

BL-060**Compensation Committees**

July 9, 2009

To: Chairman, Board of Directors
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Compensation Committees

In recent months the matter of executive compensation has received significant attention from government officials, members of Congress, investors, the media, and the public. The administration is now developing enhanced guidance on compensation practices at U.S. banking organizations. Compensation practices, if not managed carefully, carry significant reputation risks to Farm Credit System (System) institutions as government-sponsored enterprises (GSEs). System institutions' boards of directors and their compensation committees must ensure that they are prudently managing compensation programs, aligning compensation practices with sound operations and long-term performance, and providing, in an open and transparent manner, accurate, comprehensive, and understandable disclosures on their compensation programs and practices as § 620.5(i) of FCA's regulations requires. These disclosures are vitally important to System shareholders, the investing public, and FCA.¹

In 2006, FCA's governance rule required System banks and associations and the Federal Farm Credit Banks Funding Corporation (institutions) to establish compensation committees.² The regulatory requirement is relatively new. This booklet advances the objectives of good governance by conveying our expectations for the compensation committee's fulfillment of its obligations to the institution and its shareholders. The compensation committee's sensitivity to the current business environment and its prudent management of the institution's financial resources are essential in protecting the institution's reputation in the community and the marketplace. The committee's role is critical in safeguarding the institution's integrity at a time of heightened concern and scrutiny on executive compensation. Your board of directors should initiate an appropriate review to determine whether your compensation committee charter, your compensation committee's process and operations, and your institution's compensation disclosures align with our expectations or whether changes should be considered.

Board Responsibilities. A compensation committee will function more effectively when the committee charter clearly sets out the board's expectations on how the committee is to perform its duties. The board of directors must establish and maintain a compensation committee by adopting a written charter and appointing at least three directors to serve on the committee in accordance with § 620.31 and § 630.6(b) of FCA's regulations. In carrying out these responsibilities, the board should ensure that the charter:

- Delineates clearly the authorities the board is delegating to the compensation committee;
- Authorizes the compensation committee to hire, retain, and terminate external advisers and/or outside legal counsel needed to assist the committee in performing its duties. These professionals should work directly for, and report directly to, the committee and be independent of senior management (i.e., no personal or other professional relationships with senior management);³
- Authorizes the committee's direct access to any advisers that management uses on compensation programs or practices;
- Provides for the committee's easy and ready access to institution resources and personnel, particularly senior officers and managers with human resources responsibilities, to obtain needed information and gain the best overall understanding of the compensation program; and
- Requires the compensation committee to remain accountable, and report only, to the board.

The board should appoint one of the directors to chair the compensation committee. The board should also ensure that the committee members have no known or potential conflicts of interest with executive (senior) officers that could interfere with the committee members' exercise of independent judgment. Additionally, the board should be mindful of its policy on director training and revise it, if needed, to ensure that compensation committee members receive ongoing training from professionals on compensation trends and updates, including the tax, accounting, and legal implications of compensation programs. The training should provide a solid platform for the committee to evaluate and modify the compensation program with a competent and critical eye.

Compensation Committee Operations. The committee should have written procedures in place for its operations. The procedures should address the responsibilities of the committee chair, particularly the chair's role as the key contact between the committee and the board and between the committee and senior management. In that capacity, the committee chair should have discretion to brief the board chairman and advise him or her of any key decisions in advance so the board is prepared to deal with the issue(s) when the committee and board meet. The procedures should provide for committee executive sessions where critical issues can be discussed without management present. By regulation, the committee must keep meeting minutes and retain those minutes for at least 3 years. Meeting minutes should provide sufficient detail on reasons for decisions to avoid member disputes on prior decisions. Committee members should have ready access to past minutes for reference or review. If the entire board serves as the compensation committee, it is essential that directors, when meeting as the compensation committee, maintain a separate agenda and a separate set of minutes so the business of the board and the business of the compensation committee are not mixed. The committee should review its charter annually and recommend any revisions to the board. As a subset of the annual board self-evaluation process, compensation committee members should consider assessing their own performance as a board committee.

Key Factors for the Compensation Committee to Consider in Discharging its Duties. The jurisdiction of the compensation committee includes the review of the compensation policy and plan for *all* employees as well as the approval of the overall compensation program for the chief executive officer and other senior officers. Thus, the committee's reach extends to the institution's salary programs, perquisites, short- and long-term incentives, deferred compensation, retirement and/or pension programs, supplemental pension programs for senior

officers, executive employment and severance agreements, change-of-control provisions, succession planning and retention bonuses, and employee benefit plans. Consequently, we expect that the compensation committee should be able to:

