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March 19, 2007

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1261

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: RIN 1550-AB56

[redacted] of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219

Re: Docket Number 06-09

Regulation Comments
Chief Supervision
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Attention: No. 2006-33

Re: No. 2006-33

Dear Sir or Madam:

Citigroup remains supportive of the objectives of Basel II and welcomes this opportunity to comment on the notice of proposed rulemaking ("NPR"). We have responded to the detailed questions in the NPR, together with some additional issues, in the attached appendix to this letter. In this covering letter we have identified the broader concerns we have with the NPR, and have ventured to suggest possible solutions.

We have adopted this approach because of our concern that the NPR will have a significant impact not only upon the operation of our own institution, but also more widely on the United States ("U.S.") banking sector as well as potentially the US economy as a whole. The final rules will affect day-to-day lending and investment decisions, and those decisions will, in turn, affect the availability of credit in the economy. The rules also will affect the ability of U.S. financial institutions to compete with foreign banks both domestically and internationally; to the extent that US banks are placed at a disadvantage compared to non-US financial institutions, such result could well reduce profitability, the potential to accumulate additional capital and the reserves available to protect depositors and other lenders.

We support the goals of the Basel II capital Framework. . .

We strongly support the implementation of the international Basel II Capital Framework (the "Framework") in the U.S. After several revisions and many years of review and analysis, the Agencies and other banking authorities for the world's leading economic countries agreed to the Framework in June, 2004. The Basel II Capital Framework represents a significant and necessary improvement over the current Basel I Capital Framework. It seeks to align capital to risk in a more meaningful manner than the existing Basel I requirements. It also seeks to maintain consistency in international banking capital requirements, a key reason for the introduction of Basel I.

.....but the Agencies have proposed modifications to the Framework that will place US Basel II banks at a significant competitive disadvantage and could damage the U.S. economy:

Unfortunately, although the Agencies participated in and even led the creation of the Framework, the Agencies have added several provisions to the NPR that are inconsistent with the objective of international consistency. These provisions in the NPR mandate higher minimum regulatory capital requirements for U.S. banks than will apply to foreign banks holding similar risks. As a result, foreign banks will gain a competitive advantage over U.S. banks in lending and investment activities. This competitive advantage will apply not only within the home country of the foreign bank but also with respect to the foreign bank's branches and other activities within the US market. Thus, the competitive impact of the NPR is not just an issue for large banking institutions; it is an issue for all U.S. banks.

A further key objective of the Framework is to create a capital regime that is truly risk-sensitive, i.e. that aligns regulatory capital requirements more closely with true economic risks, and that recognizes the benefits of modern risk-mitigation techniques. The NPR will provide less safety and soundness protection than the Framework because the provisions added into the NPR reduce its risk sensitivity.

Additionally, the differences between the Framework and the NPR have turned Basel II into a costly compliance exercise. Citigroup has developed over many years a sophisticated system for measuring risk, and the NPR would require additional risk models and very costly systems modifications that have little bearing on the manner in which we actually measure risk and operate on a day-to-day basis.

We believe that the NPR should be harmonized with the Framework in order to address the competitive advantages granted to foreign banks, to improve its safety and soundness for regulatory capital measurement and to correct the potential economic and cost disadvantages which the NPR introduces. All of the Agencies agreed to the Framework. It aligns minimum required regulatory capital to risk in a more meaningful manner than the existing Basel I requirements. It also seeks to foster consistency in international capital requirements, thereby preventing institutions from gaining a competitive advantage simply based on where they choose to locate their headquarters. We also believe that concerns over capital levels under the Framework, which have been expressed by the Agencies and smaller U.S. banks, can be addressed in conjunction with the harmonization of the NPR with the Framework without jeopardizing the objectives of the Framework.

In the balance of this letter, we (i) expand on why the changes based on the QIS-4 survey are inappropriate and premature, (ii) explain the significant competitive consequences of such changes, (iii) review the other significant changes introduced by the NPR which reduce its safety and soundness compared to the Framework and (iv) discuss our recommendations for harmonizing the NPR with the Framework while addressing concerns over capital levels. While we believe that these detailed responses to the specific questions in the NPR are comprehensive, we will continue to explore the details of the NPR and, as a result, may well wish to provide additional comments up to the deadline imposed by the Agencies.

(i) The QIS-4 Data Does Not Justify The Proposed Modifications To The Framework

The Agencies have included a number of provisions in the NPR that do not appear in the Framework; some of these provisions were presented in September 2005, others were first introduced in the NPR. The NPR justifies these provisions by reference to their QIS-4 survey, which found that the Framework would result in an average reduction in minimum risk-based capital of 15.5 percent for the nation's largest banks. The changes to the Basel II Framework introduced by the NPR appear to be intended to maintain current minimum regulatory capital levels in Pillar 1 for individual Basel II banks, undermining the key principles of the Basel Framework. Moreover, the limitations of the QIS-4 survey have been acknowledged by the Agencies

We believe, for the following reasons, that the QIS-4 survey results do not justify the proposed modifications to the Framework:

- The survey examined the impact of Pillar 1 only, and did not assess the impact of the entire Framework;
- The QIS-4 Survey was a "best efforts" exercise since sufficient guidance was not available;
- The Agencies did not seek to resolve sizable divergence in the results;
- The Survey was conducted at a benign point in the credit cycle, and our data indicates that if the survey had been conducted during an economic downturn, minimum capital levels would have increased over the Basel I minimum,
- It is inappropriate to use the Basel I minimum as a basis for comparison, and
- The Agencies have recognized the limitations of the QIS-4 survey

Annex 2 to this letter expands on each of the above issues, explaining our views.

(ii) The NPR Competitively Disadvantages US Banks

One of the primary objectives of the Basel I and Basel II Frameworks is to eliminate disparities between capital requirements imposed by different countries. This objective recognizes that regulatory capital can have a significant impact on the ability of an institution to price its services competitively. The NPR undermines this objective of regulatory equality by mandating significantly higher minimum capital requirements for US banks than will apply to foreign banks under the Framework.

Among the most important provisions in the NPR that give these advantages to foreign banks over US banks are:

- The 10% aggregate floor
- The application of the leverage ratio
- The longer and more restrictive transitional period for US banks
- Different measurements for equity investment and loans

Foreign Competitors not subject to 10% Aggregate Floor

The NPR provides that a 10 percent decline in aggregate industry-wide minimum required risk-based capital at Basel II banks during the parallel run and transition period would constitute a material reduction warranting modifications to the capital framework. This limit has no relationship to either U.S. or global economic conditions. The average credit rating (i.e. the average PD) of a fixed portfolio of obligors will vary with the economic cycle, as obligors migrate to better or worse ratings. In strong economic cycles the total risk weighted assets for credit risk for a fixed portfolio may as a consequence vary by more than 20% from peak to trough of the cycle. Therefore, a drop in minimum regulatory capital of 10 percent or more, with respect to what its average value would be through the cycle, may well be expected and would not pose any safety and soundness concerns.

In addition, because of Basel II's greater risk sensitivity compared to Basel I, it provides strong incentives to banks to implement credit risk mitigation practices (such as requiring collateral on loans) that objectively lower economic risk. It would be inappropriate to recalibrate the Basel II risk weight functions during the transition period if the ratio of total risk weighted assets (as measured by Basel II relative to Basel I) fell as a consequence of an objective decrease in economic risk due to more actively implemented credit risk mitigation practices.

Like the QIS-4 survey, the 10 percent floor is measured with respect to the crude current Basel I requirements. The Basel II Capital Framework is designed to replace the Basel I framework, which lacks the desired risk sensitivity. Moreover, the 10 percent floor disregards the fact that the US banking regulators have the ability to increase the minimum capital of an individual bank through Pillar 2, and the other supervisory tools.

In summary, it is inappropriate to recalibrate the risk weights under Basel II during the transition period by using Basel I as the benchmark. To do so would ignore the cyclicality of RWA under Basel II through the economic cycle, the potential material reduction in RWA through increased use of credit risk mitigation and the greater risk sensitivity of Basel II relative to Basel I.

The 10 percent floor also adds a measure of uncertainty into the business and capital management plans for our banking institutions. The 10 percent floor introduces uncertainty in long term business planning and capital management strategies. It subjects individual banks to potential changes in capital requirements as a result of actions of other banks. Some banks will choose to manage this problem by holding additional excess capital that could otherwise support loans and investments that would contribute to economic growth. It also creates uncertainty in the debt and equity markets that may impact valuations and funding costs for U.S. banks. In other words, the uncertainty and uncontrollability results in significant, detrimental unintended consequences. Foreign banks are not subject to any similar requirement.

Foreign Banks not Subject to a Leverage Ratio

The U.S. is almost alone in imposing an additional minimum capital requirement known as the "leverage ratio." The leverage ratio mandates capital to be held as a simple percentage of book assets, regardless of the relative risk of these assets. This requirement dates from a time when risk analysis and risk measurement techniques were not available. In contrast, the Framework recognizes and utilizes many of the modern risk measurement techniques that are used by the world's most sophisticated financial organizations. Under the Framework, minimum regulatory capital levels are aligned with economic risk. Aligning regulatory capital with economic risk ensures that adequate capital exists to cover risk, but does not result in excess capital, which is then unavailable to support lending and investment activities. The leverage ratio does not adjust for risk, and will become the binding requirement for many Basel II banks. This will cause the safest U.S. banks either to hold more capital than required under the Framework, thus giving their foreign counterparts a capital advantage, or will cause U.S. banks to increase the risk of their portfolios in order to justify the higher capital requirements. The continuation of the leverage ratio requirement is diametrically opposed to the goal of establishing a risk-based capital system.

U.S. Banks Face A Longer And More Restrictive Transition Period

Another significant competitive issue is raised by the longer and more restrictive transition period in the U.S. The NPR establishes a three-year transition period for Basel II banks. Other countries apply a shorter two-year transition period.

Under the NPR, U.S. banks will be required – for a minimum of 12 months – to maintain regulatory capital equal to at least 95% of their Basel I capital requirement whereas non-U.S. banks must maintain only 90% of their Basel I capital during the first year of the Framework. In the second year, a U.S. bank, if permitted by its regulator, is required to maintain at least 90% of their minimum Basel I capital requirement, whereas non-U.S. banks are subject to an 80% limitation, and non-U.S. banks do not have to seek the agreement of their regulator to move to this lower level. In the third year, if a U.S. bank is again been permitted to move to the next level by their U.S. regulator, they are still restricted to maintaining at least 85% of their Basel I capital, whereas non-U.S. banks are not subject to any restriction. Thus, not only do U.S. banks have more restrictive transitional arrangements (longer and higher minimum requirements), but they also must seek the permission of their U.S. regulator to move to the next transitional floor, and the standards which advancement from one level to the next are not defined in the NPR. In addition, U.S. banks will have the cost of maintaining the calculation of an equivalent Basel I minimum capital requirement for at least 12 months longer.

Different Measurements of Equity Investments and Loans

U.S. banks also will be disadvantaged in lending to small- and medium-size businesses enterprises. The Framework recognizes the lower risk in a portfolio of small- and medium-size business loans and reflects this in a special risk weight formula that decreases the level of required capital relative to the standard corporate risk weight formula. Under the NPR, however, this special risk weight function for small and medium-size businesses is not recognized, and U.S. banks will be required to hold more capital for such loans than foreign banks. The obvious consequence of this difference is that U.S. banks will be at a competitive disadvantage in lending to these companies compared to foreign banks, regardless of how a foreign bank is organized in the U.S.

With respect to equity investments, the NPR requires a relatively harsh capital treatment for equity investments in a financial company that has material liabilities. This more restrictive treatment is not applied to non-U.S. banks, and puts U.S. banks at a competitive disadvantage when seeking to expand business opportunities through equity investments.

Citigroup is also concerned that the NPR would create a significant competitive disadvantage for U.S. banks with respect to holdings of local currency sovereign obligations that are funded locally, since local regulators are allowing local banks a continuation of the Basel I, 0% risk weighting.

(iii) The NPR Provides Less Safety And Soundness Protection Than The Framework

In addition to international consistency, a further key objective of the Framework is to create a capital regime that is truly risk-sensitive, i.e. that aligns regulatory capital requirements more closely with true economic risks, and that recognizes the benefits of modern risk-mitigation techniques. A risk-sensitive capital regime also will reduce the artificial incentives for banking institutions to shift their best assets off-balance sheet in order to achieve more favorable capital treatment. The provisions the Agencies have added to the NPR blunt the risk-sensitivity of the rule.

In addition, as the NPR is less risk sensitive than the Framework, it will provide less safety and soundness protection than the Framework. A truly risk-based capital requirement enhances the safety and soundness of our financial system in a number of ways. Risk-based capital recognizes the actual factors (such as the probability of default of each obligor, the loss given default of a facility) that cause different banking assets to carry different risks. The Framework is a significant advance in this respect and its minimum regulatory capital requirement for a bank will more accurately reflect the risk profile of the bank, and thereby provide a more reliable cushion for the deposit insurance funds.

The alignment of risk and required capital in the Framework also promotes safety and soundness by eliminating the current incentive in Basel I for a bank to remove low risk assets from its balance sheet and replace those assets with riskier assets. Under the current Basel I rules, a bank has an incentive to increase its return on capital by selling or securitizing its best assets and retaining or acquiring riskier (and higher yielding) assets. This perverse effect is significantly diminished under the Framework.

Further, the Framework enhances safety and soundness by motivating banks to develop and use advanced risk measurement systems, and by providing a tangible economic benefit for those banks that choose to employ a less risky business model.

Our institution, along with other major financial institutions, has developed and utilizes sophisticated risk models to manage our business. The Framework acknowledges the success of these models as a tool for determining and responding to risk, and incorporates their use in determining minimum regulatory capital. Unfortunately, several aspects of the NPR as identified below require us to create separate models just for the purpose of complying with capital regulation, while we maintain our own internal models for actual business purposes. In effect, the NPR would require us to undertake an expensive regulatory exercise that is in addition to the actual risk evaluation that we use on a day-to-day basis. These expenses will have a direct and significant impact on the profitability and competitiveness of our institution.

<u>The Definition Of Defaults Is Not Consistent with the Framework</u>

The NPR deviates from both the Framework and customary U.S. practice by stating that a credit related loss of 5 percent or more will be treated as a default, even if a loan is fully performing. An unintended consequence of this provision will be to discourage the use of asset sales as part of risk mitigation strategy. Similarly, the changed definition focuses estimation of LGD parameters on the worst-case defaults by eliminating the recognition of defaults that are not placed on non-performing status. Implementation of this new definition will require U.S. banks to hold higher levels of capital than justified by current internal risk models at the consolidated level. Further, existing models and parameters will have to be re-estimated to accommodate the multiple definitions.

Multiple Loss Given Defaults (LGD)

The NPR would require US banks to compute both default-weighted average Expected Loss Given Default (ELGD) and a downturn LGD. If a bank's use of its own estimates is not approved, the bank must make use of a supervisory formula whereby LGD increases at an increasing rate as default-weighted average ELGD decreases. Thus for high quality assets with few instances of default, it will be very difficult, even for the largest banks to quantitatively prove that the losses are not cyclical. For example, if a particular portfolio of obligors or a product has very few instances of "default" (as defined in the NPR) (for example, securities lending), the bank will necessarily not have sufficient data at various points in the cycle to test the cyclicality of the LGD. In this case, where the bank may calculate an ELGD, based on all available data, as 10 percent, the NPR would require the loss to be increased by about 72 percent. If ELGD is 20 percent the increase is 32 percent. This increases the capital requirements for US banks and potentially makes them uncompetitive for good quality assets. The use of the LGD implies a redefinition of the confidence level of regulatory capital.

There are also significant practical issues. First, this redefinition of the terminology is confusing and inconsistent with the definition used in the Framework, the literature, and across the industry. Each usage will require clarification as to what LGD means within the specific context. We strongly suggest that LGD continue to reflect the expected LGD and the downturn LGD be re-designated. Additionally, the dual LGDs require US banks to maintain multiple LGD estimates, including application of different LGDs (and terminology) to local reporting within a jurisdiction and for application in consolidated reporting. Both the disparate definitions of default and LGD create a situation where US banks with significant international operations may have to choose to either adopt inconsistent internal measures or violate the use test in one of the jurisdictions.

Competitive Disparities With U.S. Investment Banks Are Also Possible

Finally, U.S. investment banks electing to be regulated by the SEC as a "consolidated supervised entity" ("CSE") have the benefit of calculating net capital requirements consistent with the Framework without being subject to the modifications proposed by the NPR. U.S. commercial banks will therefore be at a competitive disadvantage not only with respect to foreign competitors, but also against U.S. investment banks that elect CSE treatment, since only U.S. commercial banks will be required to comply with the increased regulatory burden and different rules of the U.S. NPR. While a broker-dealer affiliate of Citigroup has also elected CSE treatment, Citigroup will remain subject to the NPR's more onerous regulatory burdens when calculating its risk-based capital requirements on a consolidated basis (including the broker-dealer affiliate).

(iv) The Competitive Advantage the NPR Grants To Foreign Banks and Our Safety and Soundness Concerns Should be Addressed By Harmonizing the NPR With The Framework; Concerns Over Capital Levels Can Be Addressed Without Jeopardizing the Objectives of the Framework.

The competitive advantage the NPR grants to foreign banks and its reduced risk sensitivity should be addressed by harmonizing the NPR with the Framework. In other words, the differences between the provisions in the NPR that are described above should be revised to conform to the Framework. A recent report on the competitiveness of the U.S. financial services industry noted the benefits of harmonization for U.S. markets and U.S. consumers:

> ... harmonizing the relevant U.S. regulations with those adopted by much of the rest of the world would have two clear benefits. First, it would place U.S. financial institutions on an equal footing with their international competition. Second, it would make the United States more appealing to foreign financial institutions, which would not then need to adjust their capital requirements in order to participate in the U.S. markets. This would in turn benefit U.S. consumers, who would enjoy greater choices and better prices as a result of enhanced competition.[1]

Concerns over capital levels under the Framework, which have been expressed by the Agencies and smaller U.S. banks, can be addressed in conjunction with the harmonization of the NPR and the Framework as follows:

[1] *Sustaining New York's and the U.S.' Global Financial Services Leadership*, page 112.

A. Review the Impact of the Framework Based Upon "Live" Systems, and Then Make Adjustments to Capital Levels, if Necessary.

In lieu of the 10 percent aggregate floor, the Agencies should clarify that they will review the impact of the regulation on capital levels at the end of the transition period. This would eliminate the uncertainty associated with the 10 percent aggregate floor, relative to current minimum required capital standards; yet provide the Agencies with a mechanism for reasonably assessing capital levels. Such a review should include an evaluation of all factors that influence capital levels, including credit cycles, the potential increased use of credit risk mitigation, as well as international capital standards. The results of the review would permit the Agencies to make adjustments to the rule, if any, based upon an assessment of "live" systems and procedures, and following consultations with the industry and the public. This approach is consistent with the position of the foreign banking authorities and of the Agencies as of November 2005 when Comptroller Dugan told the Senate Banking Committee that "We believe that certain of the concerns identified in QIS-4 will only be fully understood and resolved as the Basel II framework is implemented through a final rule, final supervisory guidance, and rigorous examiner scrutiny."

B. Review the Relevance of the Leverage Ratio

For the reasons given above, we view the leverage ratio as fundamentally inconsistent with the Framework and the principles of risk based capital. However, we recognize the retention of the leverage ratio may be unavoidable during the transition from Basel I to Basel II given its importance to the Agencies and many smaller U.S. banks as a means of setting minimum capital requirements. Therefore, we support the retention of the ratio at the present time, provided that the Agencies thoroughly review its relevance within a given period of time (e.g., five years). As part of this proposed review, we urge the Agencies to consider adjustments to the level of the ratio (subject to the statutory 2 percent requirement), and the use of alternative forms of capital for meeting the ratio (e.g., adjustments to the components of Tier 1 capital). We want to stress that our criticism of the leverage ratio is not a comment on the general concept of "prompt corrective action". We support the principle of prompt corrective action linked with the more appropriate risk-sensitive requirements of the Framework, which would in turn strengthen the effectiveness of PCA.

