July 22, 2016

Submitted Electronically
Alfred M. Pollard, Esq.
General Counsel
Attn: Comments/RIN 2590-AA42
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20219

Re: Comments/RIN 2590-AA42; Incentive-based Compensation Arrangements

Dear Mr. Pollard:

On behalf of the undersigned Federal Home Loan Banks (**FHLBanks**) we appreciate this opportunity to comment on the proposed rule on incentive-based compensation[1] (**Proposal**) under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd-Frank Act**) issued jointly by the Federal Housing Finance Agency (**FHFA**), the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Securities and Exchange Commission (**SEC**) (collectively referred to as the "**Agencies**").

We believe that including the FHLBanks among the institutions subject to a final rule on incentive-based compensation based on the Proposal (**Final Rule**) is not appropriate under Section 956 considering the unique structure and mission of the FHLBanks as discussed in the FHLBanks' comment letter submitted in response to an earlier proposed rule published in 2011.[2] The FHLBanks again raise the comments submitted in that letter, and ask that the letter be included as part of the rulemaking record for this proposal. To the extent the FHLBanks are nevertheless included in the Final Rule, we believe the FHLBanks should be included as Level 3 covered institutions. Additional modifications or clarifications should be made in any Final Rule to better conform its requirements to the FHLBanks' existing statutory and regulatory structure and to reduce uncertainty and duplication within the Proposal.

Executive Summary

The FHLBanks have reviewed the Proposal in the context of their status as government-sponsored enterprises, cooperative ownership structures (compared to public ownership structure), par value stock, wholesale lending business model, narrowly tailored scope of operations, small employee bases, conservative risk profiles, and existing comprehensive FHFA supervision of compensation matters. Based on these factors, the FHLBanks submit that they should not be subject to the Final Rule as discussed in the FHLBanks' prior comment letter. If FHFA nevertheless includes the FHLBanks in the Final Rule, they should be treated as Level 3 institutions.

[1] 81 Fed. Reg. 37670 (June 10, 2016).
[2] 76 Fed. Reg. 21170 (April 14, 2011).

Assuming their inclusion in the Final Rule, the FHLBanks request that the following aspects of the Proposal be adjusted to reflect better the FHLBanks' attributes, including:

- The definitions of senior executive officer (**SEO**) and significant risk-taker (**SRT**) should be refined to better fit FHLBank business models and limited scope of operations and to provide predictability and stability as to whom the Final Rule covers.

- Factors triggering clawback, forfeiture, and downward adjustment are overly broad, highly subjective, and not well defined. We request that the triggers be more objectively defined and require the covered person to be culpable for the challenged action and the negative consequence.

- The independence requirements and control function requirements appear to contain internal conflicts, and to conflict with existing FHFA regulation and guidance. We urge the FHFA to reconcile these requirements to conform to existing FHFA regulation and guidance.

Given the FHLBanks' small staff sizes compared to asset size, the FHLBanks further urge the Finance Agency to consider the disproportionate impact of the Proposal on the FHLBanks as compared to other covered institutions of similar asset size, particularly due to the reduced compensation risk the FHLBanks pose. The risk presented does not appear to merit the incrementally increased administrative burden, which will likely require increased staff or outsourcing to support the operation of an incentive-based compensation program.

The Proposal is not essential for the FHLBanks because FHFA already has extensive authority over FHLBank executive compensation:

> (a) *In general*. The Director [of FHFA] shall prohibit the [FHLBanks] from providing compensation to any executive officer of the [FHLBank] 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.[3]

Furthermore, FHLBanks may not provide incentive-based compensation awards, enter into any employment agreement, increase base compensation, or pay any amount under an incentive-based compensation plan, severance plan, change-in-control agreement, separation agreement, or any other form of compensation to an FHLBank executive officer, or commit to pay a newly-hired executive officer, without providing advance written notice to the Director of FHFA for review and non-objection.[4] FHFA also has additional authority to regulate and prohibit other forms of compensation paid to FHLBank officers, directors, and employees.[5] FHFA closely

[3] 12 U.S.C. § 4518(a).
[4] *See* 12 C.F.R. § 1230.3.
[5] *See, e.g.*, § 4518(e); 12 C.F.R. Parts 1231 (governing golden parachute and indemnification payments made by FHLBanks); Advisory Bulletin 2009-AB-02, *Principles for Executive Compensation at the Federal Home Loan*

reviews all aspects of executive compensation, and has issued extensive regulations and multiple forms of specific guidance governing executive compensation matters to implement its responsibilities. FHFA closely scrutinizes all aspects of FHLBank executive compensation.

For these reasons, and given the unique characteristics of the FHLBanks, we request that the FHLBanks be excluded from the Final Rule. However, if FHFA subjects the FHLBanks to the Final Rule, we request that the FHLBanks be designated as Level 3 institutions, and regardless of designation (either as Level 2 or Level 3 institutions), we further request that FHFA reconcile the Final Rule with other conflicting and overlapping FHFA regulations and guidance.

