to compensation taken "in whole or in part" and replace it with "taken as a whole." We believe that if an executive's compensation package taken as a whole is reasonable and comparable to compensation at similar institutions for similar duties, the FHFA should not be permitted to reject a discrete element of an executive's compensation as excessive.

We also request that clause (1)(iv) of the definition of reasonable and comparable compensation be revised to clarify that the goals referenced also could be those of a division, department, or unit of a regulated entity, rather than just personal goals for the individual or enterprise-wide goals. We further request that clause (1)(iv) be revised to eliminate the reference to "guidance." While compliance with FHFA regulations and orders, and written agreements with the FHFA is mandatory and subject to enforcement action by the FHFA, "guidelines" issued by the FHFA under its 12 U.S.C. § 4526 authority do not constitute the basis for an FHFA enforcement action. Given the apparent advisory status of "guidance" or "guidelines", they should not form the basis for an evaluation of executive compensation.

IV. The Proposal Appears to Put an FHLBank Executive Officer At Risk With Respect to all Compensation the Officer May Have Received Or Earned, and is Likely to Make it Difficult For FHLBanks to Attract or Retain Highly Qualified Executive Officers.

Proposed section 1230.3 appears to give the FHFA the authority to direct an FHLBank to permanently withhold payment, transfer or disbursement of any compensation of an FHLBank executive officer based on any factors the FHFA Director considers relevant. Moreover, the proposed rule does not place any limitations on:

- The types of compensation that are subject to being permanently withheld;
- The time period in which the alleged factor justifying the withholding occurred;
- When the compensation to be withheld was earned; and
- The time period in which an action by the FHFA must be commenced and/or concluded.

Furthermore, proposed section 1230.7 refers to the possibility that the FHFA could take corrective or remedial action, including an enforcement action to require an FHLBank executive officer to make restitution or reimbursement of “excessive compensation.” Under this provision, the FHFA appears to suggest that it cannot only prohibit earned compensation from being paid to an FHLBank executive officer, but that it can require an FHLBank executive officer to repay compensation the officer has already received under the claim that such compensation was “excessive compensation.” Proposed section 1230.7 provides no limitations on the FHFA’s purported enforcement or other corrective or remedial authority in this regard.

The combination of proposed sections 1230.3 and 1230.7 and the absence of any apparent limitations on the FHFA’s exercise of this authority with respect to time or scope can only have a detrimental effect on the recruitment and retention of FHLBank executive officers. Such executive officers should not have to be concerned that an exercise of unfettered agency discretion could eliminate the financial results of years of hard work over an amorphous dispute as to what constitutes “excessive compensation.”

We urge the FHFA to consider this negative consequence to the operations of the FHLBanks in developing the final rule and to modify the rule to provide reasonable and appropriate limitations on the FHFA’s exercise of any authority under proposed sections 1230.3 and 1230.7.

V. The FHFA Should Limit the Scope of the Definition of ‘Executive Officer’ for the FHLBanks

Proposed section 1230.2 provides a list of persons by title or area of responsibility who are considered executive officers for the FHLBanks. The proposed section includes those executive officers deemed “named executive officers” under the SEC’s disclosure requirements,

as well as additional persons based on role and reporting responsibility. It further provides that the FHFA “Director may add or remove persons, or functions to or from the list set forth... by communication to the [FHL]Banks or a [FHL]Bank at any time.”

We request that the definition of executive officer of an FHLBank be modified to incorporate a ‘bright line’ test such as up to the ten most highly compensated employees at each FHLBank. There are currently eight such positions at the FHLBank Cincinnati. We believe that, across the FHLBanks, the individuals who have combined management and strategic responsibilities would likely be included in the top ten most highly compensated group, thus providing coverage to the key employees who are presumably of interest to the FHFA. As such, having the Proposal apply to the ten highest compensated officers should ensure that the FHFA has comprehensive coverage of the top compensation structure at each FHLBank in order to perform its obligations under 12 U.S.C. § 4518.

VI. The Proposal Should be Modified to Clearly Explain How It Will Apply to the FHLBanks

The intended application of the Proposal to the FHLBanks is not clear. We will first discuss the sources of the lack of clarity, and then suggest potential revisions to address these issues.