C. Pillar 2 and Benchmarking

We recommend that the Agencies place a greater emphasis on the role of Pillar 2. The Pillar 2 supervisory process can be an important tool to address capital levels at individual Basel II banks. To the extent that the Agencies are concerned about consistency in the application of Pillar 2, a system of "benchmarks" related to risk exposures could be developed that could guide supervisory actions under Pillar 2. As long as such benchmarks are not used mechanically (as in Pillar 1), it would be possible for banks to segment their portfolios somewhat differently, with the benchmarks adjusted or interpolated appropriately. As the state-of-the-art improves and practices converge, the benchmarks could evolve. Aggregate benchmarks for typical portfolios could be compared to the general capital rules to provide the Agencies and the banking industry with a fair comparison from bank to bank, regardless of approach. Because they are used in Pillar 2, the benchmarks should not be hard and fast capital requirements.

D. Compliance Options

Finally, we recommend that the Agencies offer all U.S. banks the option to use any of the approaches authorized under the Framework, including the so-called "standardized" approach. The standardized approach is part of the Framework. Its terms and conditions are set forth in great detail in the Framework that the Agencies approved in June 2004. Giving banks a choice of methodologies for risk-based capital compliance has several benefits. It allows banks to choose among methodologies that are simple and transparent, it assures a competitive marketplace both domestically and internationally, it ensures appropriate minimum regulatory capital requirements, and it allows banks of all sizes to make their own cost/benefit assessments of the risk sensitivity of each option.

As we have already stated, we have been and continue to be supportive of the objectives of Basel II and strongly support the implementation of the international Basel II Capital Framework. We also have spent considerable resources over many years to develop and continually enhance our internal risk methodologies and systems.

Thus our support of offering US banks the option to use any of the approaches authorized under the Framework should not be taken to imply a criticism of a true risk sensitive minimum capital requirement or of the need to develop and use sophisticated risk methods and systems to measure, report and manage risk.
We also believe that the Basel IA rule should be aligned with the capital rules applicable to large banks, to the extent possible, in order to avoid a competitive imbalance between large and small U.S. banks. In other words, we urge the Agencies to more closely align the Basel IA rule and the capital rules for large banks to minimize any overall differences in capital when considering credit, market, and operational risks. We note that European Banks of all sizes are able to fit within one of the three tiers of the Framework and recommend a similar system for US banks.

V. Conclusion

The NPR includes several provisions that give foreign banks a competitive advantage over U.S. banks. These provisions were included in response to a survey of the impact of the Framework on Basel II banks. That survey is not a valid basis for the proposed changes. In addition, the NPR introduces requirements which reduce its risk sensitivity and which reduce the safety and soundness benefits which the Framework introduces. These concerns with the NPR can be alleviated by harmonizing the NPR with the Framework. Concerns over capital levels under Basel II can be addressed by (i) reviewing the impact of Basel II *after* it is fully in effect, and then making adjustments to the rule, if any; (ii) retaining the leverage ratio, but reviewing its continued need after a certain period of time; (iii) making appropriate use of Pillar 2; and (iv) aligning, to the extent possible, the capital rules applicable to smaller U.S. banks with the rules applicable to larger U.S. banks.

Sincerely,

Annex One: Replies to specific questions and other topics
Annex Two: QIS 4 Results

ANNEX 1 OF CITIGROUP'S COMMENTS ON NPR

REPLIES TO SPECIFIC QUESTONS AND OTHER TOPICS

March 19, 2007

US Basel II NPR

Credit and Operational Risk

Questions being asked by US banking Agencies – Contents

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Question 1: The Agencies seek comment on and empirical analysis of the appropriateness of the proposed rule's AVCs for wholesale exposures in general and for various types of wholesale exposures (for example, commercial real estate exposures).

No Comment on the AVC for wholesale exposure

Question 2: The Agencies seek comment on and empirical analysis of the appropriateness and risk sensitivity of the proposed rule's AVC for residential mortgage exposures – not only for long-term, fixed-rate mortgages, but also for adjustable-rate mortgages, home equity lines of credit, and other mortgage products – and for other retail portfolios.

Our main concern is about the choice of the 4% AVC for credit card portfolios. The evidence that we have gathered from both internal and external sources suggests that the AVC should be significantly under 4% and no higher than 2%. Internal empirical estimates suggest that AVCs should be less than 2% and generally less than 1%, based on up to 30 years of data in some cases. In addition, external data does not appear to support high AVCs for larger banks and indicates that for the largest banks a figure less than 2% would be reasonable.

In addition, while internal economic capital and regulatory capital under Basel II are not expected to be aligned, we currently estimate that the Basel II regulatory capital requirement for our credit card portfolio is about 50% greater than the economic capital that we assign to the same portfolio (adjusted for the same confidence level). To introduce a change in regulatory capital that moves these measures of capital further apart when Basel II is about intending to bring regulatory and economic capital more into line, seems perverse.

In order to assess what we consider be the actual AVC should be, we estimated default correlations using the empirical variance of portfolio default over time and determined the pair-wise correlation of stochastic processes representing a consumer's "asset value" that calibrates to estimated default correlations. We assumed that consumer default is based on single systemic risk process and individual idiosyncratic risk as well as assuming that every pair of consumers has the same default correlation. This showed that, based on the internal information available, that the AVC was a relatively constant function of PD and that over the last ten years, for any given 5 year history, that the AVC was consistently below 2% and usually below 1%.

From external data we were able to compare Citi's loss rates with those of the top 100 banks with card portfolios and these showed very similar profiles. In addition, anecdotal evidence of other industry estimates of AVCs seems weak, and we have little information from either consultants or regulators to support the 4% AVC statistic. The only meaningful analysis seems to be based on Federal Data, which for large banks for periods from 1985 onwards all show AVCs estimated at under 2%, although it does show higher AVCs for smaller banks. In addition, research by Daniel Rosch and Harald Scheule in the Journal of Risk Finance in 2004 supported AVCs at 60bps or 1% for credit card loans (depending on methodology).

We would therefore request that the AVC for credit cards is reduced to be in line with the above practical findings. To the extent that additional information is available prior to the final NPR comment date we may wish to expand on the above response to this question.

Question 3: The Agencies seek comment and supporting data on the appropriateness of this limit (Note: The limit refers to the participation of excess reserves to Tier 2 capital).

There is a difference between the accounting and regulatory definitions of expected loss ("EL"). Under Basel II EL is defined as the loss over a one-year time horizon (i.e. the sum of PD x LGD x EAD per exposure excluding equity and securitizations). However for accounting purposes the EL for the wholesale business is based on the actual maturity of the exposure and for retail businesses based on typically 180 days.
It is difficult to predict the impact of the difference between accounting and regulatory requirements which will vary according to maturity, risk profile, mix of business and other factors. It is unfortunate that the accounting and regulatory definitions are arranged to be different and it would be more appropriate if they were aligned. We would encourage the regulators to work with the accounting standards bodies to seek alignment of these definitions. If these definitions where aligned the chance that there would be surplus reserves would be significantly reduce and so there would be less impact on Tier 2 capital.

Until there is consistency between the accounting and regulatory definitions of ALLL it would seem inappropriate for banks to be penalized by having to follow the accounting treatment if this results in an EL which happens to be higher than that permitted by the regulatory definition. We would therefore recommend that there is no limit to the amount of ALLL that can be included in Tier 2 .

If the accounting requirement is based on LGD which is that as defined in the NPR (i.e. the ELGD x downturn formulae) the excess of ALLL above the 0.6%*RWA over EL may be even larger, which would be a further concern about using the downturn formula for converting ELGD into LGD.

Question 4: The Agencies seek comment on the use of a segment-based approach rather than an exposure-by-exposure approach for retail exposures.
We prefer the segmentation-based approach for estimating risk parameters for retail exposures and have committed substantial resources toward this end to date in accordance with the evolving Basel II Framework and U.S. NPR requirements.

Moreover, the requirement is inline with current management practice and reporting as well as company experience demonstrating a differentiation of customer default behavior across products. (E.g. a customer's default in one product / account does not necessarily translate into a default of all of that customer's accounts)

We also believe the requirement to differentiate credit card exposures greater that $100,000 provides minimal net benefit for the level of additional complexity and inconsistency it introduces. Consequently, we would suggest that this rule is not applied when the value of accounts over $100,000 is lower than some relatively immaterial threshold of the value of the

relevant credit card portfolio. We would also like to better understand analysis supporting this distinction and the accompanying adjustment in RWA formula if this approach is not accepted.

We have commented separately on the retail reporting requirements in our response to question 62. This raises the issue that while the NPR provides for expectations for "substantial flexibility" in the segmentation process, this contrasts with the fixed reporting (template) requirements via predetermined segments. We also request guidance on the regulatory expectations for balancing the trade-offs between stable long run score histories and more frequently updated scores.

We recommend at most an annual re-assessment process for delinquency managed commercial exposures to determine the $1MM threshold. We believe a more frequent review process would be an administrative burden with limited account movement between the retail and wholesale categories

Question 5: The Agencies seek comment on this approach to ensuring that overall capital objectives are achieved (Note: The "approach" refers to the proposed capital floors and the 10% limit to capital reductions).

As set out in the covering letter Citigroup is strongly opposed to the statement by the Agencies included in the NPR, but not the actual rule text, that a 10% aggregate capital declines in regulatory capital will trigger "modifications to the supervisory risk functions or other aspects of this framework".

The Agencies' reliance on this numerical benchmark ignores the principle of risk sensitivity on which Basel II was developed. This arbitrary threshold, which is defined relative to the current Basel I capital requirements and without reference to fluctuations in credit quality, will by its very definition, produce comparisons that do not reflect the risk embedded in banks portfolios: precisely the flaw that Basel II was intended to correct.

In strong economic cycles, credit conditions will improve and a drop in minimum required regulatory capital of 10% or more may well be expected, and would not, per se, pose any safety and soundness concerns. If risk weights were to be recalibrated and increased at the peak of an economic expansion, this can result in minimum capital requirements even greater than current requirements during a recession, potentially leading to unnecessarily tying up funds that should be used for economic growth. In addition, as this provision is not included in the international framework, it does not apply to non-U.S. based banks and, if implemented, would creative competitive inequalities.

Moreover, the exact method of calculation and the statement of consequences for exceeding this limit, proposed without any technical justification, are ambiguous and unclear. The uncertainty regarding the magnitude and timing of any resulting future modifications introduces unpredictability into the capital planning process and harms a firm's ability to make longer-term strategic decisions.

The Agencies should also take into consideration circumstances where declines in capital requirements would be logical and appropriate, without affecting the solvency of individual banks or the system as a whole. In this context, it should be considered that a more risk sensitive

capital regime will provide an incentive to banks to better actively manage their credit risk, through the increased use of credit derivatives, collateral and other credit risk mitigation tools. A more risk sensitive regime will also provide an incentive to a bank to particularly focus on credit risk mitigation for its lower rated obligors.

In addition, the 10% reassessment potentially links the fate of all banks implementing the advanced approach in the US to the decisions of a small number of banks that choose to adopt conservative lending and investment policies, which in turn would impact the capital rules determining the plans of all advanced approach banks. Even a decline in capital due to balance sheet restructuring of a few banks could trigger this clause, resulting in the situation where the actions of a few banks could dramatically affect the regulatory capital requirements of a competitor.

Finally, the Agencies should also recognize that the proposed limit is not needed for supervisory purposes given that the Agencies have the ability to increase the required capital of an individual bank through Pillar 2, and through the use of other supervisory tools, should there be an objective need to do so. The Agencies should also recognize that fluctuations in minimum Pillar 1 capital requirements would not necessarily be reflected in similar fluctuations in actual capital. Bank capital management policies would be expected to dampen such fluctuations and maintain a buffer between regulatory and actual capital for a variety of purposes.

For these reasons, we strongly urge the Agencies not to adopt the 10% numerical benchmark.

Question 6: The Agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks. (Note: "this proposal" refers to the delayed implementation schedule proposed by the US Agencies).

Banks have worked with the Basel Committee over several years to design a more risk-sensitive capital framework, culminating in the June 2004 Revised Capital Framework (Basel II). In the Introduction to the 2004 Framework document the Basel Committee stated:

"*The Committee has sought to arrive at significantly more risk-sensitive capital requirements that are conceptually sound and at the same time pay due regard to particular features of present supervisory and accounting systems in individual member countries.*"

As set out in our covering letter the NPR raises significant competitive, cost, economic and prudential concerns. We recommend that the Agencies implement the internationally agreed version of the Basel II Framework.

We strongly believe that the additional requirements in regard to the capital floors, longer transition periods, the retention of the leverage ratio and the elimination of the lower capital requirement for lending to SMEs, disadvantages the competitive standing of US banks. For example, it is clear that subjecting regulatory capital requirements to artificial floors for a longer period and at a higher level moves further away regulatory capital from banks' internal risk management practices, a fundamental principle of Basel II. Furthermore, it creates additional

difficulties for the comparison of capitalization levels across jurisdictions, one key feature of the international Framework. Finally, the additional capital floors, arbitrary by definition, artificially interfere with the capital management process of banks.

Question 7: The Agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provided under the New Accord. With respect to the credit risk capital requirement, the Agencies request comment on whether banks should be provided the option of using a U.S. version of the so-called "standardized approach" of the New Accord and on the appropriate length of time for such an option.

A critical departure from the International Framework is that large internationally active US banks are required to adopt the advanced approaches. In contrast, the international framework permits the choice of the Standardized, Foundation, and advanced A-IRB approaches for credit risk and the Basic Indicator, Standardized, and advanced (AMA) approaches for operational risk. In addition, the Standardized approach for credit risk is generally introduced without a 12 month parallel reporting requirement.

As a general principle, we urge that every effort be made to align the U.S. rules with the international framework. Consistency across national jurisdictions was a key objective of Basel I. Basel II was designed to promote the same consistent Framework. The new Framework was designed to protect the stability of the financial system as well as encourage adequate provision of financial services. In line with this reasoning, we believe that harmonization with the international framework requires that substantially the same menu of approaches offered under Basel II (including Standardized) be offered by the Agencies to all US banking organizations.

Providing banks with at least the standardized approach to risk-based capital as an alternative would have these important benefits:

- Banks could, after an assessment of their risk-management and business needs select alternative methodologies that are most appropriate for them.
- Give US banks options available internationally and by giving this option to non-US banks active in the US should help provide a more level playing field which may mesh better with their international Basel II implementation planning.
- Adequate capitalization would still preserved since all approaches were designed by the Basel Committee to ensure appropriate minimum regulatory capital requirements given the different risk-sensitivity of the approaches; and
- Banks, irrespective of size, could make their own cost/benefit assessments of each option.

Citigroup believes there are no significant drawbacks to making alternative approaches available in the U.S. The results from QIS 5 published by the BIS indicate that the less advanced approaches provide acceptable trade-offs between reduced complexity and increased capital requirements in comparison to the international advanced approaches. In particular, the standardized approach is sufficiently straightforward to permit evaluation without requiring another quantitative impact study or lengthy NPR consultation and also is likely to share many

elements in common with the Basel 1A approach currently under evaluation. The Agencies, given their active involvement in the Basel II process over the past several years, can adopt these approaches without additional delay and with confidence as to the capital result. . The judgments banks ultimately make about which approach to adopt, would, of course, be affected by their assessment of the quality and appropriateness of the final rules adopted in the US.

Our objective is the promotion of continued improvement of risk management practices through the introduction of risk-sensitive regulatory capital framework. We believe that these are objectives that are shared by the regulatory community as expressed when the Basel reform process was launched over seven years ago and again by the U.S. Agencies in this NPR. Were the U.S. Agencies to offer the Standardized option without addressing our concerns on the advanced approaches, we believe the result would be detrimental to the US financial-services industry in the global context

Question 8A: The Board seeks comment on the proposed BHC consolidated non-insurance assets threshold relative to the consolidated DI assets threshold in the ANPR.

No comments on this issue, other than to note that banks with assets below the threshold now have three options available to them, Basel I, Basel IA and Basel II advanced with the ability in defined circumstances to switch between Basel I and Basel IA. Under the international framework, once a bank opts for a more advanced approach there are very limited circumstances that the bank can revert to a more simplistic approach.

Question 8B: The Agencies seek comment on the proposed scope of application. In particular, the Agencies seek comment on the regulatory burden of a framework that requires the advanced approaches to be implemented by each subsidiary DI of a BHC or bank that uses the advanced approaches.

It would seem reasonable to require any US DI that is a significant subsidiary (as defined as a business which would, if stand alone entity, require to be Basel II compliant) of a bank adopting the advanced approach also to apply the advanced approach for its regulatory capital adequacy calculation. However, this should not result in a significant additional regulatory burden for subsidiaries that do not so qualify. Smaller subsidiaries should have the option of whether they wish to adopt the Basel II, Basel IA or Basel I which would appear to be the options open to banks to whom Basel IA applies

Often a DI is located in a different state from that of the parent bank. In these cases, if the bank wishes to adopt Basel II, the state regulators should be willing to accept that the risk models used by the parent bank should be used by the subsidiary DI even if the asset mix and loan loss history of the DI is different from that of the parent bank.

In the particular case of the AMA, the calculation of the operational risk for the subsidiary DI should be based on an appropriate allocation from the AMA calculation of that of the parent, even where the subsidiary would qualify as an "advanced" Basel II bank under the NPR. So long as the allocation is reasonable, the group AMA should be accepted and the only discussion would apply to the basis of allocation; there should not be any re-approval process associated

with the AMA or any requirement to develop a stand-alone operational risk model based on the operational risks of that subsidiary DI.

Question 9: The Agencies seek comment on the application of the proposed rule to DI subsidiaries of a U.S. BHC that meets the conditions in Federal Reserve SR letter 01-01 and on the principle of national treatment in this context.

To the extent that a BHC that meets the conditions in Federal Reserve SR letter 01-01 and is required to adopt the advanced approach then the US regulators should apply similar standards for model approval as they expect to be adopted by non-US subsidiaries of US banks that adopt the advanced approach in foreign jurisdictions. For example a US bank, having developed a global AMA approach, will probably wish to allocate operational risk capital based on that global model. In our experience US regulators are working well with banks that are adopting this approach. However, to the extent that the US regulators do not permit DI subsidiaries of foreign banks to adopt an allocation basis for their AMA capital computation but require a stand alone model in the US, then the US regulators may well be applying a higher standard than that being applied to US banks' overseas operations. This could result in overseas regulators requiring similar approaches for US banks DI's in their country, unnecessarily increasing cost and regulatory burden for little net benefit.

Question 10: The Agencies seek comment on this approach, including the transitional floor thresholds and transition period, and on how and to what extent future modifications to the general risk-based capital rules should be incorporated into the transitional floor calculations for advanced approaches banks.

The additional year of Transitional Floors, the higher floor levels and the requirement to formally "graduate" from one floor to the other are all divergences from the International Framework. Furthermore, these divergences lack any clear justification from a US perspective. In our view, the floors established in the International Framework provide sufficient safeguards and achieve the same prudential objectives sought by the Agencies and, therefore, we question the need for adding extra requirements that were not deemed necessary when the BCBS finalized Basel II after years of careful deliberation.

The NPR proposals in this respect add to the complexity that banks operating in the US will face when implementing Basel II. In effect, US banks not only start the implementation of Basel II twelve months after most other large international banks, but they are also are required to comply with more restrictive transitional arrangements over a longer period of time. The mandatory capital floors, as expressed percentages of minimum capital requirements under Basel I, are shown in the following table. It is evident that competitive differences between US based banks and other international banks occur in every time period.

		2008	2009	2010	2011
1	Basel II Framework	90%	80%	No floor	No Floor
2	NPR	Parallel	95%*	90%*	85%*

* Subject to regulatory approval and based on a different (and an additional set) of Basel I v Basel II ratios.

It is important to note, in addition, that the difference in implementation timing in the US could be extended beyond 2011, as a US bank must seek the permission of their U.S. regulator to move to the next transitional floor. This is not a feature of the transitional arrangements currently applied by other regulators and seems unnecessary in light of other supervisory tools that are available, including extension of the floors if a supervisor judges this necessary for a given institution.

