FEDERAL HOME LOAN BANK
OF CINCINNATI

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President

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Federal Housing Finance Board
1625 Eye Street, NW
Washington, DC 20006

ATTN: Public Comments
Federal Housing Finance Board
Proposed Rule: Financial Interests of Appointive Directors
RIN Number 3069-AB34
Docket Number: 2007-05

On behalf of the Federal Home Loan Bank of Cincinnati (the "Cincinnati Bank" or "Bank"), the following are formal comments on proposed revisions to the director eligibility, appointment and election regulations of 12 C.F.R. Part 915 proposed by the Federal Housing Finance Board (the "Finance Board") and published in the Federal Register on March 27, 2007 (the "Proposed Rule").

The Bank thanks the Finance Board for giving the members of the Federal Home Loan Bank System (the "System" and "System Banks") and others the opportunity to comment. This letter responds to your specific request for comment on whether the Finance Board should apply the same standard for determining if a holding company's securities are permissible investments for an appointive director to other types of relationships--namely, service as a *director or officer* of the holding company. For the reasons given below, we believe that the same standard should apply and that, without additional broadening, the Proposed Rule may, in fact, be counter-productive. Without an exception to the Proposed Rule, we believe that it will be much more difficult for a System Bank to attract eligible appointive directors with those special qualities noted as desirable by the Finance Board in the discussion of the Proposed Rule, namely that (a) it is important "that some of a Bank's individual appointive directors have more sophisticated skills and a deeper understanding of financial markets to provide strong oversight" and (b) that such directors be eligible for appointment under rules that "remain flexible enough not to create unnecessary barriers to finding candidates with the skills and experience to be strong directors."

Initially, we suggest that the current broad interpretation of "member" that the Finance Board has informally adopted via the application for appointive directors does not appear to have any clear grounding in the Federal Home Loan Bank Act (the "Act"). Under that interpretation--set forth in footnotes 7 and 9 of the discussion to the Proposed Rule--a "member" is deemed to include such member's direct parent and ultimate holding companies.

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That Act states that "No Federal Home Loan Bank director who is appointed pursuant to this subsection may, during such Bank director's term of office, serve as an officer of any Federal Home Loan Bank or a director or officer of any *member* of a Bank, or hold shares, or any other financial interest in, any *member* of a Bank."[1] Currently, Regulation §915.11 defines the term "financial interest" to include a broad range of direct and indirect interests and relationships between a person and a System Bank. As the Finance Board notes on page 14 of the discussion of the Proposed Rule, prior versions of the Regulations excluded investments in certain bank holding companies from constituting "financial interests" in members of System Banks.[2] Continuing in that vein, the Proposed Rule suggests that ownership of shares in a holding company is not a "financial interest" if the assets of all members of a System Bank held by the holding company comprise less than twenty-five percent of the total assets of that holding company.

The Proposed Rule notes that where the System Bank member percentage contribution to a holding company is below the twenty-five percent threshold, the relationship between the holding company and such member banks represents something less than an "interest in the member" for conflict of interest purposes. Although this reasoning makes sense given the fluid and subjective conceptual nature of the term "financial interest", we would suggest that the 1991 amendment clarifying the definition of a diversified holding company was not in need of any change. However, if there were to be a change--from a percentage of consolidated net worth and earnings to that of total assets--it could be reasonably argued that the threshold level should be fifty percent (or less than a majority position) of total holding company assets. Such a change would be consistent with the previous Finance Board interpretation that a financial interest was established if both a member's earnings and net worth position accounted for more than fifty percent of a holding company's consolidated net worth and earnings. Such an expanded threshold up to 50 percent would also provide more flexibility in attracting qualified directors.

In addition, as used under the Proposed Rule, the terms "director" and "officer" would normally not be subject to such similar incremental interpretation or treatment. As noted above, the Act prohibits an appointive director from serving as a "director or officer of any member of a Bank." One is either a director or officer of a System Bank member or he or she is not. And a director or officer of a holding company that owns a System Bank member is simply not a director or officer of that System Bank member. One cannot be an "indirect" director or officer of a company. Expanding the normal definition of a "member" without some tie to the original legislative history of the Act empowering the Finance Board to so expand that definition--a tie that we cannot find--caused our counsel, with all due respect, to advise us that there is a serious question as to the statutory authority of the Finance Board to interpret the term so broadly.