- Under proposed sections 1230.5(b)(1)-(5) and (7), an FHLBank is required to submit certain compensation related information to the FHFA for its review within one week after a specified event has occurred. The compensation related information could include actions that could result in an immediately effective increase in an executive officer’s compensation. However, nothing in the proposed sections suggests that there is any restriction on an FHLBank’s ability to immediately implement such increases in executive officer compensation.<sup>15</sup>
- Proposed section 1230.3(c) provides that:

During a review under paragraph (a) of this section, the Director *may* require a regulated entity or the Office of Finance to withhold any payment, transfer or disbursement of compensation to an executive officer, or to place such compensation in an escrow account. (emphasis added).

This provision appears to suggest that if an FHLBank is expected by the FHFA to take any action with regard to an executive officer’s compensation, it will be

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<sup>15</sup> In an October 1, 2008 memorandum, FHFA Acting Deputy Director Ronald Rosenfeld informed the FHLBanks that pending FHFA action on section 1113 of HERA they should submit to the FHFA all compensation actions relating to the five most highly compensated officers, including compensation plans of general applicability to those officers at least four weeks in advance of any planned board of directors action with respect to such actions, including studies of comparable compensation.

directly and expressly informed of such a directive by the FHFA. However, proposed section 1230.3(c) does not contain any provision for such notification.

- Neither the preamble to the Proposal nor the text of the proposed rule explains how proposed section 1230.3(c) relates to proposed section 1230.3(e). In contrast with proposed section 1230.3(c) which apparently is triggered only when a notice is given by the FHFA to an FHLBank, proposed section 1230.3(e)(1) does not expressly contain such a notice requirement. It provides that:

Subject to paragraph (e)(2) of this section, a regulated entity or the Office of Finance *shall not* transfer, disburse, or pay compensation to any executive officer, or enter into an agreement with such executive officer, without the approval of the Director, for matters being reviewed by the Director under § 1230.3. (emphasis added).

Since both proposed section 1230.3(c) and proposed section 1230.3(e)(1) refer generically to executive compensation matters under review by the FHFA Director under proposed section 1230.3, we do not understand in what circumstances proposed section 1230.3(c)'s discretionary provision would apply, and in what circumstances proposed section 1230.3(e)(1)'s apparent mandatory provision would apply.

The intended relationship between proposed sections 1230.3(c) and 1230.3(e)(1) and the meaning of proposed section 1230.3(e)(1) is complicated further by proposed section 1230.3(e)(2). Proposed section 1230.3(e)(2) appears to operate in a manner such that the otherwise mandatory provisions of proposed section 1230.3(e)(1) would not operate in a wide range of situations. Presumably any compensation action and/or payment that is not covered by proposed section 1230.3(e)(2) would not be subject to the prohibition and prior approval requirements of proposed section 1230.3(e)(1).

Under proposed section 1230.3(e)(2)(iii), it would appear that proposed section 1230.3(e)(1) would operate such that an FHLBank would be prevented from providing **any compensation** to an executive officer without prior approval of the FHFA Director, if the FHFA Director has provided written notice to the FHLBank that a particular executive officer's compensation is being reviewed by the FHFA Director.

While proposed section 1230.3(e)(2)(iii), providing for written notice, would be a circumstance in which proposed section 1230.3(e)(1) becomes operative for matters being reviewed by the FHFA Director under proposed section 1230.3, the provisions and their operation lack clarity and raise numerous issues, some of which are noted below:

- o How does an FHLBank know that a review is underway in regard to the circumstances described in proposed sections 1230.3(e)(2)(i) and (ii)?

(The provisions do not specifically provide for a written notice to the FHLBank.)

- o Is it the FHFA's intent for an FHLBank to assume that a circumstance covered by proposed section 1230.3(e)(2)(i) or (ii) is automatically a matter being reviewed by the FHFA Director under proposed section 1230.3? What is expected of the FHLBank if this were the case?
- o How does the notice referred to in proposed section 1230.3(e)(2)(iii) relate to a notice that might be contemplated by proposed section 1230.3(c) or do such notices potentially have different impacts?
- o Under what circumstances does a review of annual compensation, bonuses, and other incentive pay provided by an FHLBank to its President (as described in proposed section 1230.3(e)(2)(ii)) require the FHLBank to obtain prior approval from the FHFA to transfer, disburse or pay compensation to the President, or to enter into an agreement with the President?
- o Which circumstances require the FHLBank to obtain prior approval from the FHFA to transfer, disburse or pay compensation to an executive officer in connection with the review of a written agreement that provides the executive officer with a term of employment of six months or more or that provides for compensation in connection with termination of an executive officer's employment (as described in proposed section 1230.3(e)(2)(i))?<sup>16</sup>

A procedure that requires an FHLBank to obtain the FHFA Director's approval to continue to pay any compensation to an executive officer presumably was not the intent of Congress.