Last -- but by no means least --we observe that the floor percentages are applied to different definitions of minimum capital requirements. In effect, the NPR calculation of minimum required capital is based on current Basel I risk-weighted assets without adjusting for the separation of expected (ECL)and unexpected loss (UL), which is a fundamental principal agreed to by the BCBS for the calculations under Basel II. Consequently, the ratios used are significantly more restrictive than those used in the International Framework due to the exclusion of the impact of ECL. The result is a higher transitional capital requirement (before multiplying by the floor percentages in the above table). Thus the requirement to have 5 Basel I v NPR ratios is excessively conservative and cautious. We strongly recommend that the final provisions regarding Transitional Floors use the International Framework's definition, to reduce an otherwise significant, across-the-board competitive disadvantage for US banking organizations.

Most fundamentally, we would urge that the US supervisors:

- Accept the international two-year floors as agreed by the Basel Committee. Those floors, on the basis conceived in the Framework provide ample protection against unexpected or inappropriate results.
- Eliminate the requirement to seek regulatory permission to move to the next transitional floor.
- Align the transitional capital ratio calculations with that in the Basel II Framework, in particular with respect to inclusion of ECL and UL on a consistent basis.

Question 11: The Agencies seek comment on what other information should be considered in deciding whether those overall capital goals have been achieved.

See response to questions 6 and 10.

Question 12: The agencies seek comment on the proposed timetable for implementing the advanced approaches in the United States.

See response to questions 6 and 10.

Question 13: The Agencies seek comment on this aspect of the proposed rule and on any circumstances under which it would be appropriate to assign different obligor ratings to different exposures to the same obligor (for example, income-producing property lending or exposures involving transfer risk). (Note: "this aspect of the proposed rule" refers to the prohibition to consider the value of collateral that supports an exposure when assigning the rating to an obligor of the exposure).

We think it appropriate to differentiate the probability of default of a wholesale obligor from the potential loss given default on any particular facility of the obligor.

Question 14: The Agencies seek comment on this proposed definition of default and on how well it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on a wholesale exposure. In particular, the Agencies seek comment on the appropriateness of the 5 percent credit loss threshold for exposures sold or transferred between reporting categories. The Agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.

There are two important changes to the wholesale definition of default in the draft NPR compared to that in the ANPR and the Basel II Framework as below:

1. The elimination of the words: "without recourse to actions by the organization such as the realization of collateral" from the definition in the draft NPR, and

2. The inclusion in the draft NPR of the specific figure of 5% in the following part of the definition:

   "Incurred a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category."

High Level Considerations:

1. By the removing the words "without recourse to actions by the organization such as the realization of collateral" in the definition of default, and inclusion of the 5% loss requirement, the draft NPR moves away from the central concept of measuring actual default and loss events. In particular, the first issue requires that PD quantification and LGD estimation exclude obligor defaults where the bank has recourse to strong loss mitigants, such as cash collateral, underlying goods, letters of credit, among others, which have historically not been placed on non-accrual given the strength of the mitigants. Similarly, the second issue focuses solely on transactions that result in losses, whether or not there is an actual default by an obligor (e.g., losses incurred as part of portfolio rebalancing unrelated to an obligor default but simply reflecting current market prices).

   As such, the draft NPR moves away from the concept of bifurcated ratings, which measure default at the obligor level and loss at the facility level. By effectively eliminating recognition of defaults at the obligor level where there are no losses, the draft NPR shifts the definition of default to the facility level. This creates a situation where the

PDs do not reflect the actual default rates among obligors and the LGDs do not reflect the actual losses related to those obligor defaults.

2. The differences in the wholesale definition of default have important repercussions for Citigroup. First, there is the inconsistency in the parameters calculated by the parent bank and that used by our overseas subsidiaries who wish to adopt the advanced approach, especially as these regulators have adopted a definition of default largely in line with the Basel II definition and, therefore different from that in the draft NPR As a result, PD (and consequently LGD) calculated for the US Agencies will not be comparable to the same metrics calculated for other regulators. Similarly, LGD estimates will need to be recalculated using the differing definitions of default. Multiple estimates and models will require multiple database structures, multiple systems solutions, multiple reporting systems, multiple validations of models and estimation processes, all of which will require additional resources and could, potentially create high levels of confusion. A related consequence will be the inconsistencies created in bank's statistical databases, In effect, we would be required to have several years of default data available on two different bases and systems to support both, which is completely impracticable, increases operational risk and cost, and would be at odds with good risk-control from a group perspective.

Practical Considerations:

1. While a simpler and consistent definition of default would have been welcomed by the banks in the early drafts of Basel II and the ANPR, this change in a key foundation of the AIRB at this late stage is problematic. A decision was taken in 2004 to align our systems, policies, practices and estimation calculations to the broader Basel II definition, given delays foreseen in the NPR and indications from other regulators that they would adhere closely to the Basel II definition. The definition of obligor default in our wholesale rating policies was broadened to encompass defaults where no facilities were placed on non-accrual but where the obligor had defaulted and the bank had to resort to mitigants to be made whole.

2. Similarly, extensive discussions were held around Distressed Asset Sales, with a decision to define distressed sales where the credit obligation is sold at a price below 90% of carrying value *and* the bank is selling the obligation with a high expectation that the obligor will default in the near-term, e.g., the sale would be characterized as an exit from a distressed credit. It was determined that asset sales at prices higher than 90% of carrying cost were rarely associated with an obligor default and more likely to reflect portfolio management objectives (reducing concentrations, for instance). There are many factors that determine the market value of a loan, including a) whether it is fixed or floating rate, b) its tenor, c) the current value of its pledged collateral, d) the general level of interest rates, etc. In some circumstances the market price of the loan could be below 90% of par without the obligor being likely to default in the near term. Therefore a bank might sell a loan at less 90% of par without the sale being a credit event.

The definition of default used by most other banking regulators, and in the Basel II framework (as well as in the ANPR) gives discretion to the bank as to when to include, as a default, the sale of an exposure at an appreciable discount. In practice the discount that we are willing to sell an exposure will depend on several features, and, in particular, the risk rating of the facility, the liquidity associated with that obligor (or facility) and the size of the exposure and portfolio considerations. To sell an AAA or an AA exposure at a 5% discount would certainly indicate concern about that name, but in our experience be a very rare event. However, in today's market and with increasingly highly structured loans often having multiple priority levels it would not necessarily be unusual to sell a low priority and relatively illiquid tranche at a 5% discount, especially if it were connected with other sales of larger amounts of higher ranking tranches at lower discounts, or for other reasons. It would seem inappropriate, just because one low ranking tranche was sold at a 5% discount, to have to regard the whole obligor as a defaulted exposure.

Given that there are many reasons to sell down an exposure we believe that the bank is best placed to understand the reason for the sale and whether it is connected to a possible default. This is what Basel II assumes and other regulators permit.

3. The changes we already have implemented internally continue to have validity in other AIRB countries and for internal purposes, as these definitions are more in line with a true, bifurcated rating system. A differing US definition will require that duplicate processes be established solely for purposes of consolidated reporting. For instance, both PD quantification and LGD estimation are highly dependent on the definition of default (more specifics follow). So the PD quantification for US Consolidated reporting will be different from that used in other AIRB jurisdictions. Similarly, LGD estimations and models will need to be redone using the differing definitions of default. Multiple estimates and models will require multiple database structures, multiple systems solutions, multiple reporting systems, multiple validations of models and estimation processes, all of which will require additional resources and could, potentially create a good deal of confusion. Given the additional projects that would stem from this very "late in the game" change in rules, Citigroup's ability to meet AIRB standards in the US under even a revised timeframe could be jeopardized.

Impact on Parameter Estimation and RWA:

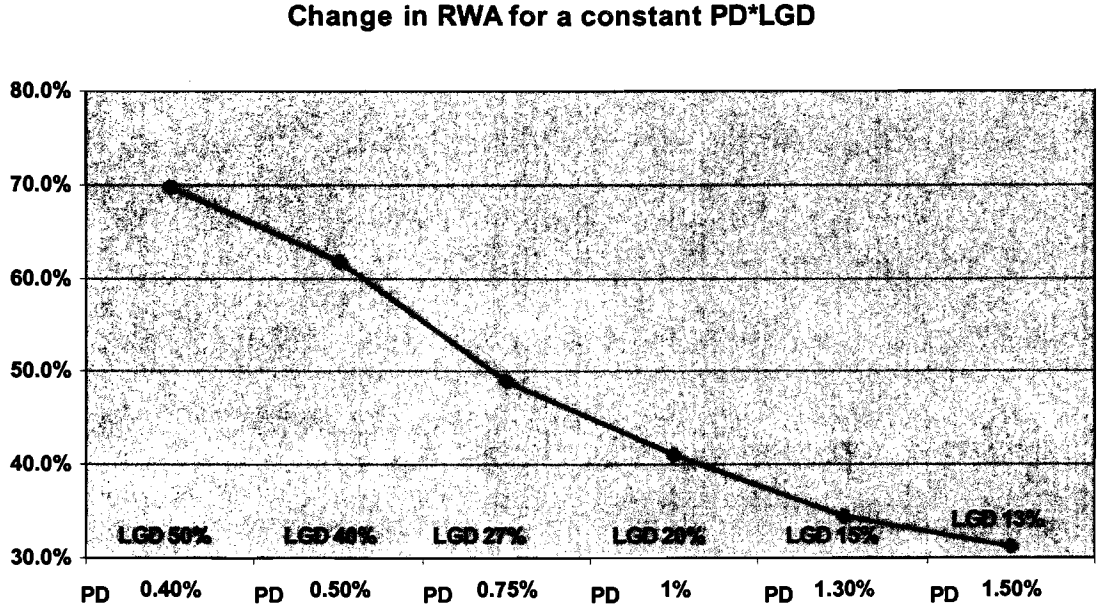
1. The most significant impact is likely to be on Loss Given Default estimations and LGD model development. The elimination of many defaults with significant loss mitigants in place has the impact of increasing the Loss Given Default estimations by focusing on defaults where there are expectations of losses (facilities placed on non-accrual). This, *in addition to the requirement to use stressed measures of Loss Given Default*, will bias these parameter estimations even further toward conservatism and increase the likelihood that a bank will be subject to the stressed LGD formulae because it will capture fewer default events (which means fewer samples to test if there is a correlation between LGDs and economic downturns).

2. In addition, by removing the ability to use these defaults in estimating the Loss Given Default the definition effectively eliminates much of data that would be used to estimate Loss Given Default for low risk facilities, such as in short-term trade finance, cash collateralized facilities, etc.

An example: We almost never place facilities that are fully cash-collateralized (meeting all standards of the policy) on a non-accrual basis because the risk of loss is minimal in our experience, even in the event of an obligor default. Given that it is often the obligors with the lowest credit ratings for which we require full cash collateral on loans, we can expect fully cash-collateralized facilities to have a relatively high rate of defaults, while losses are mitigated. If we assume that 90 out of 1000 obligors, each with one such facility, default under the Basel II rules, we would capture them as defaults and estimate an LGD. Further, assume that we place only 5 such facilities on non-accrual because we anticipate potential losses. So there are zero losses on 85 of them (accrual) and assume a 10% LGD on the ones placed on non-accrual. Under Basel II, the average LGD for cash collateralized facilities would be approximately 1% (10% LGD on 5 of the 90 defaulting obligors). Under the NPR, we would only recognize the 5 defaults with the 10% LGD. As such, we would be required to assign a 10% LGD for cash collateralized facilities. And, given the small number of recognized defaults, we would be unlikely to have sufficient data to prove LGDs had no correlation with stress scenarios. Thus, if we were required to use the stress LGD formula, the observed 10%LGD would be transformed into an LGD of 17% for fully cash collateralized facilities under the NPR, compared to 1% under Basel II. Clearly, the 17% is not representative of the actual risk and could not and would not serve as the basis for risk management decisions or pricing.

While there will be some offsetting reduction in the observed default rates, the structure of the Risk Weighted Asset formula is such that the effect of any increase in LGDs will more than offset the effect of a reduction in the PD that would result from the exclusion of these obligor defaults. In the graph above, we have plotted the Risk Weight associated with a constant value of PD x LGD as a function of different values of PD for a corporate exposure of 2.5years.

As can be seen, a reduction from 0.4% to 0.5% in PD with a compensating increase in LGD causes average RWA to increase by 8%. Assuming that corporate exposures represent about 40% of total RWA (per results of QIS 4) then, if 10% of defaults are excluded as a result of



this change in definition, the total average minimum capital requirement of US banks will rise by about 3% as a result of this change. If this is the desired result of the US regulators it is suggested that it would be better to make this an explicit requirement rather than cause the disruption of having a definition different from all other major Basel II countries.

In conclusion, our recommendations would be to revert to the Basel II Framework version of default for wholesale portfolios.

Question 15: In light of the possibility of significantly increased loss rates at the subdivision level due to downturn conditions in the subdivision, the Agencies seek comment on whether to require banks to determine economic downturn conditions at a more granular level than an entire wholesale or retail exposure subcategory in a national jurisdiction.

We consider the requirement (that the economic downturn condition at the retail exposures subcategory level in a national jurisdiction) is at a sufficient granular level

Question 16: The Agencies seek comment on and supporting empirical analysis of (i) the proposed rule's definitions of LGD and ELGD; (ii) the proposed rule's overall approach to LGD estimation; (iii) the appropriateness of requiring a bank to produce credible and reliable internal estimates of LGD for all its wholesale and retail exposures as a precondition for using the advanced approaches; (iv) the appropriateness of requiring all banks to use a supervisory mapping function, rather than internal estimates, for estimating LGDs, due to limited data availability and lack of industry experience with incorporating economic downturn conditions in LGD estimates; (v) the appropriateness of the proposed supervisory mapping function for translating ELGD into LGD for all portfolios of exposures and possible alternative supervisory mapping functions; (vi) exposures for which no mapping function would be appropriate; and (vii) exposures for which a more lenient (that is, producing a lower LGD for a given ELGD) or more strict (that is, producing a higher LGD for a given ELGD) mapping function may be appropriate (for example, residential mortgage exposures and HVCRE exposures).

Introduction of ELGD

The concept of distinguishing ELGD from LGD as a component of the capital requirement for non-defaulted exposures is an innovation of the NPR and is not present in the Basel II Framework. It creates an additional calculation and reporting burden for banks reporting under advanced approaches in the US and overseas and constitutes a competitive disadvantage for banks whose capital requirements are determined by the NPR rules. The Framework permits only one LGD parameter that reflects economic downturn conditions and is not less than the long run default weighted average loss rate.[1] The NPR, however, employs capital formulas containing both a downturn LGD and a second default weighted average LGD (ELGD) defined as the bank's empirically based estimate of the default-weighted average economic loss per dollar of EAD in the event of default within a one-year horizon.

However, the result of creating a new formal requirement to calculate an additional IRB parameter, ELGD, will create capital requirements for non-defaulted exposures and expected credit loss that are incompatible with figures calculated under the Basel II Framework. Banks reporting under advanced approaches in the US will suffer an additional procedural burden compared with other banks not subject to the NPR and the late introduction of this requirement creates a systems challenge for banks in meeting the qualification requirements as described in Section 22 of the NPR relating to the quantification of risk parameters.

We think it would be very inappropriate to require all banks to use a supervisory mapping function to estimate LGDs.

Downturn LGD:

The issue of "downturn": or "stressed" LGDs needs to be put in context:

There have been academic studies (notably by Ed Altman of the Stern School of NYU) that have measured a negative correlation between the market value of a defaulted bond, measured soon after default, and the number of defaults occurring within a year. The primary explanation of

[1] "International Convergence of Capital Measurement and Capital Standards", BCBS, June 2006, Par. 468.

this observation is supply and demand – that is, in years when the supply of defaulted securities increases, the price of newly defaulted securities tends to fall, given the demand for this asset class by investment funds and firms that buy defaulted debt.

It would be very inappropriate to draw any conclusions about the LGDs for wholesale or retail loans from this analysis of defaulted bond data. We have not seen evidence of a material correlation of LGDs with the economic cycle for either our wholesale or retail portfolios (see below).

We think the Expected LGD is itself a very conservative estimate of potential losses in the event of default for the purpose of calculating RWA for credit risk for the following reasons:

- Since the majority of LGD observations used in the estimations are related to defaults that occur during economic downturns (highest periods of defaults), the ELGD is highly influenced by stressed circumstances.
- Unlike the assumptions underlying the study of defaulted bonds, banks typically manage defaulted loans with workout processes. The work-out process may take several years for wholesale credit and this results in a distribution of LGDs over time that is very different from that observed for defaulted bonds. This also raises the question of whether the correlation should be measured as of the year of default or resolution of default or at some point in between for longer workouts.
- Each bank may have its own strategy and policy for its workout process that would validly cause each bank to measure different LGDs for the same facility. For example, one bank may have a policy of selling its defaulted loans soon after default, to keep its balance sheet clean, while another bank may have long-term workout policy, which seeks to obtain the maximum long-term value from the defaulted obligor.
- Banks will tend to add covenants to its wholesale loans if an obligor seeks additional credit lines when it has begun to have some financial difficulties. This may be particularly true during an economic downturn, when credit standards may be tightening. The result will not only mitigate the effect of the economic cycle but may cause a negative correlation between LGDs and the economic cycle, because during an economic downturn a bank may tend to add covenants more readily than during periods of widespread economic growth.
- For some wholesale obligors with financial difficulties, a bank may require the obligor to liquidate its more liquid collateral to draw down the bank's total credit exposure to the obligor. If that process is followed and the obligor does default, the loss on the outstanding credit at the time of default will tend to be higher than the average loss on all credit that had been extended to the obligor one year before default. In other words, the LGD measurement has will have a selection bias that makes it very conservative.
- The problem of estimating downturn LGD is particularly concerning for portfolios which have a long history of low default experience because of the credit quality of the obligors, as statistical evidence will be very limited. In view of this situation, the proposal that failure of a single, high quality, portfolio to meet unpublished regulatory standards should be the cause of a bank's not being permitted to use advanced approaches for any portfolio within broad subcategories is draconian and inconsistent with the risk-based approach.

- Also, the use of stressed LGDs would imply an increase in the confidence level of risk capital since they are estimated from scenarios whose frequency of occurrence is lower than those used for estimating expected LGDs.
- In additional to all of the above arguments, there is one additional consideration. The credit risk of a large international bank is affected by the economic conditions of each country it has exposure in. These economic conditions are not perfectly correlated. Consequently, requiring such a bank to use stressed LGDs for all portfolios would overstate risk because a) most portfolios may show no evidence of cyclicality in LGDs and b) economic cycles across countries are not perfectly correlated.