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[1] 12 U.S.C. §1427(a)

[2] See 56 FR 55219-55220 and 12 C.F.R. §931

Assuming, however, that the Finance Board *has* statutory authority to limit the ability of an appointive director to serve as a director or officer of a System Bank member's holding company, we believe that the Finance Board's reasoning--in proposing to deem a holding company's "financial interest" in a System Bank member to phase out below the twenty-five percent or otherwise established threshold--should *also apply* to whether a person is qualified as an appointive director if he or she is a director or officer of the holding company of a System Bank. The concern about one person serving as a director or officer of *both* a System Bank *and* one of that bank's members or an affiliated holding company is one of conflict of interest. Specifically, one might worry that a person serving as a director of a System Bank--and also as a director of a parent thereof--would be inclined towards always supporting actions of the System Bank that provided economic benefit to or otherwise favored the member (and thus, indirectly, the parent of the member) or opposing actions which would have the opposite effect, regardless of benefit to the System Bank or the overall System. Clearly, however, where a System Bank member comprises less than the established threshold level of a holding company's total assets, the performance of that member has a relatively diluted impact on the overall performance of the holding company. Such a director or officer--serving both the System Bank and the holding company--then might have considerably less of an incentive to favor or oppose actions of the System Bank just because of potential impact on the holding company.

On page 16 of the preamble to the Proposed Rule, the Finance Board highlights this conflict issue in a slightly different way:

> "It would appear incompatible with the independence expected of an appointive director and the public interests the director is expected to serve to allow that person simultaneously to serve as an officer or director of any holding company that controlled any member of the Bank. As an appointive director, the individual would owe fiduciary duties to the Bank and the Finance Board does not believe that an appointive director also should owe fiduciary duties to a member or its holding company. These competing duties could make it difficult for the appointive director to competently serve in either capacity."

It is not uncommon, however, in the general business world for qualified individuals to serve on multiple corporate boards. Indeed, this is exactly the situation for many if not most of the elective directors of System Banks. In situations where the two relevant corporations are confronted with transactions with each other--including sometimes in industries that share a common need for special expertise on their boards--our counsel has informed us that courts have indicated that, although these situations may give rise to potential conflicts of interest, such conflicts can in fact be managed and even mitigated through full *disclosure* to all parties, demonstrations of good faith and fairness to such parties, and, if necessary, abstention from participation in a vote concerning the particular matter.[3] Indeed, it is precisely for this kind of situation that the conflict of interest policies required of System Banks by the Regulations (§915.11) are designed to deal with. Even under the Proposed Rule, if a System Bank director

[3] See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

owns stock in a holding company whose total assets are comprised of *less* than twenty-five percent of a member or members of System Banks (and thus, where such ownership would not constitute a disqualifying "financial interest"), the existing conflict of interest rules *still* require such an individual to disclose to the System Bank's board *all* such ownership interests and such individual could be required to recuse himself (or herself) in the event of an actual or potential conflict. We see no reason why a similar disclosure and conflict vetting process would not generally work where an appointive director also serves as a director or officer of a holding company of a System Bank member.

Indeed, the same concept applies as to the Proposed Rule provision[4] which would not consider contractual money benefits that an appointive director received from a remote affiliate a tainting financial interest where such benefits are never more than 10% of the income of the appointive director--i.e. such interest would still need be disclosed as a potential conflict of interest.

Furthermore, we believe that a blanket prohibition of directors of System Bank member holding companies serving as appointive directors of System Banks would have the undesirable effect of prohibiting qualified and experienced individuals from offering their talents to the Federal Home Loan Bank System. In 1991, the Finance Board considered proposed regulations that would have imposed expanded disclosure requirements on System Bank directors relating to relationships between System Bank members and other companies for which such persons serve. Declining to adopt the proposed rules as final, the Finance Board noted that "the types of people who would be most likely to have financial relationships covered by this requirement are those who may be among the most qualified to serve on the board of the FHLBanks. The rules should not discourage such persons from serving as a result of a reporting requirement that may be of limited value."[5]

These 1991 comments by the Finance Board on the importance of qualified and experienced appointive directors are echoed in the discussion of the Proposed Rule and elsewhere--and by the fact that the Act only requires two of the appointive directors to be truly free of conflicted economic motivations by being associated with community service or financial consumer protection organizations[6] . This all speaks to the point that the Finance Board should not be more concerned about dual directorships with member affiliates than it would be for elective directors, especially when those affiliates make up a less than majority portion of the total affiliate asset base.

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[4] Proposed § 915.10(f)(5)

[5] 56 F.R. 55211.

[6] 12 U.S.C. § 1427(a)

SUMMARY

Respectfully, we therefore urge the Finance Board (a) to not proceed with the expanded concept of "member" in the Proposed Rule and delete Line 5 of your Instructions to your Appointive Director Eligibility Certification Form, *and* (b) to amend Section 915.11(f)(3) of the Proposed Rule to provide a similar asset test exception for serving as a director or officer of a "member" for financial interests. In the latter case, we suggest revising Section 915.11(f)(3) to read is as follows:

> (3) Holding Company. Service as an officer or director of, or ownership of debt or equity securities issued by, a holding company that controls, directly or indirectly, one or more members of the Bank on whose board an appointive director serve, shall not be prohibited hereby, or such securities considered a prohibited financial interest in a member hereunder, provided that the assets of all such members constitute less than 50 percent of the assets of the holding company, on a consolidated basis.

Again, we appreciate the opportunity to comment on the Proposed Rule and thank you for your consideration of same.

Respectfully submitted,

David H. Hehman
President