Given all of the foregoing, we believe that it is essential that the proposed rule be revised to provide a clear and precise process for the operation of the FHFA's review function. In that regard, we recommend that proposed section 1230.3(c) and (e) be combined into a single section to eliminate any potential conflict or ambiguity between their current provisions.

We further recommend that the new section make it clear that, except to the extent that the FHFA has given written notice to an FHLBank that it is conducting a review under proposed section 1230.3 with respect to a particular executive officer, the FHLBank will be under no

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<sup>16</sup> We note that the preamble to the Proposal provides that termination benefits provided under a corporate-wide or top hat policy previously approved by the FHFA Director do not require an additional approval but that point is not addressed in the text of proposed section 1230.3(e)(2)(i)(B).



restrictions on transferring, disbursing or paying compensation to any executive officer, or entering into an agreement with any executive officer.<sup>17</sup>

The revised section also should provide for specific written notice to be given to an FHLBank in the event that the FHFA determines to conduct a review of a particular executive officer's compensation. The notice should specify what forms and amounts of compensation, if any, that the FHLBank is directed not to transfer, disburse or pay to the executive officer pending the outcome of the FHFA's review. In this regard, we believe that the regulation should provide direction that such withheld amounts not include:<sup>18</sup>

- Base salary at levels generally consistent with amounts provided in the prior year;
- Pension benefits under qualified and excess benefit plans and employer and employee contributions with respect to such plans;
- Compensation previously deferred;
- Health, life, and disability insurance benefits under nondiscriminatory plans or consistent with amounts set aside in prior years;
- Benefits in the form of use of regulated entity equipment and resources;
- Any wages that are protected under state statute; and
- Vacation, sick, bereavement, community service and other leave benefits.

The FHFA should not withhold compensation such that it is treated as deferred compensation under Section 409A of the Internal Revenue Code of 1986, as amended, nor act in a manner that exposes an executive officer to unwarranted tax liability. FHFA and Treasury should coordinate so that the payments are considered in the nature of legal settlements excepted from Section 409A.

VII. The Proposal Should be Modified To Address the Due Process Rights of FHLBank Executive Officers

Proposed section 1230.3(b) of the Proposal provides that in determining whether compensation provided by an FHLBank to an executive officer is not reasonable and comparable, the FHFA Director may take into consideration any factors that the FHFA Director

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<sup>17</sup> The FHLBank would remain subject to any applicable information submission requirements with respect to executive officer compensation that might apply under proposed section 1230.5(b).

<sup>18</sup> The definition of compensation in proposed section 1230.2 should be modified to expressly exclude payments to an executive officer under his indemnification and advancement rights to the extent not prohibited by applicable law.

considers relevant. Proposed section 1230.3(b) currently specifies only one factor that the FHFA Director might consider relevant to such a determination: “any wrongdoing on the part of the executive officer, such as an fraudulent act or omission, breach of trust or fiduciary duty, violation of law, rule, regulation, order or written agreement, and insider abuse with respect to the regulated entity or the Office of Finance.” We believe that the rule should be modified to provide more specificity as to the types of factors that would be deemed relevant in supporting a determination by the FHFA Director that an executive officer’s compensation is not reasonable and comparable.

Separately, proposed section 1230.3(b) does not offer an executive officer who is the subject of a compensation review based on, among other things, a potential claim of wrongdoing as set forth in that section, any notice of (i) the FHFA’s decision to consider directing the executive officer’s FHLBank to permanently withhold certain of the executive officer’s compensation or (ii) the potential amount and form of the compensation that may be withheld. The proposed rule should be modified to make it clear that certain types of compensation are not subject to being permanently withheld under proposed section 1230.3. These types of compensation should include:

- Pension benefits under qualified and excess benefit plans;
- Health, life and disability insurance benefits under nondiscriminatory plans;
- Any wages that are protected under state statute; and
- Compensation previously deferred.