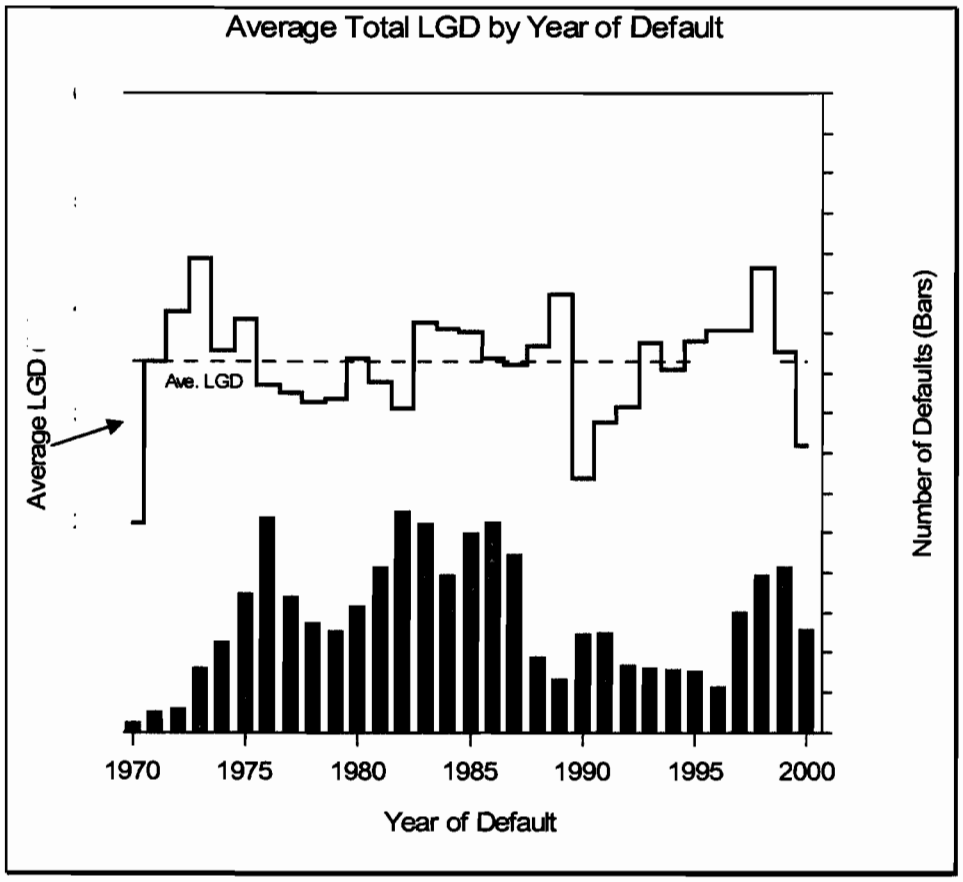
In our view, banks should not be required to estimate stressed LGD other than for subdivisions of subcategories of exposures chosen by the banks for their own calculations, reflecting each bank's mix of business and overall risk-management systems and philosophies.

If banks were required to calculate stressed LGDs at a very fine level granularity, they would not have sufficient data to do so, in additional to the fact that there may be no evidence at any level of granularity for cyclicality in LGDs.

Internal Research:

Our current research does not demonstrate that the LGD varies significantly over the economic cycle

We have carried out studies of the correlation of LGDs and periods of high default rates at a high level, where there is sufficient data to investigate. Looking at data back to 1970, across the Citigroup wholesale credit portfolios, we observe the following:



From the above there appears to be minimal relationship between LGD periods of high default frequency. In this example we have used the number of defaults as a proxy for the economic cycle. We have analyzed this data by region and observe a similar lack of relationship. Given this substantial and long-term analysis for the majority of our wholesale obligors we do not believe that further analysis will reveal substantially different profiles for LGD.

Alternative Approaches:

In the above sections we have described the relatively high degree of conservatism employed by many banks in calculating LGDs. To the degree that a bank can demonstrate that it has been prudent in its calculation of LGDs and if it has no evidence of the cyclicality of LGDs (or more precisely of the correlation of higher LGDs and increased number of PDs in a given year) it should not be required to calculate stressed LGDs or use the stressed LGD transformation. For such a bank, for such portfolios, LGD = ELGD.

Question 17: The Agencies seek comment on the extent to which ELGD or LGD estimates under the proposed rule would be pro-cyclical, particularly for longer-term secured exposures. The Agencies also seek comment on alternative approaches to measuring ELGDs or LGDs that would address concerns regarding potential pro-cyclicality without imposing undue burden on banks.

We do not see evidence that LGDs for wholesale or retail credit are cyclical (see answer to question 16). Therefore if we are allowed to base our LGDs on our observed data, the effect will not be pro-cyclical. More generally, it is not possible to have a measure of risk (e.g. RWA for credit risk) that is not partly pro-cyclical because during an economic downturn the credit ratings a bank assigns to its wholesale obligors will tend to decrease. This decrease in ratings (i.e. increase in PD) will generate on average a higher firm wide RWA number.

Question 18: The Agencies seek comment on the feasibility of recognizing such pre-default changes in exposure in a way that is consistent with the safety and soundness objectives of this proposed rule. The Agencies also seek comment on appropriate restrictions to place on any such recognition to ensure that the results are not counter to the objectives of this proposal to ensure adequate capital within a more risk-sensitive capital framework. In addition, the Agencies seek comment on whether, for wholesale exposures, allowing ELGD and LGD to reflect anticipated future contractual pay downs prior to default may be inconsistent with the proposed rule's imposition of a one-year floor on M (for certain types of exposures) or may lead to some double-counting of the risk-mitigating benefits of shorter maturities for exposures not subject to this floor.

Although the Agencies' willingness to consider recognition of the mitigating effects of pre-default pay downs is welcome, we urge the Agencies not to depart from the current treatment as established under the international framework. As it has been a common theme throughout our response, we give the highest priority to consistency to the international version of Basel II and therefore do not welcome the proposed departure.

We do not believe this topic should be given priority amongst the Agencies' proposals for potential improvements to the Basel II Framework rules. Our suggested approach is to include this issue in the list of topics that should be addressed internationally, in consultation with the Agencies' international peers through the BCBS.

Possible Future Approach:
When appropriate, we would welcome discussion about recognizing that pay downs can decrease both the effective Maturity of a loan and the likely EAD at default. One procedure for dealing with this issue would be first to allow banks to incorporate the recognition of covenants that would be triggered with lower ratings and which would cause pay downs to be made (possible by requiring the liquidation of more liquid collateral). The recognition of the value of such covenants as a risk mitigant should be based on the observation that "jump to defaults" are rare and that more typically an obligor will have a deterioration in its credit rating over time before it defaults.

If the regulators are going to recognize the real risk mitigation benefit of pay downs in covenants, they should also recognize the appropriateness of a more material short-term maturity-adjustment for short tenor credit exposures. The annualized risk of short tenor exposures tends to be less than would be calculated under the assumption of a constant position (i.e. the assumption that the portfolio of transactions with the counterparty will continue to roll-over for the entire year) because a bank will tend not to rollover short tenor exposures to obligors

with increased deteriorating credit quality, unless additional covenants and/or additional collateral were required and posted.

Question 19: The Agencies solicit comment on all aspects of the proposed treatment of operational loss and, in particular, on (i) the appropriateness of the proposed definition of operational loss; (ii) whether the Agencies should define operational loss in terms of the effect an operational loss event has on the bank's regulatory capital or should consider a broader definition based on economic capital concepts; and (iii) how the Agencies should address the potential double-counting issue for premises and other fixed assets.

General Comments:

Citigroup remains supportive of an advanced capital adequacy framework for operational risk and welcomes many elements of the requirements of Basel II the NPR. Our support for a risk-sensitive approach for operational risk is necessarily tied to implementation of risk-sensitive approaches for the other risk types as well. Citigroup believes that replacing policy requirements and associated prescriptive requirements related to organizational structure originally, contained in the ANPR, with systematic and documented processes requirements is appropriate.

We welcome the inclusion of an explicit definition of an operational risk loss and have provided specific comments on the proposed definition in the Citigroup response to question 19, found below.

We also welcome the removal of the onerous and restrictive requirements for EOL offset seen previously and support replacement of these with the more practical and more risk-sensitive requirement that highly predictable, routine losses can be used to offset EOL.

The explicit recognition of boundary events in both the text of the NPR and its associated questions 27 and 28 are useful. See further related comments in responses to question 27 and 28.

i. Definition of operational loss:
The proposed rule defines operational loss as a loss (excluding insurance or tax effects) resulting from an operational loss event. Operational losses include all expenses associated with an operational loss event except for opportunity costs, forgone revenue, and costs related to risk management and control enhancements implemented to prevent future operational losses.

Operational loss event means an event that results in loss and is associated with internal fraud; external fraud; employment practices and workplace safety; clients, products, and business practices; damage to physical assets; business disruption and system failures; or execution, delivery, and process management.

The proposed definition of an operational loss is consistent with Citigroup RCSA and Operational Risk Policy, and the Operational Risk Data Quality Manual that adds additional guidance as to what is included and what is excluded; Citigroup supports the proposed definition.

ii. Should the agency define operational loss in terms of the effect an operational loss event has on the bank's regulatory capital or should consider a broader definition based on economic capital concepts?

The definition should remain tied to direct financial effects on the bank's regulatory capital over a one-year time horizon. A pure economic view of the total loss, e.g., including opportunity costs and foregone revenues, while potentially useful in some cases for management purposes, is not the relevant view for regulatory capital purposes and goes beyond the financial effects that capital should buffer. Citigroup's policy definitions associated with loss data capture are also tied heavily to financial effects by financial reporting period.

Loss or damage to physical assets and premises may have financial, economic and reputational effects and all these effects need to be managed appropriately. However, the immediate impact to capital of any damage is based on the book carrying value. The other equally important economic and reputational impacts do not reduce capital and are appropriately managed through risk management processes such as risk control and risk mitigation. For example, in the case of premises, the potential to lose the full economic value of the premises that may include lost revenue in addition to the market value of the premises can be adequately covered by insurance policies.

Citigroup recommends continuing with the current NPR approach of basing regulatory capital of the potential loss reflected directly in the financial statements over the one-year time horizon.

iii. How the Agencies should address the potential double-counting issue for premises and other fixed assets.

The current proposed rule of requiring that bank premises have a risk weighted asset value equal to the carrying value of the premises and requiring that operational risk capital reflect losses associated with damage to physical assets does result in double counting. Loss associated with damage to physical assets are treated as all other operational losses within the operational risk capital model and, to the extent that the model has been validated, accurately captures the operational risk exposure associated with owing bank premises. Therefore including the risk associated with owning premises within the operational risk model is a more accurate determination of the amount of capital that is required to support these assets than the crude risk weighted asset approach.

Citigroup recommends, in order to avoid double counting, removing the additional capita requirement associated with the risk weighted asset approach to bank premises and continue to include these within the operational risk capital model.

However, if the agency were to instruct that premises and certain other fixed assets should be capitalized by a separate schedule, then an explicit exclusion of these risks from operational risk should be included in the rules. Again, we do not support this approach, because, even though it would eliminate double counting, it would lead to a gap between our internal economic risk capital and regulatory capital principles

Question 20: The Agencies seek comment on the appropriateness of the 24-month and 30-day time frames for addressing the merger and acquisition transition situations advanced approaches banks may face.

In the circumstance where a listed bank has been acquired through a competitive bidding process and the acquiring banks has not had access to the banks books and record nor detailed discussions with management, then to produce a plan for moving to the advanced approach within 30 days is very aggressive. It could be argued that provided the acquired bank is adequately capitalized then there are higher business priorities than switching to the advanced approach. For example, instilling the acquired bank's credit and trading risk management culture, examining the quality and accuracy of its financial accounting systems and making any necessary management changes should have higher priority. The 30-day requirement should be flexible and should only be associated with the period during which the plan for moving to the advanced approach will be tackled amongst other competing priorities. In addition there should be flexibility to extend the 24-month timetable in appropriate circumstances. If these considerations are added then this requirement may be reasonable so long as it is also flexible and the acquiring bank demonstrates that there is a plan in place which tackles the key acquisition challenges in an appropriate priority and with appropriate urgency.

Question 21: Commenters are encouraged to provide views on the proposed adjustments to the components of the risk-based capital numerator as described below. Commenters also may provide views on numerator-related issues that they believe would be useful to the Agencies' consideration of the proposed rule.

The definition of capital and the deductions against tier 1 and/or Tier 2, is a topic of such importance that a thorough debate by international regulators is absolutely necessary before a change to the US rules is contemplated. Those elements, which are a fundamental component of the Basel Framework, were developed in rounds of consultations with the industry and among regulators for several years. A unilateral revision of such elements by an individual Basel Committee member country could not only jeopardize the international character of the Framework but also create greater regulatory inconsistencies across jurisdictions, an outcome that both industry and regulators should endeavor to prevent.

Question 22: The Agencies seek comment on the proposed ECL approach for defaulted exposures as well as on an alternative treatment, under which ECL for a defaulted exposure would be calculated as the bank's current carrying value of the exposure multiplied by the bank's best estimate of the expected economic loss rate associated with the exposure (measured relative to the current carrying value), that would be more consistent with the proposed treatment of ECL for non-defaulted exposures. The Agencies also seek comment on whether these two approaches would likely produce materially different ECL estimates for defaulted exposures. In addition, the Agencies seek comment on the appropriate measure of ECL for assets held at fair value with gains and losses flowing through earnings.

No comment.

Question 23: The Board seeks comment on this proposed treatment and in particular on how a minimum insurance regulatory capital proxy for tier 1 deduction purposes should be determined for insurance underwriting subsidiaries that are not subject to U.S. functional regulation.

The NPR requires the consolidation of insurance company assets and the deduction of insurance company minimum capital requirements from Tier 1 whereas the international framework (Par. 30 et seq.) requires deduction from tier 1 and from tier 2 of the required capital of insurance subsidiaries and the treatment of any surplus of invested capital as an equity investment.

The NPR treatment is therefore conservative in that it effectively applies two sets of regulatory requirements to insurance subsidiaries' activities. Furthermore it departs from the Basel II framework in both this respect and by requiring the deduction be made from tier 1 instead of from tier 1 and tier 2. Capital requirements for insurance companies are based on very different principles from that of banking businesses and there are clear rules set out by insurance regulators. Unless the US banking regulators can demonstrate grounds for legitimate doubts about the appropriateness of the insurance capital requirements, it is unclear why this treatment is being introduced other than for unregulated insurance entities. This adds to the compliance costs of the NPR for little benefit.

Question 24: The Agencies seek comment on how to strike the appropriate balance between the enhanced risk sensitivity and marginally higher risk-based capital requirements obtained by separating HVCRE exposures from other wholesale exposures and the additional complexity the separation entails.

No comments.

Question 25: The Agencies request comment and supporting evidence on the consistency of the proposed treatment with the underlying riskiness of SME portfolios. Further, the Agencies request comment on any competitive issues that this aspect of the proposed rule may cause for U.S. banks.

Citigroup believes that the treatment of SME portfolios under the international framework is a valid and robust one. In fact, the risk weighting proposed under Basel II is commensurate to risk levels in large and diversified portfolios as those of banks implementing the new framework in the US.

Therefore, we believe there is no need (or justification) for establishing a new and revised approach to SME loans as proposed in the NPR. We therefore strongly encourage the Agencies to refrain from establishing additional departures from the international framework which would result in inconsistent capital requirements, competitive disadvantages for US banks and duplicative reporting systems for banks using advanced approaches both in the US and overseas.

While we have not done an analysis of the underlying riskiness of an SME portfolio relative a standard wholesale portfolio of similar PDs and LGDs, the claim that SMEs tend to have a lower

asset value correlation seems plausible. It is easily observed in the corporate bond market that the volatility of the idiosyncratic component of corporate bond spreads tends to increase as the credit rating of the issuer declines (i.e. as the PD increase). This reflects the fact that all else held constant, firms with lower credit ratings tend to be relatively more susceptible to idiosyncratic factors than firms with higher ratings. By a similar reason one would expect that the PDs of SMEs would tend to be more dependent on idiosyncratic factors relative to systematic factors than larger firms. For example, an SME would likely have less geographical diversification in its customer base and have less product diversification than a much larger firm. As a consequence, a portfolio of loans to a large number of SMEs would likely have more diversification than a portfolio of loans to much larger firms of similar rating.

Question 26: The Agencies request comment on the appropriate treatment of tranched exposures to a mixed pool of financial and non-financial underlying exposures. The Agencies specifically are interested in the views of commenters as to whether the requirement that all or substantially all of the underlying exposures of a securitization be financial exposures should be softened to require only that some lesser portion of the underlying exposures be financial exposures.

We are in favor of relaxing the proposed rule's that limits underlying exposures in a securitization to all (or substantially all) financial exposures. This would include lease securitizations, one of the key market segments directed impacted by this rule. Leases often combine a rental payment component -- which is a financial exposure -- with residual rights component -- which is a non-financial exposure. Rating agency criteria are similar for lease exposures and for financial exposures that argue for similar risk based capital approach.

The SEC has already included lease securitizations in the definition of "asset backed securities" and has set quantitative limits on the position of the securitized pool that is attributed to residual value, particularly for auto leases. A similar approach should be considered by the Agencies. Consistency between the SEC and the Agencies limits would be helpful.

Our major concern is that the requirement not stand in the way of the development of innovative securitization structures, especially those that including underlying positions that are non-financial under the regulatory definition of such assets.

We suggest that, in general, if NRSROs have either 1) defined rating criteria for the underlying positions, or 2) rated one or more tranches of the securitization, the Basel II bank should be permitted to use securitization treatment on the same grounds as securitization of "financial" positions. As such, the securitization treatment could include the RBA for rated or inferred-rating tranches; the IAA for ABCP tranches, the SFA for unrated tranches, or deduction for positions that are not eligible for any of the other treatments.

Examples of such "non-financial" underlying positions might include future royalties associated with, say, the sale of music.

In addition to the above, we recommend that qualifying banks should be permitted to use the IAA on exposures to securitizations of non-IRB exposures (including non-financial exposures) so long as there are publicly available rating criteria, (or, in those cases when no published rating

methodology exists because of a special feature or a securitization, when the qualifying banks consults with NRSRO) and the other requirements of the IAA are satisfied.

We see no reason why non-IRB assets and IRB assets should be treated differently under IAA, since they are both subject to the same NRSRO rigor and the same independent check on bank assessments of their internal ratings.

To the extent that IAA does not apply to certain exposures, such as music concert or film receivables, then these exposures should be analyzed as wholesale exposures, similar to the A-IRB approach prescribed for specialized lending categories involving object, project or commodity finance.

Question 27: The Agencies seek commenters' perspectives on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to losses on HELOCs).

The definition the boundary between credit and operational risk, is a topic of such importance that a thorough debate by international regulators is absolutely necessary before a change to the US rules is contemplated. Those elements, which are a fundamental component of the Basel Framework, were developed in rounds of consultations with the industry and among regulators for several years. A unilateral revision of such elements by an individual Basel Committee member country could not only jeopardize the international character of the Framework but also create greater regulatory inconsistencies across jurisdictions, an outcome that both industry and regulators should endeavor to prevent. Furthermore, Citigroup has not identified any other areas where the boundary between credit and operational risk should be evaluated further.

Question 28: The Agencies generally seek comment on the proposed treatment of the boundaries between credit, operational, and market risk.

Citigroup supports treating operational losses that are related to market risk as operational losses for purposes of calculating risk-based capital requirements. Treating losses such as those incurred from a failure of bank personnel to properly execute a stop loss order, from trading fraud, or from a bank selling a security when a purchase was intended, as operational risk losses is consistent with Citigroup practice.
As noted above, the definition of the boundary between credit and operational risk is a topic of such importance that a thorough debate by international regulators is absolutely necessary before a change to the US rules is contemplated. Those elements, which are a fundamental component of the Basel Framework, were developed in rounds of consultations with the industry and among regulators for several years. A unilateral revision of such elements by an individual Basel Committee member country could not only jeopardize the international character of the Framework but also create greater regulatory inconsistencies across jurisdictions, an outcome that both industry and regulators should endeavor to prevent.

Question 29: The Agencies seek comment on this approach to tranched guarantees on retail exposures and on alternative approaches that could more appropriately reflect the risk

mitigating effect of such guarantees while addressing the Agencies' concerns about counterparty credit risk and correlation between the credit quality of an obligor and a guarantor.

We support the proposal to include recoveries from any insurance or other form of loss protection within the calculation of the ELGD and LGD for exposure with material protection.

However, we are unclear as to the efficiency/value of a "tranching" approach in portfolios where the credit protection applies only to small proportion of the portfolio or is only applied to a few exposures.

Question 30: The Agencies seek comment on wholesale and retail exposure types for which banks are not able to calculate PD, ELGD, and LGD and on what an appropriate risk-based capital treatment for such exposures might be.

If a bank does not have sufficient data to calculate PD, ELGD and LGD there should be several paths open to it. If the bank can calculate the expected loss of the portfolio it should be able to either a) assign a reasonable default ELGD and LGD and then derive the PD from the relationship PD = Expected Loss/LGD or b) assign a reasonable PD and then derive the LGD from the relationship LGD = Expected Loss/PD.