Discussion of Comments

1. If the FHLBanks Must Be Covered By the Final Rule, They Should Be Level 3 Institutions.

Congress did not include the FHLBanks within the scope of Dodd-Frank Act Section 956. Compared to the other covered institutions, whose inclusion is statutorily mandated, FHFA has greater latitude in deciding whether to subject the FHLBanks to the Proposal, and if so, which aspects of the Proposal to make applicable to the FHLBanks. The FHLBanks reiterate that including them in the Final Rule is unnecessary, but if they are to be included, they should be included as Level 3 institutions.

FHFA is correct: "generally for the Federal Home Loan Banks, asset size is not a meaningful indicator of risk."[6] There are several reasons why this is true. The FHLBanks are wholesale *cooperative* financial institutions whose stock is not publicly traded and is issued, traded, and redeemed at par. The FHLBanks are managed to protect the par value of their capital stock, rather than to achieve an ever-increasing stock price or maximize return on equity, as would be normal for a publicly traded institution.

As wholesale government-sponsored entity lenders, the FHLBanks serve a clearly defined mission that is much different from the business of the highly diversified banking organizations that are otherwise included in Level 2. The FHLBanks' primary activity is to make loans, called advances, to their members, who are also their stockholders. Virtually all members are regulated financial institutions, and all advances are fully secured by eligible collateral, as defined by FHFA. Some FHLBanks also acquire eligible mortgage loans from members in their acquired member asset (**AMA**) programs. FHLBanks are also permitted to maintain a limited portfolio of investment securities, primarily to provide liquidity to ensure they can meet their statutory mission and achieve other mission objectives. The FHLBanks enter into a variety of derivative and hedging transactions to manage their interest rate risk, and are prohibited from engaging in derivative transactions for any speculative purpose. Finally, the FHLBanks provide ten percent

Banks and the Office of Finance; *In Re: Information Submission with Respect to Executive Compensation*, FHFA Order No. 2014-OR-B-4, Nov. 24, 2014.

[6] Proposal at 37688.

of their annual net income in affordable housing grants. These activities are highly regulated, and the FHLBanks generally must obtain regulatory approval to undertake new activities.[7] These factors combine to reduce the risk posed by FHLBanks, as well as the opportunity for excessive risk-taking, particularly as compared to the institutions that are in Level 2.

FHLBanks also are subject to limitations on the asset mixes they may hold. FHFA has adopted an advisory bulletin that strongly encourages the FHLBanks to maintain a ratio of advances and AMA to consolidated obligations (debt) of at least seventy percent.[8] If an FHLBank fails to meet this level, the advisory bulletin sets forth FHFA expectations regarding the FHLBank's efforts to meet the seventy percent threshold.[9] In addition, if an FHLBank experiences "extraordinary growth" in non-advance assets and subsequently violates certain prudential standards, FHFA is required to take corrective measures against the FHLBank.[10]

The FHLBanks carry out their narrow statutory mission subject to specifically-tailored regulation, their cooperative structure, and par-value nature of their stock, and do so with unique statutory protections and extensive risk safeguards. These circumstances limit the opportunity – and incentive – for excess risk-taking intended to increase compensation. FHFA has recognized this for executive compensation purposes through the limitations it has imposed on FHLBank executive compensation levels, which are commensurate with Level 3 – not Level 2 – financial institutions.[11]

The Proposal contains restrictions and requirements for incentive-based compensation programs in Level 1 and 2 that do not apply to Level 3 institutions. These additional restrictions and requirements are substantial enough that incentive-based compensation programs in Level 2 institutions may not be comparable to those of Level 3 institutions. This mismatch is important to the FHLBanks because, in consultation with FHFA, the FHLBanks generally define their executive compensation peer groups for benchmarking purposes to be executive officers at the other FHLBanks and publicly-traded financial institutions with assets from $5 to $20 billion (*i.e.*, Level 3 institutions), and division heads at certain larger commercial banks.[12] If the FHFA defines the FHLBanks as Level 2 institutions, compensation programs at Level 3 institutions –

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[7] *See* 12 C.F.R. Part 1272.
[8] Advisory Bulletin 2015-AB-05, *FHLBank Core Mission Achievement* at 3.
[9] *Id.*
[10] *See* 12 C.F.R. §§ 1236.2 & 1236.5(b).
[11] If FHFA were to agree that the FHLBanks should be included within Level 3, the FHLBanks recommend eliminating proposed § 1232.6.
[12] One FHLBank uses commercial banks with assets of $20-$65 billion; the median asset size for its commercial bank peers as of the time of calculation was $25.9 billion. Another FHLBank focuses on Regional/Commercial Banks $20B+ in assets as the "Primary Peer Group" for benchmarking at the 50th percentile. For jobs within Risk and Capital Markets and other specialty areas not in ready supply within the Regional Banks, that FHLBank will use a customized peer group of Banks with $50B+ in assets at the 25th and 50th percentile to reflect realistic recruiting pressures. Additionally, the FHLBanks will look to data from larger institutions (including Level 2 institutions) for specialty or high-demand positions and markets.

including those the FHLBanks have identified as peers – may no longer be comparable. The FHLBanks should continue to be able to define their peer groups in such a way to ensure that their executive compensation remains reasonable and comparable in all circumstances. We therefore expect that, if FHFA determines the FHLBanks should be Level 2 institutions, the FHLBanks will need to establish new peer groups to determine what compensation would be reasonable and comparable for them and to remain competitive in the marketplace for attracting and retaining talent.