In addition, proposed section 1230.3(b) does not provide any opportunity for an executive officer to present his or her views or defenses with respect to either the factors that the FHFA Director is considering, including any alleged wrongdoing or the amount and form of any compensation that may be potentially withheld. Proposed section 1230.3(b) also provides no standard as to the degree of proof of a claim of wrongdoing or other conduct that would be required to support a decision by the FHFA Director to order an FHLBank to permanently withhold compensation that had been earned by an executive officer.

As such, Section 1230.3(b) in its current form raises significant due process concerns. An adverse compensation determination by the FHFA Director based on “wrongdoing” or other factors could have a materially adverse financial impact on an executive officer. Moreover, any adverse compensation action against an executive officer, particularly one premised on some type of finding by a government agency of “wrongdoing” could have severe adverse reputational and employment impacts on the executive officer. As a practical matter, such a determination by the FHFA, based in whole or in part on purported wrongdoing by an FHLBank executive officer, could have adverse consequences for the officer’s current position and could make it very difficult for the officer to secure a similar type of employment in the future. This is particularly the case given the possibility that a Form 8-K might be required to be filed in connection with an arrangement or order to withhold any compensation due to the executive officer. Thus, an

executive officer has a compelling interest in the outcome of the FHFA Director's compensation review. The applicable FHLBank likewise has an interest in understanding the circumstances that might result in an adverse compensation determination against one of its executive officers. At the same time, the FHFA also has a strong interest in ensuring that any determination that it makes is well founded and based on a full understanding of the applicable facts and circumstances.

We note here that the importance of protecting employees' due process rights was recognized by the FHFB with respect to its actions relating to the suspension or removal of directors, officers or employees of an FHLBank. In December 2000, the FHFB proposed a rule regarding agency rules of practice and procedure that would have authorized the agency to suspend or remove such an individual without any prior notice or opportunity to be heard.<sup>19</sup> However, in the final rule published in March 2002, the FHFB withdrew the proposed suspension and removal portion of the rule. The FHFB provided the following explanation for its action:

Numerous comments on the removal provision argue that the agency lacks authority to adopt the rule and challenge whether the rule met the constitutional requirements of due process. The Finance Board has deleted the removal provision from the final rule . . . . [B]ecause section 2B(a)(2) of the Act . . . does not require that a hearing on the record be held to remove or suspend an officer, director, employee or agent of a Bank it raises additional and disparate administrative law issues.<sup>20</sup>

On June 16, 2005, the board of directors of the FHFB issued an order that established a process for the removal or suspension of an FHLBank director or officer ("Order").<sup>21</sup> That Order included a resolution by the board of directors that referred to "ensur[ing] that the process for removal or suspension of a Bank director or officer is fair, impartial, and meets constitutional due process requirements". The Order required that at least 20 calendar days before taking any action FHFB staff will communicate in writing to the director or officer ("Respondent"), the Respondent's counsel, and the relevant FHLBank the factual and legal circumstances the staff believes may warrant removal or suspension. The Order provides that the Respondent will (i) have the opportunity to respond in writing to the factual and legal bases cited by FHFB staff and (ii) have the opportunity to make an oral presentation at a meeting of the board of directors of the FHFB. The board of directors is required to issue a written decision to the Respondent and the FHLBank. If the Respondent is removed or suspended the board of directors' decision must describe the factual and legal bases for the findings of cause for removal or suspension.

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<sup>19</sup> 65 Fed. Reg. 78994 (2000) (to be codified at 12 C.F.R. § 908.7).

<sup>20</sup> 67 Fed. Reg. 9897, 9901 (2002).

<sup>21</sup> FHFB Order Number 2005-12, (June 16, 2005).

We believe that the notice, hearing and decision principles that the FHFB ultimately included in the Order properly recognize the importance of providing appropriate due process protections to an FHLBank officer who may be subject to adverse action by a government regulatory agency. We therefore believe that the FHFA should incorporate similar protections into any final rule.

VIII. The Proposed Rule's Information Submission Requirements Should be Modified in Certain Respects

The one-week timeframe for submissions set forth in proposed section 1230.5(b) is inadequate. As a matter of corporate practice, board minutes and resolutions are often not officially approved until the next board or committee meeting which typically does not occur until well after one week following a board or committee meeting. The proposed rule should be revised to recognize this factor.

