ADVISORY BULLETIN 2009-AB-02

October 27, 2009

Federal Housing Finance Agency
Division of Federal Home Loan Bank Regulation

To: Chairs and Presidents of the Federal Home Loan Banks,
Chair and Managing Director, Office of Finance

From: Stephen M. Cross
Deputy Director, Division of Federal Home Loan Bank Regulation

Subject: Principles for Executive Compensation at the Federal Home Loan Banks and the Office of Finance

Background

The Housing and Economic Recovery Act of 2008 (HERA) gives the Director of the Federal Housing Finance Agency (FHFA) the authority to prohibit compensation that is not reasonable and comparable to compensation paid to executives at other financial institutions. In this advisory bulletin, we outline several principles for sound incentive compensation practices to which the Federal Home Loan Banks (FHLBanks, Banks, or organization) and the Office of Finance (OF, or organization) should adhere in setting executive compensation policies and practices. In evaluating compensation at the FHLBanks and the OF, the FHFA Director will consider the extent to which an executive's compensation is consistent with these principles.

Guidance

1. **Executive compensation must be reasonable and comparable to that offered to executives in similar positions at other comparable financial institutions.**

   Total executive compensation should be reasonable and consistent with the Bank's status as a government-sponsored entity. In general, reasonable compensation is defined as what executives with similar duties at similar organizations in similar locations are paid. In setting compensation, the board of directors or its designated committee should survey comparable positions within the FHLBank System and comparable positions at financial institutions that are similar in size, complexity, and function. While survey information may be a factor in setting executive compensation, surveys should not override the need for independent decisions that are consistent with the Bank's financial condition and future prospects.

2. **Executive incentive compensation should be consistent with sound risk management and preservation of the par value of the Bank's capital stock.**

   Incentive compensation plans should be consistent with sound risk management practices. Compensation plans should reflect a reasonable assessment of the organization's financial situation and prospects. Incentive compensation should not represent an inappropriate share of total compensation. Incentives should not encourage imprudent or excessive risk-taking that might jeopardize the financial condition or the future performance of the FHLBank, including the ability to redeem and repurchase capital stock at par from member institutions.

   The board of directors should ensure that staff engaged in risk management and compliance functions are compensated in a manner that is independent of the financial performance of the business areas they monitor. Compensation plans should base executives' compensation on performance metrics that are linked to the objectives of their principal functions.

3. **A significant percentage of an executive's incentive-based compensation should be tied to longer-term performance and outcome-indicators.**

   Measuring performance based solely on the near-term financial performance metrics could encourage executives to pursue risky practices to generate higher profits or growth in the short run, while exposing the institution to undue risk over a longer term. Consequently, incentive compensation plans that link compensation to any short term financial metrics should do so in a manner designed to limit excessive risk taking A portion of an executive's incentive compensation should be linked to the FHLBank's longer-term condition and performance. Performance metrics might include adherence to risk management policies and risk limits, and non-financial indicators, such as remediation of examination findings, attainment of mission-achievement goals, and compliance with laws and regulations.

   Poor performance should adversely affect an executive's incentive compensation. Incentive payouts should normally decline or be eliminated when an FHLBank develops financial or operational difficulties, such as an increase in classified or troubled assets, or in reported losses. Similarly, payouts should properly reflect a performance-related reduction or elimination of dividends, or the suspension of stock redemptions. Incentive compensation plans should include provisions that reduce compensation if (i) operational errors or omissions result in material revisions to the financial results, information submitted to the FHFA, or data used to determine incentive payouts; (ii) submission of information to the SEC, OF and/or FHFA is untimely, or (iii) the organization fails to make sufficient progress, as determined by the FHFA, in the timely remediation of examination, monitoring, and other supervisory findings and matters requiring attention. Good performance, including effective remediation of pre-existing problems, should be rewarded. Targets should be set so that new hires, even in troubled circumstances, have a reasonable opportunity to achieve them The FHFA expects the organization's board of directors to actively oversee and evaluate the performance of the organization and the progress made in resolving the issues identified. The board should exercise independent judgment in establishing incentive compensation and ensuring a link to identified shortcomings and progress in remedying those shortcomings.

4. **A significant percentage of an executive's incentive-based compensation should be deferred and made contingent upon performance over several years.**

   To encourage executives to take future risk into account, a significant portion of any incentive compensation that is linked the Bank's financial performance should be deferred and linked to Bank's future financial performance.

5. **The board of directors of each FHLBank and the OF should promote accountability and transparency in the process of setting compensation.**

   The board of directors or its designated committee should play an active role in the design, operation, and periodic evaluation of the compensation program for senior executives. In making its assessment of executive compensation, the committee should exercise independent judgment and not rely solely on the opinions of others.

   The committee should have the expertise needed to carry out this function and to understand the implications of compensation policies on risk and risk management. At least one director on the committee should have practical skills and experience in risk management. The committee should have appropriate measures in place to manage conflicts of interest.

   The compensation committee should have the resources to access compensation consultants and/or outside counsel as needed.

   To promote transparency, the organization should clearly document its compensation policies and procedures. The board of directors should disclose, in the organization's annual report, the basis for incentive-based compensation payments.

It is the responsibility of each FHLBank and the OF to ensure its corporate governance policies and practices, of which compensation is just one component, meet the highest standards of transparency and accountability. Meeting these standards will give the FHLBanks and the OF the greatest chance of ensuring they meet the needs of their constituents in both the short and long term while serving as corporate role models in a manner consistent with their public policy mandate.

Principal Finance Housing Finance Agency Contacts

Daniel E. Coates, Associate Director for Risk Analysis and Research, (202) 408-2959, daniel.coates@fhfa.gov.

Appendix

The table below provides some examples of acceptable outcome-indicators, and related targets.

Outcome-indicators	Stretch target during the period of evaluation	Why is the outcome-indicator important?
Ratio of market value of equity to the par value of its capital stock (MVE/PVCS)	Remains stable (if at par), or increases, or falls no more than a predefined amount	The maintenance of the MVE/PVCS ratio as close to one as possible is of paramount importance to the safety and soundness, and ultimately the mission achievement of the institution since the FHLBank stock is sold and expected to be redeemed and repurchased at par.
Level of retained earnings	Increases with increased expectation of credit, market, and operational risks, and in response to deteriorations in the MVE	In a cooperative, retained earnings serve as the primary loss-absorbing form of capital. This is especially true when the cooperative's members and members' regulators adhere to the expectation that the cooperative's shares of stock will always be redeemed at par.
Disbursement of Affordable Housing Program (AHP) funds	Remains stable (if full disbursement), or increases, or falls no more than a predefined amount	The Bank Act requires each FHLBank to allocate 10 percent of their net income to fund AHP. The full disbursement of the allocated funds is of paramount importance to the affordable housing mission achievement of the institution.
Resolution of MRAs, FHFA examination, monitoring, or other supervisory findings	To the satisfaction of FHFA.	Incentives should be aligned to ensure FHLBank executives take FHFA findings seriously and resolve them promptly. It is difficult to support incentive payouts when the Bank has not resolved FHFA issues in a timely manner.