The FHLBanks' cooperative structure gives FHLBank boards important perspective on executive compensation matters. A majority of each FHLBank's directors are directors and officers of the FHLBank's member-stockholders. FHLBank insiders cannot be directors. Therefore, the directors who are in a position to set executive compensation are representatives of the institutions that have a direct interest in ensuring that executive compensation is not excessive and that FHLBank personnel do not have financial motivations to take inappropriate risks.

The Proposal invites comments on the differences between the FHLBanks, on one hand, and Fannie Mae and Freddie Mac, on the other hand, with respect to the Proposal and whether these differences should result in any changes to the Proposal.[13] The FHLBanks request that FHFA consider this letter and how the FHLBanks' cooperative structure, statutory mission and existing regulatory guidance informs their governance and board decisions, particularly as to compensation matters.

2. The Proposal May Place Undue Burdens on the Operation and Design of an FHLBank's Compensation Program and Create Misalignment with an FHLBank's Compensation Philosophy, Without Necessarily Having Any Impact on Inappropriate Risk Taking.

If the Final Rule applies to the FHLBanks, we request that it be tailored to their specific structure.

2.1. <u>FHLBanks have fewer tools than other types of financial institutions for compensation design, and the Proposal further impairs their ability to align employee and member interests.</u>

FHLBanks typically compensate their employees with a combination of base salary, incentive-based compensation, retirement benefits and other benefits (such as health insurance, pension and 401(k) plans), and occasional individual performance bonuses. ***The FHLBanks are unable to use any equity-related tools to compensate their employees*** because an FHLBank's stock may only be owned by that FHLBank's members and their successors.[14] Incentive compensation is therefore the most feasible option available to the FHLBanks to align employee and officer

[13] *See* Proposal at 37757; 12 U.S.C. § 4513(f).
[14] 12 U.S.C. § 1426(c)(5)(A); 12 C.F.R. §§ 1277.25 & .26(a)(1).

interests with the interests of their members. Restricting incentive-based compensation thus impairs the FHLBanks' ability to align the interests of their employees and members.

Assuming that the FHLBanks should be Level 2 institutions, the prohibition on increasing the value of deferred amounts over time described in proposed § 1232.7 is excessive. Section 1232.7(a)(3) of the Proposal should be amended to permit an increase in value of deferred amounts during the deferral period, which would be consistent with the approach currently permitted by FHFA. Losing this additional incentive opportunity would amount to a substantial cut in overall compensation for each participant, and would remove opportunities for the FHLBanks to hold executives accountable for additional goals and objectives, thus potentially increasing risk. Moreover, this positions the FHLBanks at a competitive disadvantage to other Level 2 institutions' employees who receive stock or options as well as cash incentive compensation. The stock or options may experience upside market adjustment with solid performance. For institutions that offer stock or options to employees, limiting additional increase on cash incentives may make sense; it prevents those employees from seemingly double dipping from the leverage potential (on both leveraged cash incentive compensation and stock options). The FHLBanks do not present this risk because they do not provide stock or option compensation.

The Proposal may also impact the FHLBanks' ability to issue "spot bonuses," or unplanned bonuses used to recognize substantial contributions or exceptional circumstances for employees other than executive officers, because of the risk that a bonus could be interpreted to be incentive-based compensation or could have an unanticipated effect on the balance of the recipient's incentive-based compensation. Having this compensation tool at the FHLBanks' disposal is important to their ability to manage unique situations in a manner that treats employees fairly and equitably.

2.2. <u>The Proposal increases the burden on the FHLBanks of offering incentive-based compensation while reducing its benefits to FHLBanks disproportionately to other covered institutions.</u>

Currently, the FHLBanks operate incentive-based compensation programs for substantially all of their workforces, with separate goals or plans for risk management and/or internal audit employees, consistent with FHFA guidance. The FHLBanks use incentive-based compensation to provide a cost-effective and risk-appropriate way to align the interests of their employees and their shareholders. If the Proposal were adopted in its current form and applied to the FHLBanks, the FHLBanks would need to make substantial changes to their compensation programs, and may determine it is necessary to de-prioritize, eliminate, or narrow the availability of incentive-based compensation. Moreover, the FHLBanks already follow established, effective risk management and governance policies and procedures with respect to their incentive-based compensation programs that are tailored to comply with existing FHFA regulation and guidance.