In addition, the requirement that there be no redactions in materials that are submitted should be deleted as there are *bona fide* reasons for redactions. For example, redactions may relate to information that is subject to the attorney-client privilege.

We also note that proposed section 1230.5(b)(4) requires the submission of general benefit plans applicable to executive officers to the FHFA. Does "general benefit plans applicable to executive officers" include all benefits applicable to all employees (including executive officers) or only those benefit plans meant to apply primarily to executive officers?

Finally, proposed section 1230.5(b)(5) requires submission to the FHFA of any study conducted by or on behalf of an FHLBank with respect to compensation of executive officers, when delivered. This could require an FHLBank to submit such studies to the FHFA before the board of directors has had an opportunity to review or approve the study. We believe that the board of directors should have the opportunity to review and comment on such a study prior to submission to the FHFA.

IX. Existing Executive Compensation Arrangements Should be Grandfathered

We believe that compensation arrangements with FHLBank executive officers that are in effect prior to the effective date of the final rule should not be subject to action by the FHFA under 12 U.S.C. § 4518 or under the final rule. In this regard, we note that Congress, in amending the charter acts of the Enterprises to include certain restrictions on the payment of termination benefits by the Enterprises to their executive officers, provided that such restrictions should be applied prospectively only to agreements entered into after the date of the enactment of the 1992 Act.<sup>22</sup>

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<sup>22</sup> 12 U.S.C. 1723a(d)(3)(B) and 12 U.S.C. 1452(h)(2). This principle is included in the OFHEO Compensation Rule 12 C.F.R. 1770.1(b)(2) ("Agreements or contracts that provide for termination payments to executives that were entered into before October 28, 1992 are not retroactively subject to approval or disapproval by the Director. However, a renegotiation, amendment or change to such an

Further support for this approach is provided by the FHFA's recent proposed rule on golden parachute and indemnification payments ("Golden Parachute Proposal").<sup>23</sup> The preamble to the Golden Parachute Proposal excludes pre-existing arrangements from coverage under the proposed rule:

In proposing the amendment, FHFA recognizes that prior to the enactment of HERA, the regulated entities or the Office of Finance may have entered into agreements that provide for golden parachute payments beyond that which is proposed to be permissible under section 1318(e) of the Safety and Soundness Act (12 U.S.C. 4518(e)) and the proposed amendment. FHFA intends that the proposed amendment would apply to agreements entered into by a regulated entity or the Office of Finance with an entity-affiliated party on or after the date the regulation is effective.<sup>24</sup>

We believe that the same principle that the FHFA has indicated that it intends to follow in the Golden Parachute Proposal should be applied in the final rule, so that the rule does not apply to compensation arrangements with FHLBank executive officers entered into prior to the date that the final rule becomes effective. Such an approach would help avoid possible legal issues or challenges that might arise if the regulation were applied to pre-existing compensation arrangements.

X. The Proposed Section Regarding the FHFA Director's Temporary Executive Compensation Power Should be Revised to Reflect the Limitations on the Applicability of that Power

Section 1117 of HERA authorizes the Secretary of the Treasury (the "Secretary") to purchase FHLBank obligations under certain circumstances until December 31, 2009. Section 1117 also contains a provision stating that the FHFA Director shall have the power to approve, disapprove, or modify the executive compensation of the FHLBank as defined under Regulation S-K, 17 CFR 229. We believe that the FHFA Director's authority under Section 1117 is triggered only with respect to a particular FHLBank if the Secretary makes a covered purchase of such FHLBank's obligation under Section 1117. Proposed section 1230.6 should be modified to reflect this limitation on the FHFA Director's authority in this respect. Moreover, we note that legal issues including potential takings or other legal claims could arise depending upon the method in which any such authority was exercised.

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agreement or contract entered into on or before October 28, 1992 shall be considered as entering into an agreement or contract that is subject to approval by the Director.”).

<sup>23</sup> 74 Fed. Reg. 30975 (2009) (to be codified at 12 U.S.C. Part 1231).

<sup>24</sup> Id. at 30976.

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We appreciate your consideration of these comments.

Sincerely,

A handwritten signature in cursive script that reads "Carl Wick". The signature is written in black ink and is positioned below the word "Sincerely,".