When a margin loan product (which may be offered typically in a bank's Private Bank or Securities Brokerage business units) meets certain criteria, such as a) requiring collateral whose market value exceeds that of the loan, b) collateral consisting of cash and/or liquid securities, c) daily mark-to-market of the collateral, d) a top-up process wherein collateral will be sold to reduce the net exposure if ratio of the market value of the collateral to the exposure falls below a specified level, the bank will tend to experience very infrequent losses. For those margin loans that are not eligible for the EAD approach (i.e. the reduction in EAD for the narrowly-defined, eligible margin posted for OTC derivatives and Securities Financing transactions), the process described in the prior paragraph is a very reasonable method for estimating the risk parameters needed to calculate RWA.

There are other portfolios, such those arising from securities lending activities, where the absence of defaults and the nature of the business should allow customized, streamlined approaches that do not result in punitive parameters.

We strongly suggest that, depending upon the context, the absence of evidence (e.g., default events or losses) should be taken as evidence. For portfolios that are long-standing and extensive in terms of numbers of obligors or products, the absence of defaults and losses is a very important piece of information (the impact of the redefinition of default on sufficient data samples is discussed earlier in this response). Reasonableness has to apply in these circumstances as opposed to conservatism if we are to avoid overestimating the low risk nature of the portfolio and a possibility of assigning higher risk weights to low risk obligors or product classes than on higher risk portfolios where sufficient data is available.

Question 31: The Agencies seek comment on the appropriateness of permitting a bank to consider prepayments when estimating M and on the feasibility and advisability of using discounted (rather than undiscounted) cash flows as the basis for estimating M.

It is appropriate and very reasonable to allow a bank to take pre-payments into account in estimating M and in using discounted cash flows, rather than undiscounted cash flows in estimating M. Within the Advanced IRB risk weight formula, M is used to estimate the decrease in the imputed economic value of a loan due to potential changes in market spreads. The actual sensitivity of a loan or a bond to changes in market spreads will be proportional to the loan or bond's modified duration. The formula for modified duration takes into account the loan or bond's expected future cash flows (include the effect of pre-payments) and discounts those expected future cash flow at the appropriate discount rate.

Therefore to accurately measure the change in the imputed market value of a loan to potential changes in market spreads, M should be defined as the modified duration, which will be a dependent on discounting and pre-payments.

Question 32: The Agencies seek comment on whether the Agencies should impose the following underwriting criteria as additional requirements for a Basel II bank to qualify for the statutory 50 percent risk weight for a particular mortgage loan: (i) That the bank has an IRB risk measurement and management system in place that assesses the PD and LGD of prospective residential mortgage exposures; and (ii) that the bank's IRB system generates a 50 percent risk weight for the loan under the IRB risk based capital formulas.

When complying with this provision the main constraint is in terms of specifically identifying those mortgages that now qualify for the 50% risk weight rather than the IRB treatment. This requires careful procedures and processes to identify these mortgages and to keep them separate from the majority. Whether the bank has an IRB system that can adequately identify the specific PD and LGD associated with these mortgages will to a large part depend on whether there are enough such mortgages in the relevant segments and sufficient history in those segments to calculate PD and LGD with sufficient accuracy. Our comments are:

- The requirement to have an IRB systems which can assess the specific PD and LGD associated with these depends on the volume of such loans and there is no guarantee that there will be enough to give good quality PD and LGD data; in these circumstances we see little benefit from adding a requirement to have to have such a system in place.
- The effort to place these mortgages in a separate segment will be required, but it seems to be an effort that is out of proportion to the work involved and is another instance of the NPR moving away from business use.
- We do not believe that the remit of the RTCRRI Act was in respect of mortgages outside the US and if the clause has to be retained with the flexibility of combining these mortgages with others, we would be grateful if these requirements could be confined to US mortgages, because to put in place procedures and IT process to identify (and monitor) the specific categorization of these mortgages outside the US where the distinction is not a standard business criteria is considered particularly onerous.

Question 33: The Agencies seek comment on all aspects of the proposed treatment of one-to-four family residential pre-sold construction loans and multifamily residential loans.

We consider that the adoption of the A-IRB treatment for mortgages meets the RTCRRI requirement to have capital standards which reflect the actual performance and risk of loss of multifamily mortgages and that no further modification is required.

Question 34: For purposes of determining EAD for counterparty credit risk and recognizing collateral mitigating that risk, the proposed rule allows banks to take into account only financial collateral, which, by definition, does not include debt securities that have an external rating lower than one rating category below investment grade. The Agencies invite comment on the extent to which lower-rated debt securities or other securities that do not meet the definition of financial collateral are used in these transactions and on the CRM value of such securities.

This is not an issue for the counterparty risk of OTC derivatives within our firm. However the proposal is contrary to current standards and practice for securities financing transactions. For example, if a bank does a repo transaction on a non-investment grade security it will use an appropriately higher haircut for the transactions. As long as a bank can demonstrate that it utilizes haircuts appropriate to the risk of the securities posted as margin or the securities underlying the SFTs there is no reason to limit collateral to securities with a external rating greater than or equal to one rating category below investment grade.

Question 35: The Agencies recognize that criterion (iii) above may pose challenges for certain transactions that would not be eligible for certain exemptions from bankruptcy or receivership laws because the counterparty—for example, a sovereign entity or a pension fund—is not subject to such laws. The Agencies seek comment on ways this criterion could be crafted to accommodate such transactions when justified on prudential grounds, while ensuring that the requirements in criterion (iii) are met for transactions that are eligible for those exemptions.

Criteria (iii) asserts that "(iii) The transaction is executed under an agreement that provides the bank the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions;"

As pointed out by this question, even when the law exempts, in an appropriate context, the margin posted as collateral from being subject to a stay, there may be exceptions to the exemption for specified types of obligors (e.g. ERISA funds, sovereigns, etc.).

There are several ways the exemptions to the no-stay rule can be treated. We support the approach adopted by the three US regulators[2], as reported in the 8932 Federal Register / Vol. 71,

[2] Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and Federal Deposit Insurance Corporation.

No. 35 / Wednesday, February 22, 2006 / Rules and Regulations "Risk-Based Capital Guidelines: Market Risk Measure: Securities Borrowing Transactions"

"III. Final Rule
After consideration of the comments received, the Agencies are issuing a final rule (the final rule) identical to the interim rule with one exception. Specifically, the fourth criterion, which requires that a cash-collateralized securities borrowing transaction be a securities contract for purposes of the Bankruptcy Code, a qualified financial contract for purposes of the FDIA, or a netting contract for purposes of FDICIA or Regulation EE, will be replaced with the following:

4.(A) The transaction is a securities contract for the purposes of section 555 of the Bankruptcy Code (11 U.S.C. 555), a qualified financial contract for the purposes of section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)), or a netting contract between or among financial institutions for the purposes of sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4401–4407), or the Board's Regulation EE (12 CFR Part 231); or

(B) If the transaction does not meet the criteria set forth in paragraph 4. (A) of this section, then either:

(i) The banking organization has conducted sufficient legal review to reach a well-founded conclusion that (1) the securities borrowing agreement executed in connection with the transaction provides the banking organization the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of counterparty default, including in a bankruptcy, insolvency, or other similar proceeding of the counterparty and (2) under applicable law of the relevant jurisdiction, its rights under the agreement are legal, valid, binding, and enforceable and any exercise of rights under the agreement will not be stayed or avoided; or

(ii) The transaction is either overnight or unconditionally cancelable at any time by the banking organization, and the banking organization has conducted sufficient legal review to reach a wellfounded conclusion that (1) the securities borrowing agreement executed in connection with the transaction provides the banking organization the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of counterparty default and (2) under the law governing the agreement, its rights under the agreement are legal, valid, binding, and enforceable.

The fourth criterion has been revised to broaden the types of securities borrowing transactions that qualify for the interim rule. Subpart (A) preserves the existing method of qualification. It is the responsibility of the banking organization to determine if the transaction meets the criteria of subpart (A). If the transaction does not meet the criteria under subpart (A), or if there is uncertainty about it, the banking organization can rely on the criteria of subpart (B) to apply the capital treatment set forth in this final rule.

Subpart (B) extends the treatment set forth in the interim rule to transactions that are exempt from any automatic stay in bankruptcy, insolvency, or similar proceedings or that are conducted on a basis that is either overnight or that provides the banking organization the unconditional right to terminate that transaction at will. In this regard, the Agencies will not view a reasonably short notice period, typically no more than the standard settlement period associated with the securities borrowed, as detracting from the unconditionality of the banking organization's termination rights. With regard to overnight transactions, the counterparty generally should have no expectation, either explicit or implicit, that the banking organization will automatically roll over the transaction.

Under subpart (B), transactions may qualify only if the banking organization has conducted sufficient legal review to conclude that its rights under the agreement under which the transactions are executed is legal, valid, binding, and enforceable. No such review is required for transactions qualifying under subpart (A). For transactions executed under standard industry contracts, trade groups representing the financial services industry with established expertise often commission and maintain a library of current legal opinions with respect to the legal status, validity, binding effect, and enforceability of such contracts with various counterparties under the laws of a number of jurisdictions. While the Agencies do not discourage a banking organization from obtaining a specific legal opinion tailored to a particular transaction, a banking organization's review of the legal opinions described above to determine the legal status, validity, binding effect, and enforceability of a particular contract with a specific counterparty, for example, generally would meet the requirement for sufficient legal review under subpart (B)."

Question 36: The Agencies seek comment on the appropriateness of requiring that a bank have a perfected, first priority security interest, or the legal equivalent thereof, in the definition of financial collateral.

The proposed rules need to differentiate between a) financial collateral that is held as credit risk mitigation to reduce the LGD and b) financial collateral that is held as margin, as that term is used for OTC derivatives and securities financing transactions, as a means of reducing EAD. It is only in regard to the latter that the legal issue of "no stay" is relevant.

It is both appropriate and consistent with industry practice to require a bank to have a "perfected, first priority security interest" to recognize collateral as "financial collateral" but the definition in the NPR of "perfected, first priority security interest" which requires an agreement that "will not be stayed or avoided under applicable law in the relevant jurisdictions" is inappropriate when applied to both collateral (used to reduce LGD) and margin (used to reduce EAD), as described in the prior paragraph. The requirement is at odds with industry practice and should be withdrawn.

There is a broad category of product called "margin loans" that are usually transacted within a bank's Private Banking and/or Retail Broker Dealer business. The broad "margin loan" product includes both "for purpose" loans (loans for the purpose of purchasing other securities) and "non-purpose" loans, it includes transactions booked in a broker deal and a bank legal vehicle and it includes transactions done in the United States as well as in jurisdictions outside the US.

By their nature eligible margin loans, broadly defined as loans where:

- The exposure is collateralized by cash or securities whose values are marked to market,
- The exposures are subject to re-margining and sell-down provisions and managed in accordance with these provisions and
- The sale of financial collateral is a typical means for repaying loans (i.e., not through the collections or workout process for troubled debt)

are very low risk exposures since there is a mechanism for the bank, or borrower, to quickly convert a portion of the collateral held to cash and bring the loan back within margin as a normal part of business.

Policies and procedures covering margin loan documentation, and the standards required to ensure appropriate legal review, are a core requirement for margin lending since it is necessary to for a lender to fully understand their rights under the agreements they have entered into with their customers.

That said, despite ample legal review across the industry, there is, no single best practice with regard to the form of agreement under which a margin loan is transacted. The documentation required for margin lending typically varies by the type of institution offering the margin loan not the type of loan being offered.

Traditional broker-dealer margin lending is typically documented under a form of securities contract while bank-booked margin loans for the purpose of buying securities and other non-purpose bank margin loans secured by financial collateral are typically documented under a loan agreement. These different approaches are largely the result of historic regulatory guidance.

Whether subject to Regulation T, Regulation U, Regulation O, or transacted outside of the United States and not subject to those regulations, the margin lending product, whether documented under a securities contract or a loan agreement, has demonstrated a consistently low risk of loss.

In the event of a borrower bankruptcy, there can be some differences between bank and broker-dealer loans as to the legal certainty that the lender will be able to immediately sell collateral to repay the loan since it is possible that loans made by banks subject to a loan agreement will be subject to a stay prohibiting the sale of collateral.

In practice, however, most banks make little or no distinction between the two forms of agreement in their risk management practices, and banks do not believe the behavior of

borrowers differs materially based on the type of entity in which the loan is booked or the type of contract under which they have transacted the margin loan.

The reasonableness of this grouping is supported by similar historical loss experiences on broker-dealer margin loans and bank margin loans. There are several reasons for this: 1) most borrowers experiencing financial distress repay their margin loans prior to bankruptcy to extract the equity value tied up in the managing loans, 2) upon bankruptcy, the duration of the stay (if any) is usually very short.

In short, bank and broker-dealer margin loans, while documented differently, are economically and operationally similar – neither the nature of the borrower nor the lender determines the risk of the loan; the nature of the collateral does.

Although banks may differ in policy or practice as to how quickly they liquidate collateral – either among banks or between the bank and broker-dealer within one bank – the consequence of any such differences should be observed in their loss rates which are both extremely low and similar.

As currently proposed, only the broker-dealer margin loans documented under a securities contract would meet the required documentation standard while those transactions entered into under a bank loan agreements would not which would result in two different capital requirements for identical transactions based solely on choice of documentation.

Limitations imposed on the recognition of collateral held as "financial collateral" based solely on the form of lending agreement are unreasonable and will have a significant adverse capital impact on firms entering into these types of transactions under lending agreements instead of securities contracts that far outweighs the perceived (limited) increase in legal certainty which can result in competitive disadvantage, unnecessary costs and potential customer dissatisfaction.

Accordingly, we recommend that the requirement in the definition of "perfected, first priority security interest" for collateral to qualify as financial collateral that an agreement "will not be stayed or avoided under applicable law in the relevant jurisdictions" should be withdrawn to ensure equal treatment of both forms of contract.

The requirement is only appropriate for the narrowly defined concept of margin, as used for counterparty credit risk or OTC derivatives and securities financing transactions, when margin is used to reduce EAD.

Question 37: The Agencies recognize that this is a conservative approach and seek comment on other approaches to consider in determining a given security for purposes of the collateral haircut approach.

No comment as Citigroup will not be using this approach.

Question 38: The Agencies seek comment on methods banks would use to ensure enforceability of single product OTC derivative netting agreements in the absence of an explicit written legal opinion requirement.

It is appropriate to require a written legal opinion from internal or outside counsel on the legal enforceability of single product OTC derivative netting agreements. We think there would be a problem in only relying on the form of the contract (e.g. an ISDA Master Netting agreement) because the enforceability of the netting agreement will depend on several factors: a) the form of the contract, b) the specific product, c) the type of counterparty (e.g. municipality, insurer, ERISA fund, etc.) and the applicable laws of potentially several legal jurisdictions (i.e. the jurisdictions corresponding to the booking center and/or domicile of the counterparty as well as the jurisdictions corresponding to a bank's own booking center and domicile). Because the enforceability of a netting agreement depends on these several factors, care must be taken (i.e. legal opinion sought) to know whether a particular netting agreement is legally enforceable.

Question 39: The Agencies request comment on all aspect of the effective EPE approach to counterparty credit risk, and in particular on the appropriateness of the monotonically increasing effective EE function, the alpha constant of 1.4, and the floor on internal estimates of alpha of 1.2.

We have several comments to make on the effective EPE approach.

Level of Calculation of EPE and Effective EPE

We do not think that there is a good basis for specifying that Effective EPE must be calculated at the netting set level. Effective EPE can logically and coherently be measured at the counterparty party level across all transactions with the counterparty, including a) transactions not covered by any netting agreement and b) the set of transactions covered by each separate netting agreement entered into with the counterparty. The logic for doing this has been presented to the Basel Committee and has been published[3]. The method of simulating an exposure profile at the counterparty level fully recognizes that only transactions covered by a netting agreement can be netted together. However a robust simulation method will take into account that for any simulated state of the market, at any future date, not every netting set has exposure – i.e. there are portfolio effects across netting sets.

There are two reasons for allowing banks to measure Effective EPE at the counterparty level a) it is the correct method of measuring Effective EPE, and b) it is consistent with the methods and processes banks invented and implemented years ago. Banks do not typically simulate exposure profiles at the netting set level (i.e. for each transaction on a standalone basis) when there is no netting agreement. Requiring each bank to calculate exposure profiles at the netting set level when there is no netting agreement would materially add to

[3] Evan Picoult, (2005) Calculating and Hedging Exposure, Credit Value Adjustment and Economic Capital for Counterparty Credit Risk, Chapter in *Counterparty Credit Risk Modeling: Pricing, Risk Management and Regulation* edited by Michael Pykhtin, London, Risk Books; Evan Picoult and David Lamb (2004) Economic Capital for Counterparty Credit Risk, Chapter in Economic *Capital: A Practitioner Guide*, London, Risk Books

processing costs and the numbers that would be calculated would solely be used for regulatory report, not internal risk management.

Banks have a strong incentive to enter into netting agreements with their counterparties. However, as per our answer to question 38, above, the legally enforceability of a netting agreement is dependent on several factors including, a) the form of the contract, b) the specific product, c) the type of counterparty, d) the applicable laws of potentially several legal jurisdictions. For this reason, in spite of its best efforts, a bank may have derivative transactions that are not covered by a legally enforceable netting agreement.

The incremental processing costs of calculating Effective EPE at the netting set level will be very high. As a fall back position, if the regulators insist on requiring banks to calculate Effective EPE at the netting set level, they should allow banks to use a simple scaling factor to transform Effective EPE calculated at the counterparty level to Effective EPE calculated at the netting set level.

Floor on Internal Estimate of alpha of 1.2

We do not think that a floor, equal to 1.2, should be set on the internal estimate of alpha. As the US regulators know, the origin of a floor on alpha equal to 1.2 is as follows:

> The joint industry associations (ISDA/LIBA/TBMA) did an initial study when it first proposed the use of alpha and found that alpha would have a value of about 1.1, given the characteristics of a typical, large derivative trading business. At the request of the Basel/IOSCO Working Group, a further study was done that took "general wrong way" risk into account. Alpha was then found to equal approximately 1.2

The actual alpha applicable to a given firm can be less than 1.2 and should be based on the appropriate empirical study by that firm.

For example, a firm might structurally have "general right way" risk rather than the "general wrong way" risk. That could occur, as one example, if a bank tended a) to transact interest rate swaps with corporate end-users for which the bank paid fixed and received floating and b) to hedge market risk by entering into offsetting swaps in the interbank market. Counterparties in the interbank market tend to enter into bilateral margin agreement, whereas corporate end users tend not to enter into margin agreements. As a result of this structural arrangement, the bank would tend to have "right way" risk with its corporate end users (exposures will increase when interest rates rise and the systematic component of default tends to decrease) whereas there will be negligible exposure with the interbank customers in a falling rate environment because of margin.

Floors of any kind tend to distort the measurement of risk. This is an example of where that distortion would occur.

Question 40: The Agencies request comment on the appropriateness of these criteria in determining whether the risk mitigation effects of a credit derivative should be recognized for risk-based capital purposes.

. Please see our discussion below in "Other Topics" regarding credit default swap (CDS) and contingent credit default swap (CCDS) contracts.

Question 41: The Agencies are interested in the views of commenters as to whether and how the Agencies should address these and other similar situations in which multiple credit risk mitigants cover a single exposure.

We think the proposed rules are reasonable.

Question 42: The Agencies seek comment on this alternative approach's definition of eligible retail guarantee and treatment for eligible retail guarantees, and on whether the Agencies should provide similar treatment for any other forms of wholesale credit insurance or guarantees on retail exposures, such as student loans, if the Agencies adopt this approach.

We would support the treatment of adjusting the LGD/ELGD to take account of the benefit of guarantees and other forms of retail credit risk mitigation in lieu of adjusting the PDs.

However, we encourage extension of eligibility to a broader range of guarantees to encourage consistency of approaches.

Question 43: The Agencies seek comment on the types of non-eligible retail guarantees banks obtain and the extent to which banks obtain credit risk mitigation in the form of non-eligible retail guarantees.

We prefer treatments that are broadly consistent across exposures and regulatory jurisdictions and that appropriately characterize the underlying economics. Thus, while we do not, in theory, object to option 2, we await further clarification of the floor and its alignment with the underlying economics to assess its preference to option 1.