If the FHLBanks were classified as Level 2 institutions (which the FHLBanks believe should not be the case, as noted above), the Proposal would increase the costs and administrative burden of operating incentive-based compensation programs while diminishing their perceived value to

employees. The risk management and controls requirements found in proposed § 1232.9, governance provisions in proposed § 1232.10, and policy and procedures requirements in proposed § 1232.11 are expected to disproportionately increase the FHLBanks' expense and administrative burden of operating their incentive-based compensation programs without any commensurate risk-mitigating benefits to the FHLBanks. Restrictions on goal design in proposed § 1232.4(d) and § 1232.8(d) would have the effect of rewarding control activities (without regard to cost or the other risks created by such activities) over prudent risk taking. At the same time, the Proposal would reduce the value of incentive awards to recipients by imposing inefficient, vague goal design requirements, eliminating the possibility of increasing deferred amounts, and increasing compensation risk through the combined ten-year period of risk for clawback, forfeiture, and downward adjustment.

If adopted as issued, the Proposal would result in significant FHLBank compensation program design overhauls as the FHLBanks seek prudently to balance meeting competitive compensation pressures, meeting FHLBank business goals, maintaining internal compensation equity, and encouraging internal staff growth and development. To maintain compensation competitiveness the FHLBanks expect they would likely have to increase base salaries, which could have significant and compounding impact on their expense levels. Changes in compensation program design at the FHLBanks – such as by increasing emphasis on base salary – will have costs over and above the costs of salary increases. FHLBank costs for pension and 401(k) programs, employment taxes, disability, and insurance costs will all proportionately increase with increases in base salary. Future increases to base salary and related costs will also proportionately increase. Over time, these increased compounded costs will have a significant impact on the FHLBanks' low-margin wholesale business model, putting increased pressure on each FHLBank's ability to fulfill its mission, provide a return to its members, and maintain its affordable housing program contribution levels.

2.3. <u>The Proposal is unnecessarily broad as applied to the FHLBanks.</u>

If FHFA chooses to apply this regulation to the FHLBanks as Level 2 institutions, in lieu of the SEO and SRT concept, it should apply the regulation only to individuals the FHLBanks already identify as "named executive officers" in SEC filings. This is consistent with current FHFA practice and the Federal Home Loan Bank Act, which expressly adopts the SEC definition for executive compensation.[15] Coordinating these definitions would reduce the burden of managing, complying with, and reporting on the obligations in the Proposal.

If the FHFA disagrees with the suggestion to use "named executive officers," then to avoid being unnecessarily broad in the Proposal's scope, FHFA should use the individuals identified as "Executive Officers" in the FHLBanks' annual reports on Form 10-K. As in the case of the named executive officer standard described above, coordinating the definition of "senior executive officer" with the definition of "executive officer" for purposes of Form 10-K still reduces uncertainty and unnecessary reporting burden, and would leverage the existing SEC reporting framework for the FHLBanks. Coordinating these definitions would reduce the burden

[15] 12 U.S.C. § 1431(l)(5).

of managing, complying with, and reporting on the obligations in the Proposal, consistent with FHFA practice.

2.3.1. FHLBank directors and principal shareholders should be excluded from the definition of "covered person."

The Proposal applies to "covered persons," which are any executive officer, employee, director, or principal shareholder of an FHLBank who also receives incentive-based compensation.[16] Neither directors nor principal shareholders should be included as covered persons for FHLBanks. No FHLBank employee may be a director of an FHLBank. FHLBank director compensation is governed by 12 C.F.R. Part 1261, and is otherwise subject to FHFA review and supervision. Similarly, FHLBank stock can only be owned by members or their successors, who cannot be natural persons. The FHLBanks do not have any program that offers incentive-based compensation to directors or members (or any shareholders of their members). We therefore request the terms "director" and "principal shareholder" be deleted from the definition of "covered person" for FHLBanks.

2.3.2. The definition of "control function" is too broad as applied to the FHLBanks.

The Proposal's concept of "control function" is overbroad as applied to the FHLBanks. In the FHLBank setting, the functional areas with primary responsibility for identifying, measuring, monitoring, or controlling risk-taking are concentrated in risk management and internal audit departments to comply with FHFA regulation and guidance. To include the other departments or areas of the FHLBanks in the proposed definition of "control function" would be too broad and would capture individuals and departments who have a role in the control environment, but whose primary responsibilities are not independent risk management roles. Instead these areas have roles in management, legal support, or GAAP compliance. This structure is consistent with existing FHFA regulation and guidance. The definition of "control function" in the Final Rule should be consistent with other FHFA regulation and guidance governing risk management and internal controls.

We therefore recommend revising the term "control function" as follows:

> (h) Control function means, with respect to a Federal Home Loan Bank, the Federal Home Loan Bank's risk management and internal audit departments, and with respect to an Enterprise, the Enterprise's . . . .

2.3.3. The definition of SEO is too broad as applied to FHLBanks.

If the Final Rule retains the SEO concept for the FHLBanks, instead of coordinating with the SEC standards as we recommend, the proposed SEO definition should be tailored for the FHLBanks. This would include identifying roles that are specifically used in FHLBanks. Additionally, the phrase "major business line or control function" found in proposed

[16] Proposed § 1232.2(j).