Carl F. Wick, Chairman  
Board of Directors  
Federal Home Loan Bank of Cincinnati

## Appendix B

July 23, 2009

McLagan is submitting this letter in support of the Federal Home Loan Banks' comment letters regarding the Federal Housing Finance Agency's ("FHFA") proposed rule on Executive Compensation (the "Proposal"), which was published on June 5, 2009 (74 Fed. Reg. 26989 (2009) - to be codified at 12 C.F.R. pt. 1230).

### Background on McLagan's Relationship with the Federal Home Loan Bank System

In the spirit of full disclosure, the FHFA should know that McLagan has provided compensation benchmarking and advisory services to the 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance independently, beginning in 1998 with the Office of Finance. McLagan has been conducting a compensation survey for the FHLBanks since 2005. The survey covers a broad range of financial service firms including regional, national and international banks engaged in various lending and capital markets activities. The FHLBanks independently participate in various other compensation survey programs. From time to time, McLagan also provides compensation and related advisory services to the Board and/or Executive Management of individual FHLBanks including assessment of market compensation trends, a Bank's relative pay positioning versus the market, evaluation of salary administration and design of annual and longer-term incentive plans. The FHLBanks independently engage with other consultants who provide similar services. We are well acquainted with the challenges of determining fair and reasonable pay levels for executives.

### McLagan's Position of Support for the Federal Home Loan Banks' Comment Letter

Based on our reading of the proposed regulation, it appears to substitute FHFA's judgment regarding FHLBank executive compensation for the judgment of the respective FHLBank's Boards of Directors. We would caution the FHFA against such a move for the following reasons:

1. Determining reasonable executive compensation requires many diverse inputs in addition to market data. Most importantly there is a need for real insight into the relative complexity of the role versus the benchmark and an assessment of the capability of the individual filling that role. These assessments cannot be made remotely.
2. The FHLBanks' Boards of Directors are most familiar with their individual Bank's performance, needs and constraints and therefore best positioned to determine the process for establishing competitive market pay.
3. In our experience, the FHLBanks already have a robust process used to establish competitive market compensation, which includes defining a compensation and

- benefits philosophy and constructing customized peer groups against which to benchmark relative pay and performance.
4. The FHLBanks also seek to take into account the total compensation and benefits package, volatility/risk of employment, quality of work environment and geographic location in establishing a broad employment proposition versus the external market.
  5. The FHLBanks' executive compensation process is transparent. The details of the process are disclosed in their Compensation Discussion and Analysis included in each Bank's annual Form 10-K and as well as in compensation disclosures included from time to time in Forms 8-K.
  6. The FHLBanks Boards of Directors are comprised of directors or officers of member shareholder institutions and Independent Directors who have a fiduciary responsibility to act in the best interest of shareholders while meeting their public policy mission. There is no motivation for them to approve unreasonable executive compensation.

We recognize that the FHFA has a critical role in ensuring the stability and effectiveness of the Federal Home Loan Bank System, but we strongly believe that the FHFA should only intervene in the compensation process if the FHLBank's Board of Directors are not effectively exercising their responsibilities and proper procedures are not followed.

#### The Use of Market Data Sources in Establishing Reasonable and Comparable Compensation

Market data sources such as surveys are just one set of tools for Board of Directors and their Compensation Committees to make informed decisions within the context of their own Bank's performance, needs and constraints. Surveys provide a useful starting point in establishing competitive pay, but should in no way replace the judgment of Boards of Directors and their Compensation Committees who are most familiar with their needs and constraints.

#### The Compensation Benchmarking Process

The compensation benchmarking process is composed of establishing a philosophy, articulating goals and objectives, determining a comparative peer group of firms, establishing benchmark jobs and defining a desired position versus market. In order to make the best use of external market data, each Bank establishes its own compensation and benefits philosophy. The Banks generally seek to take into account the total compensation and benefits package, volatility/risk of employment, quality of work environment and geographic location in establishing a broad employment proposition versus the external market.

The goals and objectives of the various components of the compensation and benefit plans are to attract, retain and motivate employees. The emphasis on attracting versus retaining and motivating employees must be balanced and continues to evolve as the Banks adjust to their internal needs, the requirements of the markets and their own resource constraints.