Question 44: The Agencies seek comment on both of these alternative approaches to guarantees that cover retail exposures. The Agencies also invite comment on other possible prudential treatments for such guarantees.

See response to question 43

Question 45: The Agencies seek comment on this differential treatment of originating banks and investing banks and on alternative mechanisms that could be employed to ensure the reliability of external and inferred ratings of non-traded securitization exposures retained by originating banks.

We do not believe that originating banks should be treated differently from investing banks and that for the sake of international consistency where more than two ratings are available that the final rules permit the lower of the two highest ratings to be used.

Question 46: The Agencies seek comment on whether they should consider other bases for inferring a rating for an unrated securitization position, such as using an applicable credit rating on outstanding long-term debt of the issuer or guarantor of the securitization exposure.

The requirement for two external ratings for an originating bank, in the context of a retained, un-traded position (that is not a first-dollar position subject to deduction), is another area of difference between the U.S. proposed treatment and the European version of Basel II.

We do not believe that the U.S. requirement fulfills any prudential purpose -- in particular, we do not believe that the originating bank can influence in any manner the rating purchased from a single NRSRO for an un-traded position. That is, the NRSRO's reputation for objectivity is paramount to the NRSRO, and could not be "bought" in the context of obtaining any rating.

If the regulator were at all concerned over the appropriateness of the NRSRO rating, it could require, as a matter of supervisory implementation of the Basel II AIRB approach, that the bank perform its own internal rating (employing the NRSRO procedures) as is done in the case of un-rated tranches of ABCP securitizations. The lower of the internal or external rating could be the mandated rating used for regulatory capital purposes. Any systematic deficiencies in the bank's internal rating process for a retained securitization position would be as much a focus of supervisory review as the internal rating for large corporate credits.

While the retention of un-traded mezzanine tranches for securitizations are not typically a large percentage of a U.S. bank's securitization activities, the rule requiring the purchase of two ratings would likely eliminate the use of the RBA for such positions by U.S.- regulated banks.

Question 47: The Agencies seek comment on the appropriateness of basing the risk-based capital requirement for a securitization exposure under the RBA on the seniority level of the exposure.

In addition to other factors -- external rating, ratings tenor, and granularity -- seniority of securitization exposure is an appropriate attribute to differentiate risk weights. However, with regard to seniority there are important implementation issues. In particular, it is costly to track the seniority of a position over time, as other positions mature. The bank should be given the option of using Column 2 in the table rather than track seniority.
On a related issue, we understand that the EU's Capital Requirements Directive provides a 6% risk weight for some super senior exposures and sometimes permits other exposures to be treated as senior, even when there are super senior exposures within the same structure. For the sake of international competitive equality and level playing field, we request that the Agencies adopt similar provisions to the EU rules.

Question 48: The Agencies seek comment on how well this approach captures the most important risk factors for securitization exposures of varying degrees of seniority and granularity.

The credit risk weighting attributes used to determine risk weights are appropriate and capture the most important risk factors for securitization exposures of varying degrees of seniority and granularity.

Question 49: The Agencies seek comment on suggested alternative approaches for determining the N of a re-securitization.

"N" represents the granularity of a pool of underlying exposures to assess the diversification of pools that have individual underlying exposures of different sizes. The formula for effective "N" is based on exposure –weighted average loss given default (EWALGD). Since for re-securitization, an LGD if 100% must be assumed for any underlying exposure that itself is a securitization exposure, we limit the effective weighting factor to one factor (EAD alone) when calculating the EWALGD for re-securitizations.

We contend that using an LGD of 100% for all re-securitized assets is overly conservative, particularly in situations where the underlying pool consists of highly rated MBS, ABS, or super-senior tranches of CDOs, In these cases, the pool LGD would be only a small fraction of the mandated LGD of 100%. In our opinion, relaxing this LGD requirement would be more important than adjusting the approach to determine "N" for re-securitizations.

With regard to the calculation of N, the proposal to define N as ≥ 6 when the notional number of underlying exposures is ≥ 25 seems reasonable. However, it may prove expensive for the bank to track N over time as individual positions in the pool mature, prepay, or default. Over time, N must decline with such terminations of individual positions in the pool, but this decrease in granularity, from the point of view of overall pool risk, will be offset by an increase in age of the underlying assets – which, for some credit assets, reduces default risk. Implementation costs, therefore, would be reduced, without a necessary increase in risk, if the bank is required to determine N only at the outset of the securitization transaction. Alternatively, the bank might only have to determine N "periodically", if N at origination is large. For example, a pool at origination with hundreds of positions would be very unlikely to reach $N < 6$ within several years.

Question 50: The Agencies have not included this concept in the proposed rule but seek comment on the prevalence of eligible disruption liquidity facilities and a bank's expected use of the SFA to calculate risk-based capital requirements for such facilities.

There is little or no use of eligible disruption liquidity facilities within the business at this stage. Liquidity Facilities that only can be used in the event of a market disruption has limited commercial appeal given their restricted use. Nevertheless, we would assume that these facilities would be subject to IAA not SFA and should be assigned a credit conversion factor of zero as the risk is not related to the credit quality of the issuer nor its assets. This is the treatment that is afforded under the Basel II standardized approach and should be the same for AIRB banks. This approach is justified based on the low probability that these facilities would be drawn upon.

Question 51: The Agencies seek comment on the appropriateness of these additional exemptions in the U.S. markets for revolving securitizations.

We would support with the concept of exempting certain revolving securitizations from the rules involving investors interest that levies capital charges on both the drawn balances and undrawn lines of the underlying exposures that are allocated to investors in a revolving / early amortization feature securitization.

Question 52: The Agencies solicit comment on the distinction between controlled and non-controlled early amortization provisions and on the extent to which banks use controlled early amortization provisions. The Agencies also invite comment on the proposed definition of a controlled early amortization provision, including in particular the 18-month period set forth above.

Citigroup does not use a non-controlled early amortization structure. It is questionable whether an investor would accept an instrument that is structured as defined in this section.

Question 53: The Agencies seek comment on the appropriateness of the 4.5 percent excess spread trapping point and on other types and levels of early amortization triggers used in securitizations of revolving retail exposures that should be considered by the Agencies.

See response to question 52 above.

Question 54: The Agencies seek comment on and supporting empirical analysis of the appropriateness of a more simple alternative approach that would impose at all times a flat CF on the entire investors' interest of a revolving securitization with a controlled early amortization provision, and on what an appropriate level of such a CF would be (for example, 10 or 20 percent).

It is questionable whether an instrument structured like that described would be accepted by the businesses. In addition, generic 10% or 20% does not seem favorable in comparison to calculated approach.

Question 55: The Agencies seek comment on the definition of "publicly traded equity exposure".

We think the proposed rules are reasonable

Question 56: The Agencies seek comment on the approach to adjusted carrying value for the off-balance sheet component of equity exposures and on alternative approaches that may better capture the market risk of such exposures.

We think the proposed rules are reasonable

Question 57: The Agencies seek comment on the proposed rule's requirements for IMA qualification, including in particular the proposed rule's use of a 99.0 percent, quarterly returns standard.

The NPR mandates that a bank's IMA model must be sophisticated and a risk-sensitive mechanism for calculating risk-based capital requirements for equity exposures, and that the model must produce an estimate of potential losses for its modeled equity exposures that is no less than the estimate of potential losses produced by a VaR methodology.

Comparison of the IMA with a VaR method poses a problem, especially when the exposures are mainly illiquid. It is relatively simple to measure the risk and correlation of liquid exposures on

the basis of regular movements of publicly observable market prices. Illiquid exposures, however, are not measured on a "marked-to-market" basis. For Illiquid exposures then, how would one compare the results from an IMA model with those from a VaR model to meet the stipulations within the Draft NPR?

Furthermore, the Draft NPR requires that daily market prices for all modeled equity exposures, either direct holdings or proxies be available for modeling. Daily data is not readily available for illiquid investments. Thus, for illiquid exposures, would the SRWA be more appropriate then, as stated in the standards?

Question 58: The Agencies seek comment on the operational aspects of these floor calculations.

The calculation of the aggregate adjusted carrying value or the ineffective portion of hedge pairs will not be simple and will require careful definition and may require time to assemble the information to support the floor requirement.

Question 59: The Agencies seek comment on the necessity and appropriateness of the separate treatment for equity exposures to investment funds and the three approaches in the proposed rule. The Agencies also seek comment on the proposed definition of an investment fund.

We strongly object to the underlined component of the proposed definition of an investment fund:

"The proposed rule defines an investment fund as a company all or substantially all of the assets of which are financial assets and which has no material liabilities."

We have been told that the intended meaning of the last clause is to exclude all leveraged funds from the equity investment treatment and to subject them, instead, to the securitization rules. We do not understand the reason that leveraged investment funds would be excluded from the equity investment treatment. Almost all firms that a bank makes an equity investment in are leveraged – which is to say that the non-asset side of the balance sheet of the legal entity invested in consists of both debt and equity. Why should an investment in a leveraged fund be subject to a different treatment than an investment in an unleveraged fund?

Second, and even more troubling, we see no justification for treating leveraged investment funds under the securitization approach. We have been told that the justification for this is that the cash flows of a leveraged fund will be bifurcated into those that service debt and those that contribute to the increase (or decrease) of the owner's equity and that any vehicle with bifurcated cash flows should be subject to the securitization approach. This argument does not make sense. According to that "argument-for-securitization", one would have to apply the securitization rules to virtually all equity investments because virtually all firms have a mixture of debt and equity. Applying that logic even further, one would have to treat all equities in a trading portfolio under the securitization approach. We are obviously not advocating such a view but simply pointing out the fallacy of the argument.
Finally, if a bank were forced to apply the securitization approach to investments in leveraged funds, then for most third party leverage funds the bank would be forced to deduct the exposure

from capital because no other securitization rule would apply. Therefore under the securitization rules, investments in most leveraged hedged funds would default to a deduction from capital!

We strongly advocate that investments in leverage funds should be treated like any other investment in an investment fund.

Question 60: The Agencies are interested in commenters' views on other business lines or event types in which highly predictable, routine losses have been observed.

Citigroup has identified fraud losses associated with debit and ATM cards, in addition to securities processing and credit card fraud, as operational risk losses, which should qualify as highly predicable, and where routine losses should qualify for the expected operational risk loss offset.

Comments on proposals for Pillar 3 and Regulatory Reporting

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Question 61

The Agencies seek commenters' views on all of the elements proposed to be captured through the public disclosure requirements. In particular, the Agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the capital strength of individual institutions, fostering comparability from bank to bank, and reducing burden on the banks that are reporting the information.

All of the following comments reply to Question 61.

Overall Comment on NPR Pillar 1 and Pillar 3

A reasonable person would expect a model built of two parts, "facts" and "formulas", as the primary driver for implementing the proposed US version of the Basel II rules (NPR Pillar 1 and the related disclosures under Pillar 3--"the Proposal").

The facts would be bank specific. One would expect a complex -- but doable with modern technology -- data collection process. The formulas may be too complex for the average person to understand, but these have been agreed by experts and are based on statistical studies and research and therefore these formulas would be comparable across different banking organizations, both US and Non-US. With this set of expectations, the output of the actual mix of facts and formulas, the "results" in the form of risk-weighted assets or capital requirements, should be comprehensible to a reasonable person.

These reasonable expectations are not met by the reality of the Proposal.

The Proposal requires an unprecedented volume of micro-judgments, both by the regulators and by banking organizations. Because the Basel II Framework allows national discretion and because the US regulators have chosen to exercise this right and apply it to the most fundamental components of the Pillar 1 calculation and Pillar 3 disclosures, such as LGD, the lack of comparability between US banking organizations and their Non-US competitors will result in misleading information being provided to the users of public financial information. This will discredit the initiative in the eyes of these users once they find out that LGD is the most sensitive input factor to the formula, having a linear impact on the dollar amount of the capital requirement.

Furthermore, those requirements that cause micro-judgments by banking organizations are skewed by mandates from the US regulators, rather than based on internal models and procedures, and this will cause a significant implementation burden. In addition to our concern about creating a non-competitive situation with Non-US banking organizations, we are also very concerned that US banking organizations will be placed in unintended examination jeopardy. Examination jeopardy will arise once the supervisory validation process commences, and will likely cause delays in moving to a full Basel II basis. This is the true cost of the excessive reporting burden that will be caused by the NPR.

One potential outcome of the complexities of the U.S. national discretions and reporting is that some banking organizations will consider whether to provide Tier 1 capital ratios in their quarterly earnings releases, which will decrease the information currently provided to market participants.

With regard to the proposed supervisory reporting requirements ("the templates") that have been released by the Agencies supplemental to the Pillar 3 proposal:

(1) The proposed templates will force sub-optimal solutions for systems data collection and aggregation. The incremental, US-only reporting requirements will cause a significant burden and cost for both (i) data collection on a centralized basis and (ii) reporting on an aggregated,

centralized basis. The incremental requirements are not needed for the underlying calculation of risk weighted assets (hence, capital requirements) and the Agencies have not provided a sufficient rationale that would justify the increased burden. Therefore, we believe the Agencies should eliminate these incremental, US-only requirements. Some examples:

- A U.S.-only requirement for weighted average PD percentages for mandated portfolio cuts
- A U.S.-only requirement for calculation of risk-weighted assets impact of guarantees and credit derivatives (for example, Canadian regulators only require the related EAD amounts, which does not require additional processing)
- A U.S.-only requirement for loan-to-value ratios for residential mortgage exposures
- A U.S.-only requirement for (external) bureau scores on retail exposures by bands
- A U.S.-only requirement for aging of accounts for retail exposures
- Finally, the vaguely-defined proposal for a "lookback" analysis

Such information is not practical to store and calculate in typical financial systems, unlike other reporting requirements in Basel II. The aggregations of such information will not follow simple logic due to their complexity. For example, how are bureau scores to be added together from US and Non-US bureaus that are on a different basis? Further, most of the US-only information is not related to the calculation of risk-weighted assets.

(2) The schedules (especially Schedule B) emphasize PD as the primary risk indicator but they should focus instead on risk-weighted assets as the primary measure of riskiness in this context, because it includes all factors and input variables. The interrelationship of these factors has been finely calibrated as a result of the statistical research by the Basel Committee and industry over the years and is embedded solely in the risk-weighted assets amount. The schedules downplay this critical measure.

The (derived) effective risk weight percentage should be the focus, not the four inputs (PD, LGD, M, EAD) into the formula. PD is not a satisfactory risk measure because its impact is not linear in the Basel II formula. The same goes for the "capped-at-5-years" maturity factor. Although LGD and EAD are the only two inputs that have a linear impact, disclosure of those elements would not be useful to market participants because they are not common measures and we expect not generally understood and can be difficult to explain and/or develop in the Basel II framework.

In conclusion, if the Agencies decide to pursue the current proposal, we believe it is necessary for the Agencies to do the following:

- To alleviate the significant increase in reporting burden, the Agencies should allow, at a minimum, at least 60 days for the filing of Schedules C to V. The Agencies are surely mindful of the existing volume of reports in the time frame from 35 days to 60 days after quarter end.
- Introduce a phased approach for all proposed disclosures. In particular, Schedule B: in the first two years of the Transition Period, limit the quarterly reporting in the public documents such as the FR Y-9C and Call Report to the risk weighted asset amounts by

exposure type and the related on and off balance sheet financial amounts. Re-assess after two years whether to continue to require these and other additional data.

- The look-back analysis, if ultimately determined to be meaningful, should be limited to Pillar 2 procedures, such as examinations and model validations, and not required on a quarterly basis.

Finally, we believe it is essential for the Agencies to make these points explicit in their final rulemaking:

- The core set of Pillar 3 disclosures represents an onerous reporting burden. We believe that the Agencies should eliminate the US-only reporting requirements in accordance with our recommendations in order to alleviate an excessive incremental burden. In any case, the Agencies must establish the principle that disclosure items resulting from US national discretions will be re-evaluated on a timely basis to determine whether they can be phased or eliminated from routine filings in order to reduce the onerous and excessive reporting burden. This re-evaluation process should be ongoing during the Parallel and Transition Periods and should not wait until the end of such periods.
- During the Transition Period, banking organizations must be allowed flexibility as to timing of submissions for those confidential disclosures to regulators that are supplemental to the components of capital and risk weighted asset amounts to be included in (public) bank Call Reports and FR Y-9C reports.
- The Agencies must acknowledge that issues arising from items deemed by the banking organization to be proprietary and confidential may impact the timing of submissions of supplemental data, and the banking organizations will have the right to hold back such information until the matter is resolved. Such items are currently expected to have no impact on Safety and Soundness concerns, credit rating agency or SEC disclosure requirements for the sake of investors and analysts because we expect they would be solely related to highly specific details of the Basel II capital calculation process.

- At the end of the Transition Period, the Agencies must re-evaluate, in consultation with banking organizations, the reports and related instructional guidance to determine appropriate public or confidential disclosures going forward. The Agencies must determine clarifying criteria for all such disclosure items that banking organizations and/or the Agencies have found to be problematic.

Pillar 3 Proposal in General

We agree with the Agencies that the scope of the Pillar 3 disclosures that are intended for the general public apply only at the "top-tier legal entity", that is, the "top-tier BHC or DI that is a core or opt-in bank". However, we believe the Agencies' language is not sufficiently clear. The Pillar 3 disclosures should not be applied at the lead depository institutions ("DI's") of a BHC that is subject to Basel II and provides the Pillar 3 disclosures at the BHC level. Otherwise, the reporting burden and cost will not justify the benefits to market participants. For example, the Agencies must delete the words "in general" from their statement that "....in general, DI s that are a subsidiary of a BHC or another DI would not be subject to the disclosure requirements..."

but could add terminology indicating that capital ratios and risk weighted assets may nevertheless be required ("...with the exception of capital ratios and risk-weighted assets.").

We agree with the Agencies' stated intention that the materiality concept will apply to these disclosures, however, we urge the Agencies to clarify that this means consistency with how it is practiced for financial reporting. We are very concerned about the potential for supervisory examinations to hold up the validation and approval process due to immaterial errors in reported data. In particular, we are very concerned about statistical or other ancillary data that is required in the reporting schedules but which has no direct impact on the capital calculators. For example, the US reporting templates proposed in conjunction with the NPR will require: the number of obligors in each PD range for every credit risk portfolio; the weighted average bureau scores for retail exposures by each PD range; and the aging of customer relationships for credit card exposures.

A related concern causes us to recommend that the Agencies change the title and purpose of one line item in the proposed Schedule B (which will be public). Line 30 "Immaterial Exposures", we argue below, should be re-titled "Credit Exposures on Other Methods". Credit exposures resulting from recent merger and acquisition activity, from continuous development of new products, and from portfolios for which is not statistically valid or cost-effectively feasible to calculate risk weighted assets on the AIRB method would be included here.

We also support the Agencies' intention for flexibility as to location and format of the disclosures.

However, we object to the timetable for providing the ancillary disclosure information. The Agencies will receive the most critical Basel II data in the quarterly filings and the SEC filings on a quarterly basis in accordance with established timetables. Information that is not sufficiently critical for the capital calculation (such that it does not appear in these filings) is ancillary in nature and should be required no sooner than 60 days after quarter-end. A sufficient rationale has not been put forward by the regulators as to why the market participants need data that is ancillary to the capital calculation on a timelier basis.

We support the agencies' statement of intent that "disclosures that are not included in the footnotes to the audited financial statements would not be required to be subject to external audit reports for financial statements or internal control reports from management and the external auditor." However, we have concerns regarding the separate proposal for the chief financial officer to certify that the required disclosures are "appropriate" and that the board of directors and senior management are responsible for "establishing and maintaining an effective internal control structure over financial reporting" including the information required by the NPR. Highly detailed disclosures of information that is not financial in nature are not the appropriate subject of attestations intended for financial information. If the agencies persist, given that key parts of the information are comprised of (or based upon) credit risk statistics representing forward-looking estimates, the agencies must indicate that the standard of acceptance required for certification by the CFO will reflect the different nature of such credit risk statistics compared with data typical for financial reporting.