§ 1232.2(gg) is vague and should be deleted because it can generate unintended results and uncertainty when applied to an FHLBank. For example, an FHLBank may consider its affordable housing programs to be a major business line because of its importance to the Bank's mission, but it does not present risk profiles appropriate for inclusion in the Proposal. Similarly, there is great disparity among the FHLBanks' relative AMA activities, which is driven in part by structural and operational differences among approved AMA programs; AMA is not a major business line for all FHLBanks, and AMA departments are typically subordinate to a person otherwise identified as an SEO.

We therefore recommend the definition of SEO be revised as follows to reflect existing FHFA requirements for FHLBanks:

> (gg) Senior executive officer means, with respect to a Federal Home Loan Bank, a covered person who ~~holds the title or,~~ without regard to title, ~~salary, or compensation, performs~~ is assigned specific responsibility to perform the function of one or more of the following positions at ~~a covered institution~~ the Federal Home Loan Bank for any material period of time in the relevant performance period: President, chief executive officer, ~~executive chairman,~~ chief operating officer, chief business officer, chief financial officer, the most senior officer responsible for treasury and capital markets functions (which may be a chief investment officer or treasurer), chief legal officer, the most senior officer responsible for making advances to members (which may be a chief lending or credit officer), chief risk officer, chief compliance officer, chief audit executive, ~~chief credit officer~~, or chief accounting officer~~, or head of a major business line or control function~~. Senior executive officer means, with respect to an Enterprise, ….
>
> 2.3.4. The SRT designation is too broad when applied to FHLBanks.

As discussed above, the FHLBanks recommend that the SRT concept not be applied and instead FHFA continue to subject the same persons to incentive-based compensation restrictions that it does now, or in the alternative, to those persons identified as "executive officers" or "named executive officers" in the FHLBanks' annual reports on Form 10-K, as discussed above.

The SRT concept does not fit the FHLBanks and is not appropriate for them. Unlike other financial institutions, FHLBank employees who are responsible for implementing investment or funding strategies or approving advances do not receive commission-based compensation. These employees – who are required to initiate transactions in large denominations, given the wholesale nature of the FHLBanks – are simply implementing lending policies and capital management strategies within the policies, limits, and authorities established by the board and senior management. They typically receive the majority of their compensation from base salary, with incentive-based compensation generally based in large part on enterprise-wide goals. FHLBanks do not offer such employees a direct connection between the performance of their business unit and the employee's compensation, so they are not inappropriately incented to take outsized risks. The only risk takers with sufficient visibility and authority to establish risk-taking strategies within an FHLBank are those that are identified as "executive officers," "named executive

officers," or SEOs, as discussed above. The SRT concept should therefore not apply to the FHLBanks.

The preamble's text also indicates that all voting members of committees that can make decisions to commit or expose 0.5% or more of capital will trigger the exposure test.[17] The Proposal does not explain why the ability to vote on a committee, without more, should be sufficient to trigger SRT status. Deeming all committee members to be SRTs is neither appropriate nor consistent with the intentions of Dodd-Frank Act Section 956.

If FHFA were to reject this recommendation in favor of the SRT concept, the SRT definition remains overbroad as applied to the FHLBanks because the FHLBanks' wholesale operations and the small scale of their workforces lead to inappropriate results when the SRT definition is applied, as noted above. The incentive-based compensation threshold for SRT consideration, one-third of combined base salary and incentive-based compensation, is also too low because this may capture individuals who do not have the ability to expose an FHLBank to disproportionate financial loss. Nor should this threshold be reduced; doing so would reach even further into the FHLBanks. Instead, the FHLBanks recommend increasing the threshold to greater than forty percent of combined base salary and incentive-based compensation. All FHLBank sales and marketing personnel should also be eliminated from consideration as possible SRTs for similar reasons: although they may have comparatively high proportions of their compensation in incentive-based compensation, the FHLBanks' wholesale cooperative lending model does not provide meaningful opportunity for risk taking by sales and marketing staff.

If FHFA retains the SRT concept, it should also add a minimum compensation threshold that must be exceeded before a person could be considered to be an SRT. In particular, FHLBank employees responsible for final decisions about pricing, capital allocation, and risk allocation policies are among the most highly compensated employees, and will also typically manage, control, and limit the activities of others within the FHLBank and therefore § 1232.2(hh)(1) should also include a minimum combined base salary and incentive-based compensation of $450,000, adjusted for inflation.

3. Additional Specific Comments

The FHLBanks have also identified other areas for comment.

3.1. The Proposal should more objectively define when clawback, forfeiture, and downward adjustment are required.

The FHLBanks request that the Final Rule not mandate the use of clawbacks, forfeiture, or downward adjustment. Whether to adopt such requirements, and the circumstances in which to do so, should remain squarely within the judgment of the FHLBank's board of directors.

[17] *See* Proposal at 37696.