*Peer groups of firms* are established based on labor market competitors, business competitors and practical limitations such as the availability of data. Peer groups vary among the Banks reflecting their Boards' unique assessment of competitors, but generally include commercial and regional banks that engage in wholesale lending and/or capital markets activities, as well as the other Federal Home Loan Banks. **Small retail banks, Federal Reserve Banks and Farm Credit Banks have not been included in the FHLBank's peer groups since they engage in significantly different financial activities.** This is consistent with advice McLagan has given FHLBanks on the appropriateness of excluding small retail banks, Federal Reserve Banks and Farm Credit Banks.

- Retail banks not included - The FHLBanks do not engage in retail lending and typically do not recruit from or lose employees to small retail banks.
- Federal Reserve Banks not included – The FHLBanks do not engage in the development or implementation of monetary policy, control the Federal Funds Rate, conduct open market operations, set reserve requirements, operate the discount window, conduct foreign currency operations, conduct supervisory functions, regulatory functions or provide consumer protection – the primary functions of the Federal Reserve Banks. Our experience is that the FHLBanks neither recruit executives from nor lose executives to the Federal Reserve Banks.
- Farm Credit Banks not included – The FHLBanks are involved in similar wholesale lending functions, but focus on dissimilar asset classes (e.g., Federal Home Loan Banks do not engage in agricultural-related lending and leasing activities). Our experience is that the FHLBanks neither recruit executives from nor lose executives to the Farm Credit Banks. [*FHLBanks: Is this correct?*]

*Benchmark jobs* are identified based on positions that have similar scope of responsibility and represent reasonable employment opportunities. For example, when using a large commercial/regional bank peer group the Banks typically compare their overall head of the function (e.g., Chief Financial Officer) to a divisional head of the function or “Senior Function Manager” (e.g., Divisional Chief Financial Officer representing a 2<sup>nd</sup> or 3<sup>rd</sup> level direct report to the overall Chief Financial Officer for the firm).

*Relative position versus the market* (e.g., market 25<sup>th</sup>, 50<sup>th</sup> or 75<sup>th</sup> percentile) for a selected executive is based on the peer group and benchmark job selected and may take into account the experience and performance an executive brings to the job as well as overall bank performance. The market statistics may be used in both setting targets and final determination of pay. For example, the market 50<sup>th</sup> percentile may establish the incentive pay target when the individual and Bank “meet” their performance goals while the market 75<sup>th</sup> percentile may be the target when the individual and Bank “exceed” their performance goals. **Prescribing the 50<sup>th</sup> percentile as a maximum pay level does not account for the peer group being used or the unique construct of the role and discourages performance above “target”.**

McLagan's experience working with FHLBank Boards has been that the compensation benchmarking process that establishes philosophy, peer group, benchmark jobs and

relative position versus the market is spiritedly challenged. Board Members are either representatives of member/shareholders or Independent Directors that have a fiduciary obligation to protect the shareholders of the Bank. They are locally based and understand the unique challenges and opportunities of their Banks including the skills and qualities they require of executives. The Boards of the Banks we work with have accepted, rejected and modified our recommendations through the exercise of their judgment and what they believe is in the best interest of their Bank. The process they employ in making these decisions is detailed in their Compensation Discussion and Analysis, which is included in each Bank's annual Form 10-K, as well as in compensation disclosures included in Forms 8-K that are filed from time to time.

#### Other General Considerations

Availability of non-public data needs to be determined when establishing peer groups based on specific firms level of participation in survey programs and certain restrictions on the use of confidential data.

Market data sources may define total compensation slightly differently or refer to it in different terms. The definition of total compensation should be scrutinized when comparing various market sources as well as the timing of the release of such information to ensure comparability.

The definition of "executive management" differs considerably. McLagan typically defines executive management as those individuals who lead a major function, provide strategic direction and set policy for the Bank. Within the FHLBanks major functions would typically include Executive Management (e.g., CEO, COO, and Head of Strategy), Legal, Financial Control/Reporting, Portfolio/Asset & Liability Management, Risk, Member Sales/Relations, Operations, Affordable Housing/Community Investment, Administration, Information Technology, Human Resources, and Marketing/Communications/Government Affairs. As a practical matter the Top 10 paid employees within each Federal Home Loan Bank would in almost all cases capture the individuals responsible for all the functions listed above since many executives manage multiple functions.

Sincerely yours,



Head of Corporate and Consumer Banking Consulting  
McLagan