Finally, we acknowledge and appreciate the Agencies' statements allowing the concept of proprietary and confidential information that can be omitted from the public disclosures. We respectfully point out that these items are difficult to predict in advance, are very facts-and-circumstances dependent, and can change over time as to their status without indicating arbitrariness on the part of the banking organization. Furthermore, external parties (such as bank examiners or other reviewers) may not be as sensitive to the item in question as internal parties who must assess the impact on competitive positions without being able to prove with complete certainty the competitive impact if the item in question were to be disclosed. The NPR implies that a formal request must be made on a pre-notification basis. However we note that, due to the timing of receiving responses from regulators, we believe the Agencies must (i) establish formal guidelines as to who is to be contacted and (ii) establish the principle that, until the matter is settled, the banking organization is allowed to omit the information in question. That is, banking organizations may reserve the right to provide such information to the Agencies, if desired, but not include the information in public disclosures.

Pillar 3 Tables in the NPR

Comments on Tables 11 at pp. 465 to 477 in the Staff Memo version

Table 11.1 item (e)
The scope of this item is inappropriately broad and should be limited to those legal subsidiaries that are subject to banking, securities or insurance regulators' capital adequacy rules. This should not include unregulated entities that are consolidated into the top corporate entity and should not include unconsolidated affiliates and joint ventures. Such information is not directly relevant to market participants' assessment of capital strength.

Table 11.4 item (b)
Average gross credit risk exposure should be footnoted, similar to other items in this requirement, to allow methods for determining averages that are used for financial reporting. Choice of methods is not directly relevant to participants' assessment of capital strength and a different requirement will result in reporting burden.

Table 11.5 item (a)
The requirements for qualitative disclosures of internal rating systems and risk parameters should allow banks to reserve the right to avoid disclosing proprietary information. We may or may not know in advance what is proprietary and therefore cannot be explicit at this time. Choice of methods is not directly relevant to participants' assessment of capital strength and could result in reporting burden.

Table 11.5 item (c)
The NPR diverges from the international Basel II requirements ("the International Version") by:

(i) Requiring both ELGD and LGD (stressed) for credit risk exposures and
(ii) Requiring exposure weighted-average capital requirements (K) instead of the risk weight percentage.

This creates both a reporting burden and a lack of comparability to foreign bank competitors, thereby significantly misleading market participants. These items are further elaborated in the section below regarding Schedule B.

> We object to disclosures labeled "K" instead of the "exposure weighted-average risk weight" that is required in the International Version for the reason that it is misleading to market participants. The implication would be that this Basel II "K" is similar to our internal risk capital. We object to public disclosure of measures that imply any such relation. Instead, the International Version correctly chose a measurement type (risk weight percentage) which allows comparison to Basel 1 and to Standardized Basel 2, and which implies to the user of public financial information that this measure has a strong component of regulatory mandate, which is in fact the case for the US version in particular.

Table 11.5 item (e)

We continue to have strong objections to the disclosures outlined in item (e) of Table 11.5, which aims to provide --- to the general public --- a quantitative 'back-test' of the internal PD, LGD and EAD estimates against actual outcomes over time. We have expressed our conceptual objections in our prior comment letters. We note that the NPR increases the reporting burden by requiring this for the two LGD types, stressed and non-stressed. We agree with the delay in implementation until after commencement of Basel II calculations, however the proposed timing of year-end 2010 is still not sufficient. As noted in Footnote 30, a 10-year set of data may be required for an adequate back-test. Because Basel II data requirements and guidance are not finalized by the US regulators, a more appropriate time period would be disclosure commencing 10 years after the parallel test year has been completed; for example, year end 2017 at the earliest. In the meantime, confidential disclosure of this or similar data to the bank regulators is more appropriate.

Table 11.6 item (a)

The rules should explicitly allow banks to reserve the right to withhold information deemed proprietary in relation to the requirement to discuss policies with respect to "wrong-way risk" exposures.

Table 11.6 item (b)

We object to the requirement to disclose the amounts of current credit exposure by types of credit exposure for Counterparty Credit Risk for three reasons: (1) This will be a reporting burden; (2) the OTC derivatives netting process will not allow such breakout on a factual basis; and (3) Such information is generally available from the existing US GAAP and US bank regulatory financial statements and disclosures and will not provide additional meaningful information for market participants to assess capital strength.

Table 11.7 item (b)

We object to the NPR requirement, contrary to the International Version, to disclose the amount of risk-weighted assets associated with credit risk exposures that are covered by Credit Risk Mitigation in the form of guarantees and credit derivatives. Total exposures on a GAAP or EAD basis should be sufficient. We do not understand how this will provide additional meaningful

information for market participants to assess capital strength, and will cause a significant reporting burden.

Table 11.8

The Agencies must provide explicit acknowledgement that they will accept the definitions and interpretations of the components of these Securitization disclosures used by the banking organization for its financial reporting implementation of US GAAP, that is, FAS 140 disclosures for securitization activity.

Question 62

Comments on regulatory reporting issues may be submitted in response to this NPR as well as through the regulatory reporting request…

Questions posed in the Reporting Request

Responses to Questions 1, 2, 3, 4, and a, b, c, d, e.

Pillar 3 – Proposed US Reporting Templates

Overall Comments

The proposed US reporting templates would be an excessive, incremental reporting burden to the core set of Pillar 3 disclosures set forth separately above. Even though the templates could be used – in whole or in part -- to satisfy some of those requirements, the Agencies should acknowledge the increase in reporting burden, particularly to the extent that these are not aligned. The Agencies should acknowledge that this becomes a reasonable basis to object to specific requirements in the templates, as well as to the proposed timing. The reason these may not align is primarily due to the divergence of the Agencies' proposals from the International Version of Basel II Pillar 3.

We commend the Agencies for their foresight and agree with the following:

- Two summary schedules would be included in the quarterly filings, which are available to the general public, but the remaining proposed schedules would be confidential filings to the Agencies. We strongly agree with this confidential treatment for the supplemental schedules.
- The scope is limited to each bank that qualifies for and applies the advanced internal ratings based approach for credit risk (and the advanced measurement approach for operational risk) for its capital adequacy calculations. Therefore, a subsidiary depository institution (DI) that does not intend to use AIRB should be allowed to opt-out.

However, we strongly disagree with the following, which arise primarily because of US exercise of national discretion:

- The look-back portfolio analysis would constitute the single most significant reporting burden that goes beyond the International Version.

- We have serious concerns about certain disclosure items as set forth below. In particular, we object to requests that are not contained in the International Version of Pillar 3.

- The incremental, US-only reporting requirements will cause a significant burden and cost for both (i) data collection on a centralized basis and (ii) reporting on an aggregated, centralized basis. The incremental requirements are not needed for the underlying calculation of risk weighted assets (hence, capital requirements) and the Agencies have not provided a sufficient rationale that would justify the increased burden. Therefore, we believe the Agencies should eliminate these incremental, US-only requirements.

- We believe it is important to re-title the line item in each Schedule that is called "Immaterial Exposures" to "Credit Exposures on Other Methods" and change the purpose of this line item accordingly.

- Furthermore, NPR and/or the reporting templates do not have clear and adequate definitions. A separate Glossary needs to be issued by the Agencies in order to assess and implement the categories. There is great risk of unintentional misinterpretation by banking organizations due to lack of clear definitions, instructions and interpretations.

Response to Question 1

We are strongly opposed to the proposal to submit additional data that summarizes the impact of current versus previous risk parameters for exposures that existed in wholesale and retail credit portfolios as of the previous reporting period (for example, prior quarter, prior year) – the so-called "look-back" portfolio. The stated intent of this proposal is to allow the Agencies to better identify reasons for observed changes in regulatory credit risk capital requirements and to allow for peer comparisons of changes from period to period.

The 'mechanics' of this proposal are not sufficiently clear from the Agencies' description. Nevertheless, we can surmise that this proposal would be excessively difficult to produce from an operational standpoint, particularly on a routine, quarterly reporting basis. If the Agencies desire a 'migration' analysis, then we believe this should be focused on specific portfolios and should be a special request under Pillar 2, when and if needed, and should not be a fixed requirement under the US version of Pillar 3.

The lookback would entail re-running the entire capital calculation process, not just the calculation for the impacted portfolios, and would constitute the single most significant reporting burden that goes beyond the International Version. The Agencies note that maintaining historical data such as the PD and EAD as of prior reporting periods for each exposure is appropriate. We agree. However, that is not the same as re-running the entire calculation. Historical data is maintained for specific interrogations. In situations where there has been an

immaterial change in the capital requirements, we do not see the reason to perform the calculation twice. Additionally, this approach does not address one factor that could have an equal or greater impact, which is turnover. New customers with a different credit risk profile may the reason for the change.

We strongly believe that these types of comprehensive "what if " scenarios are not appropriate in routine quarterly reports.

We strongly urge the Agencies to delay and re-address this lookback proposal after completion of the full implementation of Basel II in the US in order to evaluate the need for and the utility of this particular solution.

Additionally, as an alternative we believe that a simpler volume/rate analysis could be performed under the Pillar 2 process that would entail significantly less process burden and would isolate the specific portfolios of concern for further research.

Response to Question 2

We agree with the Agencies' counterproposal to allow banks to report Schedules C to R according to their own PD (internal rating grades) segments. This is consistent with the International Version.

Response to Question 3

In general we agree that it is reasonable to make Schedules A and B available to the public once a banking organization's Basel II process has been approved for use by the regulators. However, we have concerns about certain of the data elements, outlined below. Additionally, we are concerned about the timing of these schedules being public during the full transition period and we recommend, as stated previously, that they be delayed (as public schedules) until after the second year of transition due the Agencies' delays in issuing final rules and related guidance.

We are very concerned about the high volume of interpretations needed for the underlying data and potential for adjustments in reported figures. Therefore, the Agencies and banking organizations need a sufficient period to be comfortable with this level of detail. We note that the during the first two years of transition the Agencies will retain capital floors of 95% and 90%, respectively, therefore we do not expect that the nuts and bolts details of Basel II to be material to the public at that phase. Furthermore, the Agencies must develop guidelines for dealing with adjustments that are flexible and fair and published in advance to the banking organizations due to the newness and complexity of the data for all parties.

Response to Question 4

Banking organizations should be allowed to apply standardized methods, whether Basel II or Basel 1, to portfolios for which it is not cost-effective – or not statistically feasible -- to estimate

the appropriate credit risk parameters. Such portfolios should be included in Line item 30 on Schedule B (and similar lines on subsequent schedules) and the Line's title should be changed from "Immaterial Exposures" to "Credit Exposures on Other Methods". Using the term immaterial is subject to judgmental interpretations and disagreements. The need for this category is based on real-world fact patterns (i.e., lack of a statistical basis for an internal rating on the portfolio) and not solely on immateriality considerations.

Refer to details below for other items.

Comments on Schedule B

We expect that the supervisors want to use Schedule B to recalculate the risk-weighted asset and expected credit loss amounts because all necessary inputs are provided—PD, LGD, EAD, M—as one of their validation and monitoring procedures. However, we are concerned that this may not be accurate or feasible in all situations. Further, this will be a public schedule and general users may misunderstand that point, even if the regulators acknowledge this in a footnote to Schedule B.

Due to the high complexity of Basel II and judgments required, the explanations as to why the actual risk weighted assets reported do not agree with the simple recalculation from Schedule B could be extremely complex and burdensome. For this reason, we strongly recommend that regulators delay the planned public release of Schedule B until after the second year of transition to give both the banking organizations and the Agencies more time to assess the implications. Alternatively, during the transition period, columns B, C and G (financial balances and related risk weighted assets) could be provided in the public filings, similar to current Schedule R.

The table below summarizes the complexity and our concerns about data elements that are not required by the International Version and, per our understanding, not by other regulators. Of the 152 data elements requested on Schedule B, 65 (or 43%) are US-only or are US-variations that are distinct from the International Version and requirements of other regulators.

Analysis of Schedule B

# Risk Elements	**# Finance Elements**	**# Pure Basel II elements**	**Total Data Elements (Including Non credit risk)**
50	**34**	**63**	**152**
Of which: # US-only elements			Name of US-only elements
19			EAD Weighted Average

			Obligor PD %
	13		Total Undrawn Amount
		12	Weighted Average M in years
19			Weighted Average LGD% (on stressed basis)
		19	Expected Credit Loss
Consistency between US and Basel generally			
12 items (24%)	21 items (62%)	32 items (51%)	

Separate from its utility for banking supervisors to assess the reasonableness of the calculation of risk weighted assets and expected credit losses, it is likely that the individual components such as PD and LGD will be used by the supervisors (and market participants) for peer comparisons against US banking organizations and Non-US banking organizations.

We are very concerned about releasing Schedule B for public information if it contains the US version of LGD (stressed LGDs) that is not consistent with how other foreign regulators have interpreted Basel II. Therefore, this disclosure cannot be compared to Non-US bank competitors, yet many market participants may do this in error.

Further, providing a single data point for Weighted Average PD% by exposure type (corporate, bank, sovereign, etc.) will be misleading for several reasons:

- These weighted-average disclosures cannot be aggregated across the banking industry.
- Comparisons between individual banks will be misleading because of the simple fact that banking organizations with bi-polar distributions (material clusters at both the high end and the low end of the PD range) could appear the same as those with a portfolio clustered firmly in the middle of the range.
- Comparisons between individual banks may also be compromised by lack of clarity from the Agencies about which category certain Wholesale exposure types belong to (Corporate, Bank or Sovereign) and different banking organizations may report them in different categories. For example: Non-US states and provincial governments: Non-US governmental Agencies; other public sector entities; bank holding companies; security firm holding companies; multilateral development banks ("MDBs") that do not receive Sovereign treatment under Pillar 1. In this regard, we remind the US Agencies that the NPR does not include the entire set of MDBs allowed by Basel II to receive favorable Pillar 1 treatment.
- Therefore, this single-point measurement is artificial and not meaningful to anyone else other than the supervisors for their initial – but not ultimate -- monitoring procedures.
- Furthermore, because Basel II PDs do not coincide with external credit rating agencies measures, this will add to the confusion as market participants attempt to translate into S&P ratings.

Schedule B emphasizes PD, as the primary risk indicator but the focus should be instead on risk-weighted assets as the primary measure of riskiness in this context, because it includes all factors and input variables. The interrelationship of these factors has been finely calibrated as a result of the statistical research by the Basel Committee and industry over the years and is embedded solely in the risk-weighted assets amount. The schedules downplay this critical measure.

The (derived) effective risk weight percentage should be the focus, not the four inputs (PD, LGD, M, EAD) into the formula. PD is not a satisfactory risk measure because its impact is not linear in the Basel II formula. The same goes for the "capped-at-5-years" maturity factor. Although LGD and EAD are the only two inputs that have a linear impact, disclosure of those elements would not be useful to market participants because they are not common measures and we expect not generally understood and can be difficult to explain and/or develop in the Basel II framework.

We are very concerned that the proposed Weighted Average PD and Maturity percentages could not be accurately derived by aggregation and reporting systems on an after-the-fact basis because of the complexity of variables in this weighted (not simple) average calculation, [because these factors have a non-linear impact,] and other reasons. This would result in sub-optimal solutions for the collection and reporting of these items.

Similar complications exist when aggregating the Weighted Ave LGD% in the proposed schedules. The impact of LGD is linear, but there will be many LGDs associated with each PD anchor (which has a non-linear impact.

Separately, the Agencies must clarify in their instructions that the Expected Credit Loss amount is post-credit risk mitigation.

Finally, as mentioned previously, we believe it is important to re-title line item 30 on Schedule B called "Immaterial Exposures" to "Credit Exposures on Other Methods" and change the purpose of this line item accordingly. There will be exposure types for which it may be determined during the implementation process that a standardized Basel 1 or a standardized Basel II approach is justified. Inter-company credit exposures are one example that should be considered for this approach. Credit exposures resulting from recent merger and acquisition activity, from continuous development of new products, and from portfolios for which is not statistically valid or cost-effectively feasible to calculate risk weighted assets on the AIRB method would be included here. The aggregate amounts of such credit exposures may frequently exceed commonly understood benchmarks of "immateriality".

The Agencies' instructions are not clear regarding where to report exposures arising from securities transaction fails-to-deliver. We believe that "fails" should be reported in line item 30, which is another compelling reason to re-title that disclosure.

Considering all of these reasons, if the Agencies insist on proceeding with Schedule B, the Agencies should introduce a phased approach: in the first two years of transition, only include the risk weighted asset amounts by exposure type and the related on and off balance sheet

finance amounts in the (public) FR Y-9C and Call Report Schedule B. Then, the Agencies, in consultation with banking organizations, can re-assess after two years whether to continue to require the additional data.

Comments on Schedules C to K: Wholesale

These confidential schedules provide further details of data elements carried forward to Schedule B for the Wholesale exposure types.

The incremental, US-only reporting requirements will cause a significant burden and cost for both (i) data collection on a centralized basis and (ii) reporting on an aggregated, centralized basis. The incremental requirements are not needed for the underlying calculation of risk weighted assets (hence, capital requirements) and the Agencies have not provided a sufficient rationale that would justify the increased burden. Therefore, we believe the Agencies should eliminate these incremental, US-only requirements.

The following data requests are US-only, neither in the International Version nor in-Non-US regulatory requirements per our understanding, in addition to the stressed LGD.

- Exposure Category: Construction IPRE. This is not mentioned in Basel II, the NPR or instructions.
- Weighted Average LGD% before consideration of guarantees and credit derivatives. Note that this is irrelevant if the PD substitution method is used instead of the LGD adjustment method.
- Effect of PD substitution and LGD adjustment approaches on RWA
- Effect of Double Default Treatment on RWA
- Subcategory weighted average Expected LGD

The last three data elements require that the calculation must be run multiple iterations to obtain this information. Additionally, there could be a process burden in data maintenance and transmission caused by confusion over duplicative types.

We note that, under Basel II and the NPR, the LGD adjustment for guarantees is subject to a floor based on the PD substitution approach. Therefore, there is little incentive for banking organizations to use the LGD adjustment, in which case why the need for a separate reporting disclosure on a quarterly basis for all banking organizations?

A U.S.-only requirement for calculation of the risk-weighted assets impact of guarantees and credit derivatives (column H1 for Schedules C to H.) would be extremely burdensome because it would require a re-engineering of credit risk practices. Banking organizations would be forced to establish credit risk ratings on entities for whom this may not be feasible, because the impact requires a PD before the guarantee. This will not be available in most cases where the decision to extend credit is based solely on the strength of the guarantor and not the underlying obligor, for example a US parent company's guarantee of a Non-US subsidiary. We note that the Canadian regulators have dealt with this problem by requiring only the related EAD amounts, which does not require additional processing. If the US agencies insist that this type of

information is significant, then we believe the only practical approach is to ask for related EAD amounts and not require "with and without" risk-weighted asset calculations. EAD provides a relevant indication of volume that can be used by the agencies to identify and monitor individual banks with significant exposures. Additionally, EAD would avoid the conceptual confusion caused by reporting the RWA impact of a Sovereign guarantee in the Sovereign section: it is not Sovereign exposure that has been reduced, but more likely Corporate. Why burden all Basel 2 reporters – who may or may not have material percentages of their portfolios being guaranteed – with this requirement, particularly if its placement in the schedules is misleading?

Separately, the requirement for disclosure of "number of obligors" must be clarified. For instance, where a single guarantor provides credit protection for 3 different obligors, should that be reported as one obligor (i.e., based on the guarantor) or 3 obligors (based on the underlying obligors)? Additionally, are subsidiaries of parent companies treated as separate obligors? What if the parent provides a contractual guarantee? How are multiple facilities to a single obligor to be handled?

Comments on Schedules L to N: Retail Mortgages

These confidential schedules provide further details of data elements carried forward to Schedule B for the Retail exposure types.

The following data requests are US-only, neither in the International Version nor in-Non-US regulatory requirements per our understanding, in addition to the stressed LGD.