However, if FHFA does require these tools in the Final Rule, their triggers should be objective and require wrongdoing, *i.e.*, culpability, as the applicable standard.

Requiring a culpability standard is both appropriate and consistent with existing law related to reducing compensation for bad acts by FHLBank officers, namely the Housing and Economic Recovery Act of 2008 (**HERA**). Section 1113 of HERA authorizes the Director of FHFA to withhold compensation for an FHLBank executive based on any factors the Director considers relevant, including any wrongdoing by the executive, which may include any fraud, breach of trust or fiduciary duty, violation of applicable law or regulation, or other insider abuse.[18] It also empowers the Director to prohibit or limit any golden parachute payment or indemnification payment, after considering factors related to the recipient's role in the organization, compensation, and bad acts.[19] If FHFA does require clawbacks, forfeiture, or downward adjustment in the Final Rule, FHFA should require that the negative consequences suffered by the institution were the result of the challenged actions by the bad actor, consistent with HERA.[20]

The extent of the proposed downward adjustment, forfeiture, or clawback is also excessive. The clawback, downward adjustment, and forfeiture provisions should be qualified so that they are considered to the extent that the bad acts increased the subject's incentive-based compensation. Proportionality of consequence reduces the punitive nature of these provisions. Boards of directors could, of course adopt, more restrictive provisions.

We urge the FHFA to revise the criteria for which forfeiture and downward adjustment are required as follows:

> (2) *Events triggering forfeiture and downward adjustment review*. At a minimum, a Level 1 or Level 2 covered institution must consider forfeiture and downward adjustment of incentive-based compensation of senior executive officers and significant risk-takers described in paragraph (b)(3) of this section <u>who engage in wrongdoing consisting of any of the following</u> ~~due to any of the following adverse outcomes at the covered institution~~:
> ~~(i) Poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered institution's policies and procedures;~~
> ~~(ii) Inappropriate risk taking, regardless of the impact on financial performance;~~
> ~~(iii) Material risk management or control failures;~~
> (~~iv~~i) <u>Intentional, reckless, or knowing</u> ~~N~~<u>n</u>on-compliance with <u>or disregard of</u> statutory, regulatory, or supervisory standards <u>by the covered person</u> that results in:
> (A) Enforcement or legal action against the covered institution brought by a federal or state regulator or agency; or

[18] 12 U.S.C. § 4518(b); *see also* 12 C.F.R. § 1230.3(b).
[19] § 4518(e).
[20] See also Preamble to interim final Executive Compensation regulation: "FHFA plans to publish . . . a proposal to require the regulated entities to develop and adopt policies to provide for recapture of improvidently or improperly paid compensation in appropriate circumstances." 78 Fed. Reg. 28442, 28446 (May 14, 2013).

> (B) A requirement that the covered institution report a restatement of a financial statement to correct a material error;
> (ii) any fraudulent act or omission, breach of trust or fiduciary duty, and
> (~~vi~~iii) Other aspects of conduct or poor performance by the covered person as defined by the covered institution.[21]

Subsections (i) through (iii) of the Proposal are wholly subjective. Whether performance is "poor," whether a deviation from risk parameters is "significant," whether risk taking is "inappropriate," and whether a risk management or control failure is "material" are each subjective decisions that cannot be objectively defined and will instead be evaluated with 20/20 hindsight. If these subjective provisions ((i) through (iii)) remain in the Final Rule, the adverse consequence should be caused by the covered person whose compensation is being reduced. For example, the poor financial performance should be caused by the covered person's actions that resulted in the deviation from risk parameters.

We propose similarly revising the criteria for which clawbacks are required as follows:

> (c) *Clawback*. A Level 1 or Level 2 covered institution must include clawback provisions in incentive-based compensation arrangements for senior executive officers and significant risk-takers that, at a minimum, allow the covered institution to recover incentive-based compensation from a current or former senior executive officer or significant risk-taker for ~~seven~~ four years following the date on which such compensation vests, if the covered institution determines that the senior executive officer or significant risk-taker engaged in:
> (1) ~~Misconduct~~ Intentional, reckless, or knowing violations of law or policy that resulted in significant financial ~~or reputational~~ harm to the covered institution;
> (2) Fraud against the covered institution;
> (3) Wrongdoing representing a breach of trust or fiduciary duty; or
> (3) Intentional, reckless, or knowing misrepresentation of information used to determine his or her ~~the senior executive officer or significant risk-taker's~~ incentive-based compensation.[22]

(It is noted that these factors align with the Finance Agency's recently issued rules 12 C.F.R. Part 1239 for the FHLBanks as well.) Reputational harm as referenced in the Proposal is highly subjective and should be deleted from item (1) of this portion of the Proposal. For a misrepresentation to give rise to a clawback, the covered person should evidence an intent to deceive.