- Articulate the board's compensation philosophy—what the institution rewards and why—and convey that philosophy in the annual compensation disclosure;
- Consult with, or employ as needed, professionals and/or external legal counsel who are independent of senior management and who bring the necessary perspective and expertise to work directly with the compensation committee on compensation-related issues;
- Fully analyze and justify the long-term liability to the institution in developing compensation packages and fully understand the financial commitment and total cost to the institution. Use appropriate analysis and metrics to develop a complete understanding of the full effects of the compensation package as it pertains to the chief executive officer and individual senior officers (all the elements of annual pay, long-term pay, severance benefits, and all other compensation);
- Ensure an appropriate linkage of pay to performance to ensure that total compensation packages are meaningful relative to the institution's long-term financial outcomes;
- Carefully evaluate incentive programs and ensure that incentive payments are based on the institution's long-term financial performance, are consistent with prudent risk-taking, and produce safe and sound outcomes;
- Ensure incentive programs align the interests of senior officers and employees with the long-term financial health of the institution (e.g., do not give undue weight to factors such as loan growth without also considering asset quality, profitability, and financial performance factors);
- Ensure that retirement benefits are appropriate and not excessive in light of bonus programs and other compensation already paid to executive officers;
- Ensure pension programs are appropriately structured to attract, retain, and reward staff, and that pension programs are appropriately funded; and
- Fully understand key assumptions used to calculate compensation and pension plan obligations, such as assumptions used for present value calculations, as well as the sensitivity of your institution's financial exposure to such assumptions.

Communication and Collaboration. The compensation committee needs to communicate and collaborate effectively with the chief executive officer. The compensation committee must also communicate regularly with other senior officers and managers (particularly those with human resources or risk management responsibilities) so that the flow of information between the committee and management is not impeded. Because of the complexity of compensation arrangements, committee members are expected to challenge management and the committee's external advisers on any compensation issue that they do not understand. The FCA also expects the compensation committee to provide prompt notice to FCA of any material changes in the institution's compensation program and to then disclose this information to the institution's shareholders in a timely manner.

Disclosures and Transparency. Section 620.5(i) of FCA's regulations details the compensation information that must be disclosed in the annual reports of System banks and associations.⁴ FCA expects the compensation committee to review the compensation discussion and analysis to determine whether it meets the regulatory requirements of § 620.5(i) and whether the discussion is prominent, inclusive, and understandable. The board of directors and its compensation committee should not rely on the qualified public accountant for review of the

compensation disclosure because such a review is not generally within the scope of the audit of the financial statements. The critical question for the compensation committee is whether the committee's decisions with respect to compensation matters are sufficiently transparent so that the reader of the disclosure understands the institution's compensation philosophy and practices.

FCA Oversight. FCA will continue its oversight of the conduct and operation of System institutions' compensation committees and the process by which the institutions develop compensation disclosures for reporting purposes. FCA will also take appropriate steps to ensure that full disclosure of compensation programs occurs.

In conclusion, System shareholders and investors in System securities are watchful of how the boards of directors, through their compensation committees, are carrying out their fiduciary obligations, both individually, to their respective shareholders and, collectively, to their investment community. This is evidenced by the institutions' annual published disclosures on executive compensation and compensation programs and the Systemwide report to investors. As a collective of farmer-owned cooperatives, the System holds a unique and distinguished position in agricultural financing and plays an increasingly significant role in lending to agriculture and rural America. It is essential that the System remain safe, sound, and financially strong, so it is there for America's next generation of farmers, ranchers, cooperatives, and rural communities. To ensure this outcome, System institutions must remain accountable to their respective shareholders, maintain strong governance practices, and demonstrate financial prudence in their decisions, including those on executive compensation.

If you have any questions regarding this communication, please contact your institution's examiner in charge or you may contact Andrew D. Jacob, CFA, Director, or Gary Van Meter, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102-5090, at (703) 883-4414, or by e-mail to jacoba@fca.gov or vanmeterg@fca.gov.

Copy to: Chief Executive Officer
Each Farm Credit Bank and Association
Federal Farm Credit Banks Funding Corporation

¹Under section 514 of the Farm Credit Banks and Associations Safety and Soundness Act of 1992, Pub. L. 102-552, 106 Stat. 4102 § 514 (1992), FCA must ensure that the financial disclosures (including disclosure of compensation) by System directors, officers, and employees provide (1) the institutions' shareholders with information they need to make informed decisions regarding System institutions' operations, and (2) investors with information they need to make decisions on purchasing System debt. FCA monitors, examines, and regulates the financial disclosures of all System institutions to ensure accurate reporting and disclosure occurs.

²Under § 620.31 of FCA's regulations, each bank and association board of directors must establish and maintain a compensation committee by adopting a written charter that describes the committee's composition, authorities, and responsibilities. Under § 630.6(b) of FCA's regulations, the Federal Farm Credit Banks Funding Corporation must also establish and maintain a compensation committee.

³Section 620.31(c) of FCA's regulations requires each bank and association to provide monetary and nonmonetary resources so the committee can function effectively. Section 630.6(b)(3) of FCA's regulations has a comparable requirement for the Federal Farm Credit Banks Funding Corporation.

⁴Associations have the option of disclosing this information in their Annual Meeting Information Statements.