Even with the foregoing changes, if the Final Rule does require a clawback, the FHLBanks believe the seven-year clawback period is too long and should be reduced. The combination of the mandatory three-year deferral period and the seven-year clawback period means that an employee of a Level 2 institution could be subjected to a monetary penalty for decisions she had

[21] Proposed § 1232.7(b)(2).
[22] Proposed § 1232.7(c).

made and actions she had taken over ten years prior to the initiation of clawback proceedings. This is much too long and compares unfavorably to the typical statutes of limitations that apply to federal civil money penalty enforcement actions. By way of comparison, the principal source of FHFA civil money penalty authority is 12 U.S.C. § 4636, under which the Director could only impose such penalties for conduct occurring less than five years prior to the start of enforcement proceedings.[23] Similarly, FHFA regulations provide for a four-year statute of limitations for housing goals violations by Fannie Mae and Freddie Mac.[24] If the Final Rule does require the use of a clawback, for consistency, the clawback period for Level 2 institutions should be reduced from seven years to no more than four years.

The lack of clarity and a culpability standard in this portion of the Proposal pose substantial governance challenges to FHLBanks. Board action is necessary if any trigger is present. However, when faced with broad subjective standards, and in the absence of a causation element to connect the consequence to the person, it may not be possible to determine whose compensation should be at risk, whether a trigger has occurred, or even if the Board should consider whether a trigger occurred. This conflict could be magnified for control functions, which may bear the burden of attempting to identify these actions, potentially without regard to any harm, risk, or other negative consequence that the FHLBank actually suffered.

3.2. <u>The Proposal's independence requirements for control functions should be clarified.</u>

The Final Rule should clarify independence requirements for participation in incentive plans by risk management, audit and other control function personnel both as to incentive-based compensation and their activities generally. The Proposal appears to conflict with itself and other FHFA regulations governing independence for internal audit and risk management functions.

The Proposal establishes several independence requirements for all control functions that could be interpreted to conflict with other aspects of the Proposal. Specifically, incentive-based compensation arrangements must have a risk management framework with an independent compliance program,[25] and must be subject to independent monitoring to ensure that they appropriately balance risk and reward.[26] Similarly, the FHLBank's risk management or internal audit functions must prepare an independent written assessment of the effectiveness of the incentive-based compensation program that considers specific matters.[27]

Other aspects of the Proposal could be interpreted to conflict with these independence requirements. For example, the Proposal defines the chief risk officer and chief audit executive as SEOs subject to the restrictions in the Proposal.[28] Furthermore, the Proposal requires that

[23] Because that statutory provision does not provide its own statute of limitations, the default statute of limitations for federal regulatory enforcement actions under 28 U.S.C. § 2462 would seem to apply.
[24] 12 C.F.R. § 1250.3(f).
[25] Proposed § 1232.9(a)(2).
[26] Proposed § 1232.9(c)(1).
[27] Proposed § 1232.10(b)(3).
[28] Proposed § 1232.2(gg).

individuals in control functions must have the authority to influence the risk taking of the areas they monitor.[29] It is not clear how a control function may provide an independent view of incentive-based compensation programs in which they participate, or may maintain independence from business operations they have the authority to influence.

The Final Rule should reconcile this apparent internal conflict, as well as conflicts with other FHFA regulation and guidance requiring independence for internal audit and risk management such as those contained in 12 C.F.R. Parts 1236 and 1239, and in FHFA guidance.[30] Each of the undersigned FHLBanks believes its control functions are currently properly structured to permit the exercise of their risk management and internal audit activities, so that no changes would be required by proposed § 1232.9(b). If FHFA concludes that the FHLBanks should change their control functions to meet the objectives of the Proposal, the FHLBanks request that such requirements be addressed through a more comprehensive revision to existing FHFA regulations and guidance governing control functions and not through the Final Rule, to eliminate the possibility of confusion or apparent inconsistency.

3.3. <u>The Proposal should expressly exclude benefit programs such as pension and 401(k) programs that have only incidental relationships to incentive-based compensation.</u>

The FHLBanks, like most employers, have a variety of benefit programs that use total compensation as a relevant measure to facilitate administration. These programs should be expressly excluded from the application of the Proposal for the avoidance of doubt. Inadvertently subjecting these programs to the Proposal could have the unintended consequence of requiring extensive (and expensive) rewrites of all of these programs, without providing any material benefit.

These programs do not incentivize risk taking; the connection to incentive-based compensation is merely incidental. These programs include for example, various FHLBanks' defined benefit plans and defined contribution plans (including 401(k) plans). We do not believe the Proposal intended to include these types of programs within the scope of the rule, but for the avoidance of doubt, all such plans should be expressly excluded from any Final Rule.

In this regard, the Agencies should amend § 1232.2(r) as follows:

> (r) Incentive-based compensation means any variable compensation, fees, or benefits that serve as an incentive or reward for performance. <u>"Incentive-based compensation" does not include defined contribution plans, defined benefit plans, or any other benefit program, the value of which is determined as a function of the recipient's base compensation, bonus compensation, and/or incentive-based compensation.</u>

[29] Proposed § 1232.9(b)(1).
[30] *See, e.g.*, Advisory Bulletin 2013-AB-07, *Model Risk Management Guidance*; Advisory Bulletin 2005-AB-05, *Risk Management Oversight*.

3.4. FHFA should adopt a rule clarifying that all compensation-related information submitted to FHFA hereunder is granted confidential treatment.

In the preamble to the Proposal, the Agencies explain that "When providing information to one of the Agencies pursuant to the proposed rule, covered institutions should request confidential treatment by that Agency."[31] We agree; such information is exempt from disclosure.[32] We therefore urge the FHFA to adopt a provision in the Final Rule that automatically grants confidential treatment to information provided in response to such requests, and to tailor individual requests for information to ensure confidential treatment. Doing so poses no risk.

3.5. Individuals in control functions should be permitted to have some aspect of their incentive-based compensation tied to business performance.

Proposed § 1232.9(b)(2) appears to prohibit persons in control functions from having any incentive compensation goal that is linked to an enterprise-wide performance objective, requiring incentive-based compensation to be tied to the performance of their control function only. As a policy matter, the FHLBanks believe that even those within control functions should be allowed to have some aspect of their incentive-based compensation tied to FHLBank performance.

FHFA faced similar questions in adopting 12 C.F.R. Part 1239, which was published in November 2015.[33] In Part 1239, FHFA squarely considered when compensation should and need not be independent of any other measures. Section 1239.11(c)(6) states that "[t]he compensation of [an FHLBank's] CRO shall be appropriately structured to provide for an objective and independent assessment of the risks taken by the [FHLBank]." Similarly, the FHLBank's audit committee has the duty of determining the compensation of the internal auditor.[34] FHFA did not adopt any further restrictions; no further restrictions are necessary here.

3.6. The Proposal requires duplicative assessments of incentive-based compensation programs.

The Proposal requires FHLBank management and either internal audit or risk management functions to prepare an annual written assessment of risk and control aspects of the FHLBank's incentive-based compensation program.[35] It also requires the compensation committee of the FHLBank's board to obtain input from the risk and audit committees of the FHLBank's board as to similar matters.[36] FHLBanks must already consider these matters to prepare their annual reports on Form 10-K. The Compensation Discussion and Analysis and the Item 402(s) disclosure requirements require disclosures and consideration of the registrants' compensation

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[31] Proposal at 37715 (referring to submission of compensation-related information under sections ____.4(f) and ____.5).
[32] *See* 12 U.S.C. § 552(b)(6), (8).
[33] FHFA, *Responsibilities of Boards of Directors, Corporate Practices and Corporate Governance Matters*, 80 Fed. Reg. 72327 (Nov. 19, 2016).
[34] § 1239.32(e)(3)(ii).
[35] *See* proposed § 1232.10(b)(2)-(3).
[36] *See* proposed§ 1232.10(b)(1).

practices for employees as they relate to risk management practices and incentives to take risks.[37] Consequently, the FHLBanks urge the FHFA to eliminate reporting requirements from the Final Rule since they are unnecessarily duplicative of similar disclosure requirements already applicable to the FHLBanks.

Conclusion

Dodd-Frank Act Section 956 does not mandate that the FHLBanks be covered in the Final Rule, nor should they be. However, if FHFA does include the FHLBanks in the Final Rule, the FHLBanks urge the FHFA to tailor application of the rule to the FHLBanks' cooperative wholesale lending structure, their statutory mission, and existing law and extensive FHFA regulation and guidance, which would include deeming the FHLBanks to be Level 3 institutions. The FHLBanks also request that the FHFA enhance the Final Rule to reduce its uncertainty and burden.

The FHLBanks appreciate the opportunity to offer these comments.

Sincerely,

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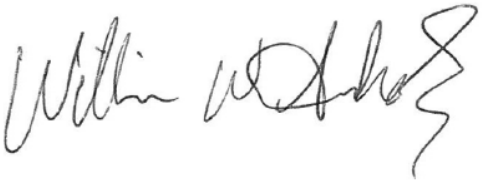
Chair, Governance and Compensation Committee of the Board of Directors

Federal Home Loan Bank of Boston

Andrew J. Calamare
Chair of the Board of Directors

Federal Home Loan Bank of Chicago



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Chair of the Board of Directors

Federal Home Loan Bank of Cincinnati

Donald J. Mullineaux
Chair, Board of Directors and Personnel and Compensation Committee

[37] *See* 17 C.F.R. § 229.402(b) & (s).

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Federal Home Loan Bank of Des Moines

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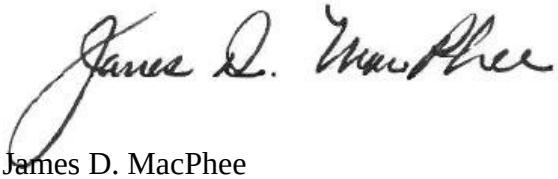

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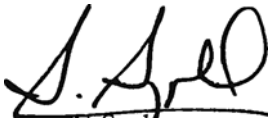

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