The incremental, US-only reporting requirements will cause a significant burden and cost for both (i) data collection on a centralized basis and (ii) reporting on an aggregated, centralized basis. The incremental requirements are not needed for the underlying calculation of risk weighted assets (hence, capital requirements) and the Agencies have not provided a sufficient rationale that would justify the increased burden. Therefore, we believe the Agencies should eliminate these incremental, US-only requirements.

The following data requests require explicit retail segmentation model of delinquency, scores, month on book (MOB) and Loan-to-value ratios (LTV). Both the International Version and the US regulatory requirements do not mandate these segmentations but provide banks flexibility to use a segmentation approach that is consistent with its approach for internal risk assessment purposes and that classifies exposures according to predominant risk characteristics or drivers. Drivers listed in the NPR, as mere examples have become part of the reporting template. The reports should allow for flexible reporting according to the segmentation used.

In addition, the templates separate "closed-end first lien" from "closed-end junior lien" which inappropriately expects segmentation of these products.

- Weighted Average LGD% before consideration of guarantees and credit derivatives. Note that this is irrelevant if the PD substitution method is used.
- Loan to Value Ratios portfolio cuts

  - The reporting requested here does not align with the LTV bands suggested in Basel IA. This would prevent a comparison between advanced and Basel IA.
  - This requires LTV to be used as a driver of segmentation, which will not necessarily be the case.
  - Additional guidance is required for exposures with "unknown" LTV bands. It might be impractical for banks to collect LTV segmentation for small (liquidating or immaterial) portfolios. We would recommend that an unknown category is introduced to ensure that the EAD sum for all LTV bands (fields J-K) aligns with the total EAD field (field E)
- Weighted average age:
  - It is assumed that MOB is a requested field. This can cause problems, as there is a difference between the month Citigroup has a mortgage on its books and the actual age of the underlying loan as not all mortgage exposures are originated within Citigroup.
  - In some cases where an additional loan is made the MOB is set at the date of the new lending and it others the date when the original loan was made. Practice varies according to specific circumstances and so the definition should be sufficiently flexible to allow for this type of divergence.
- Weighted Average Bureau Scores (i.e., external, US and Non-US)
  - We do not believe that score will always be a driver for all portfolios and it is inappropriate to assume that it will always be used.
  - This field could only contain US based bureau scores, as international scores would not align.
  - Several businesses use a blend of scores, including various combinations internal and external scores. We suggest that reporting a weighted average would not be meaningful and that where internal scores are used in part or in whole that the data would not be compatible to other banks and should not need to be reported.
- EAD of Accounts with updated LTVs
  - This requires a bank not only to collect in their segmentation model the originating LTV but also to track updated LTVs. Many businesses are currently not tracking this information for risk management purposes nor is it business practice to require such data.
  - It is recommended that this is not a field that it is required to complete.
- Subcategory weighted average Expected LGD
- Credit Scores – Names/types of credit scoring systems that were used

We wish to remind the Agencies that the LTV ratio categories proposed in the NPR are not consistent with the LTV ratio categories proposed in Basel 1A , which signifies the difficulties inherent in trying to require this level of detail in quarterly reporting.

As mentioned previously, we believe it is nonsensical to aggregate credit bureau scores from multiple sources, particularly for those banking organizations that have significant international retail exposures.

Comments on Schedules O to R: Cards, Other Retail

The same comments on reporting of EAD, Scores, average expected LGD and score models apply to this section as we commented above in section L to N: Retail Mortgages.

The following data requests are US-only, neither in the International Version nor in-Non-US regulatory requirements per our understanding, in addition to the stressed LGD.

The incremental, US-only reporting requirements will cause a significant burden and cost for both (i) data collection on a centralized basis and (ii) reporting on an aggregated, centralized basis. The incremental requirements are not needed for the underlying calculation of risk weighted assets (hence, capital requirements) and the Agencies have not provided a sufficient rationale that would justify the increased burden. Therefore, we believe the Agencies should eliminate these incremental, US-only requirements

- Weighted Average LGD% before consideration of guarantees and credit derivatives. Note that this is irrelevant if the PD substitution method is used.
- EAD of Accounts less than two years old
- Weighted Average Bureau Scores (i.e., external, US and Non-US)
- Subcategory weighted average Expected LGD
- Credit Scores – Names/types of credit scoring systems that were used
- New exposure type not previously mentioned: Other Retail Exposures – Small Business

Again we question why, at this late date, the US Agencies are adding two new exposure types, Other Retail Exposures – Small Business and Construction IPRE mentioned in Wholesale.

Comments on Schedule U: Equity Exposures

Line items 6 through 10 need precise instructions and/or a redesign of the schedule. The flow of these sections is awkward and confusing. Clear and full descriptions of these items must be provided in order for banks to assess the true reporting burden and impact. For example, banking organizations need precise instructions how to handle equity investments in investment funds that do have "material" liabilities. The Agencies must provide specific examples of types of entities expected to be in this category, why such equity investments should be excluded from the equity exposure calculation under Basel 2, what is the alternative treatment and whether this is consistent with the International Version, and why the agencies concluded that such alternative treatment is appropriate

Comments on Schedule V: Operational Risk

General Comments:
In order to respond fully on Schedule V, we would need more information about the specific subsidiaries to which these disclosure requirements would apply. Our comments below apply for disclosure at the level of Citigroup.

Column B requires clarification. Does the total for the current reporting period refer to the reporting period for the schedule that is quarterly or for the model that is annual?

Specific Line Item Comments to Schedule V:

Items 1- 2 These items are appropriate for public disclosure.

Items 3 -7 These items are valid requests for our supervisors but should not be made public. The Public disclosure required by Schedule V far exceeds the public disclosure required by the Basel Framework. This additional public disclosure could put US banks at a disadvantage to international banks that will follow the less onerous disclosure requirements of the Basel Framework.

In addition, the level of disclosure of supporting material to the public in support of understanding these lines would go well beyond what is appropriate. And without this material, the users of the public information would not be able to make valid comparisons of these line items across institutions. In addition, these disclosures would potentially involve data that is sensitive form a competitive perspective, e.g., EOL.

Item 8 Which starting and ending dates are required if these dates differ for frequency and severity estimation.

Item 9 The requirements for this item are not clear. Citigroup uses different thresholds for different purposes including data collection, reporting, and multiple elements of the modeling framework. These thresholds can then vary by other criteria, e.g., major sector.

Items 11-15 We would require clarity that this question relates to losses captured as individual events, above certain thresholds. We also capture the dollar amount of some smaller losses, below our thresholds, in the aggregate, and with out capturing the number of individual events.

Item 16-18 Given Citigroup's framework, we want to confirm that these requirements refer to the number of relevant industry events.

Items 20 - 21 Does the change refer to a change in parameter of a distribution or a change in distribution class? Note that we don't use a frequency distribution since we have shown that they have no impact on the capital estimate.

Item 23 -24 Citigroup does not use loss caps, therefore can we complete these items with not applicable even though the schedule asks for a numerical value?

OTHER TOPICS:

Basel 1A – Pillar 3 for subsidiaries

From a Pillar 3 perspective, we expect that Basel 2 disclosure requirements will not be applied to standalone regulatory filings by US banking subsidiaries other than requirements for components of capital and breakouts of risk-weighted assets by broad exposure types as relevant for each of Basel 1, Basel 1A or Basel II. We urge the Agencies to include such confirmation in their final Basel II rules.

Securitization - Trading Book Swaps:

We request changes to the proposed rules to simplify the treatment of securitization exposures in the form of interest rate or currency swaps (non-credit OTC derivatives). Section 42(e) implies that the securitization framework applies to some aspects of non-credit OTC derivatives when the derivative contract is provided in conjunction with a securitization. Most swap contracts are senior in the repayment waterfall to the tranche exposures within a securitization structure.

We are concerned that the administrative cost and difficulty in applying the securitization framework to this position will out-weight any regulatory benefit from doing so. Securitization framework should apply only to bank book exposures, not trading book exposures (unless reclassified under the proposed rules). The calculation of counterparty credit risk for OTC derivatives should be completely independent of the securitization framework, even when the protection is provided to a securitization vehicle.

Specific comments on Operational Risk

Back testing:
Citigroup believes that given the nature of operational risk, back testing is an impractically high standard. Any attempt to carry out a statistically robust form of back testing is likely to impose an extraordinarily high obstacle to achieving the AMA. Validation in operational risk must rely on the robustness of the logical structure of the model and the appropriateness of the resultant operational risk exposure when benchmarked relative to other established reference points.

Business Environment and Internal Control Factors
The NPR states: The bank must incorporate business environment and internal control factors into its operational risk data and assessment systems. The bank must also periodically compare the results of its prior business environment and internal control factor assessments against its actual operational losses incurred in the intervening period.

Citigroup is generally supportive of the direction of the requirement for larger events, but encourages the regulators to recognize that there is no single "correct" result for this exercise and that an empirically robust correlation between the assessment of business environment and internal control factor and subsequent losses is typically not demonstrable. Sound management decisions about the cost and benefit of controls for certain losses, e.g., for certain expected losses, may influence the outcome of this analysis.

Definition of EAD:

There is a different definition of EAD in the NPR compared to the Framework.

US NPR (page 55916 Federal Register Vol 71, No 185):

"(2) For the off-balance sheet component of a wholesale or retail exposure (other than an OTC derivative contract, repo-style transaction, or eligible margin loan) in the form of a loan commitment or line of credit, EAD means the [bank]'s best estimate of net additions to the outstanding amount owed the [bank], including estimated future additional draws of principal and accrued but unpaid interest and fees, that are likely to occur over the remaining life of the exposure assuming the exposure was to go into default. This estimate of net additions must reflect what would be expected during economic downturn conditions."

Basel framework

Wholesale exposures
"310. For off-balance sheet items, exposure is calculated as the committed but undrawn amount multiplied by a CCF. There are two approaches for the estimation of CCFs: a foundation approach and an advanced approach.

EAD under the advanced approach

316. Banks that meet the minimum requirements for use of own estimates of EAD .... will be allowed to use their own internal estimates of CCFs across different product types provided the exposure is not subject to a CCF of 100% in the foundation approach..."

Retail exposures
"336. For retail exposures with uncertain future drawdown such as credit cards, banks must take into account their history and/or expectation of additional drawings prior to default in their overall calibration of loss estimates. In particular, where a bank does not reflect conversion factors for undrawn lines in its EAD estimates, it must reflect in its LGD estimates the likelihood of additional drawings prior to default. Conversely, if the bank does not incorporate the possibility of additional drawings in its LGD estimates, it must do so in its EAD estimates."

The NPR is both more prescriptive than the Basel framework (which allows future drawings to be reflected in EAD or LGD) and requires future interest and fees which have not yet been recognized in capital resources to be treated as exposures for which current capital cover is required. Where firms have developed their EAD/LGD approach using the Basel framework option of reflecting further drawings in LGD, the NPR proposal would require them to change their systems and restate statistics for no prudential benefit. The impact of the NPR's inclusion of unbooked income in EAD would most be felt in portfolios such as cards, where

there tends to be a higher rate of interest/fees. We would request that the NPR definition is aligned with that in the Framework to eliminate this duplication of calculation and remove the additional capital it is likely to require.

Calculation of 'K' for defaulted exposures

The NPR states:

"To compute the risk-weighted asset amount for a wholesale exposure to a defaulted obligor, a bank would first have to compare two amounts: (i) the sum of 0.08 multiplied by the EAD of the wholesale exposure plus the amount of any charge-offs or write-downs on the exposure; and (ii) K for the wholesale exposure (as determined in Table C immediately before the obligor became defaulted), multiplied by the EAD of the exposure immediately before the exposure became defaulted."

The second requirement above states that we need to determine capital charge K using data 'before the Obligor became defaulted'. What this means is that we will have to keep track of historical information for Obligors, facilities and exposures and develop additional processing logic to access this information during the RWA calculation runs. This requirement could lead to significant processing overhead if the data has to be looked back more than a few months and is unlikely to be worth the additional amount of effort in comparison to the impact on overall RWA given this is merely an adjustment for defaulted exposures and we would recommend omitting this additional step.

Credit Risk Mitigation Using CDS and CCDS Contracts

In this section, we comment and make suggestions for improving the sections of the NPR concerning credit risk mitigation through the use of Credit Derivatives and Guarantees. Part 1) of this section is focused on the traditional credit default swap (CDS). Part 2) is focused on a new type of CDS contract, the contingent credit default swap (CCDS), which is used to hedge the market-sensitive, time-varying exposure of counterparty credit risk.

1. Traditional CDS

These comments are (i) to clarify the definitions of "eligible credit derivative" and "eligible guarantee" in order to create a better fit between these definitions and how the traditional credit default swap actually works/or is currently documented in the marketplace, (ii) to further harmonize these definitions with the requirements noted in the November 2005 paper titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" published by BCBS (the "BCBS Paper"), and (iii) to clarify the ranking requirement in the rules of recognition regarding the credit risk mitigation benefits of eligible guarantees and eligible credit derivatives.

- Eligible Credit Derivative:

These suggested changes to the definition of "eligible credit derivative" are to align the definition with how the traditional credit default swap actually works/or is currently documented in the marketplace.

- Since the nth-to-default credit derivative and the contingent credit default swap are generally recognized in the marketplace as forms of credit default swap, we suggest that the preamble be revised to read as follows: "Eligible credit derivative means a credit derivative in the form of a credit default swap (which includes, for example, an nth-to-default credit derivative or a contingent credit default swap) or total return swap provided that:"

- Since the concept of a beneficiary exists in the context of a guarantee but not the credit derivative, we suggest that clause (1) be revised to read as follows: "(1) The contract meets the requirements of an eligible guarantee (where, for purposes hereof, references to the beneficiary in the definition of eligible guarantee shall be deemed to be references to the protection purchaser) and has been confirmed by the protection purchaser and the protection provider;"

- With respect to the Credit Event of Failure to Pay, most, if not all, plain vanilla credit default swaps have a payment threshold of USD one million or Euro one million, as the case may be. Consequently, we suggest that clause (3)(i) be revised to read as follows: "(i) Failure to pay any amount due under the terms of the reference exposure subject to any relevant payment threshold (with a grace period that is closely in line with the grace period of the reference exposure); and".

- Upon the occurrence of a Credit Event, the protection purchaser may transfer to the protection seller an exposure that may not be the reference obligation nor the underlying obligation, to the extent they are different obligations. Since it appears that the intent behind clause (e) of paragraph 191 of the BCBS Paper is to ensure that the protection buyer will be able to deliver an exposure that does not allow for any required consent to transfer to be unreasonably withheld, we suggest that clause (6) be revised as read as follows to achieve that intent: "(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of the exposure to be transferred may not include any provision that permits any required consent to transfer to be unreasonably withheld;"

- Eligible Guarantee:

These suggested changes to the definition of "eligible guarantee" are intended to align this definition with the requirements listed in paragraphs 189, 307 and 484 of the BCBS Paper.

- With reference to paragraph 189 of the BCBS Paper, we suggest that clause (1) be revised to read as follows: "(1) Is written and unconditional, i.e., there should be no clause in the contract outside the direct control of the beneficiary that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the obligor fails to make the payment(s) due;"

- With reference to paragraph 189 of the BCBS Paper and in effort to clarify and clearly defined the cover as contractual payments in respect of outstanding principal balance or due and payable amount (and not *all possible* contractual payments) the obligor may have on the reference exposure, we suggest that clause (2) be revised to read as follows: "(2) Covers all or a pro rata portion of all contractual payments of the obligor in respect of outstanding principal balance or due and payable amount on the reference exposure;"

- With reference to paragraph 189 of the BCBS Paper, we suggest that clause (4) be revised by inserting the word "unilaterally" after the words "Is non-cancelable" but before the words "the protection provider".

- With reference to paragraphs 307 and 484 of the BCBS Paper, we suggest that clause (5) be revised by deleting the word "sufficient" therein.

- Rules of recognition:

  We suggest that clause (2)(i) in Section 33(b) [Rules of recognition] (page 403) be revised by inserting the words ", in terms of priority of payment," after the word "ranks" but before the words "pari passu (that is, equally)" to clarify the point that the ranking requirement is only with respect to priority of payment.

2. CCDS

In its July 2005 paper titled "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects", the BCBS noted that exposure to credit risk through a loan is different in several respects from exposure to counterparty credit risk ("CCR") associated with OTC derivative contracts. For example, unlike a loan where such exposure is unilateral in nature (i.e., only the bank as lender has the credit risk), "CCR creates a bilateral risk of loss [since depending on market conditions at the time of valuation,] the market value of the transaction can be positive or negative to either counterparty to the transaction." In addition, in the case of a loan (e.g., a term loan), the amount at exposure is fixed at inception. In contrast, the amount of exposure in the case of most OTC derivative contracts "is uncertain and can vary over time with the movement of underlying market factors."

These characteristics have prompted banks to measure, manage, and mitigate their exposure to CCR associated with OTC derivative contracts differently from their exposure to credit risk through loans. For example, Citigroup uses the contingent credit default swap (CCDS) to

manage and mitigate this type of CCR. The CCDS enables a bank to hedge the market-rate dependent, time-varying nature of counterparty credit risk.

The CCDS is a type of credit default swap (CDS) that has one important feature not found in a traditional CDS: A CCDS is similar to a CDS in that upon default of the referenced obligor, the seller of the CCDS will pay the buyer the contract notional. Unlike the traditional CDS where the notional amount is fixed at inception, the notional amount of the CCDS is not fixed but changes with the movement of the underlying market factors affecting the reference derivative. The notional amount of the CCDS is the mid-market value of a referenced derivative transaction if/when the referenced obligor experiences a credit event.

From a more general perspective, just as a CDS enables the buyer to hedge against an increase in the credit risk premium of a bond or loan, a CCDS enables the buyer to hedge against an increase in the credit risk premium of an OTC derivative contract. The credit risk premium of an OTC derivative contract is its Credit Value Adjustment (CVA). The CVA is an adjustment made to the market value of an OTC derivative contract to take into account the credit risk of the counterparty.

The derivative referenced by the CCDS contract will typically be a plain vanilla, simple OTC derivative contract. The underlying OTC derivative contract that the CCDS is hedging may be a plain vanilla, simple derivative or a derivative with more complex terms and conditions. In the former case, the change in the market value of the CCDS may fully offset the change in the CVA of the underlying OTC derivative contract. In the latter case, there may be some residual change in the CVA of the underlying OTC derivative contract that is not fully hedged by the CCDS.

The residual, unhedged exposure may arise because a) of differences between the terms and conditions of the referenced OTC derivative (usually a plain vanilla contract) and the terms and conditions of the underlying OTC derivative (which may be more complex) and/or b) the floating market rates of the referenced OTC derivative (e.g. 3 month USD LIBOR) may be highly correlated with but not identical to the floating market rate of the underlying OTC derivative being hedged (e.g. 3 month CP rate).

In this context, the OTC derivative exposure profile will need to be decomposed, as appropriate, into a component that is hedged by the CCDS and a residual component that is not hedged, in analogy to what is done for loans that are only partially hedged with a CDS.

We propose that the overall treatment of CCDS contracts used to hedge counterparty credit risk should be similar to the treatment of CDS contracts used to hedge the credit risk of loans: subject to the appropriate conditions, banks should have the option of using either the "substitution approach" or the "double-default" risk weight formula in measuring Risk Weighted Assets for counterparty credit risk.

Although the overall treatment of CCDS contracts should be similar to that of CDS contracts, some of the definitions and conditions for using these contracts should differ since as noted above, exposure to credit risk through a loan is different in several respects from exposure to counterparty credit risk associated with OTC derivative contracts.

For example:

- Effective Notional Amount and Effective EPE
  For a CDS contract hedging a loan, the NPR defines the "effective notional amount". Unlike a loan, the EAD for counterparty credit risk is calculated, in the Internal Model Method, by the simulation of the Effective EPE of a single transaction or of multiple transactions that qualify to be treated as a netting set.

  Under the "substitution approach", the Effective EPE to a counterparty would need to be decomposed into a hedged Effective EPE and an unhedged Effective EPE. The former would be multiplied by the risk weight using the PD of the qualified seller of the CCDS; the latter would be multiplied by the risk weight using the PD of the underlying obligor. Under the "double default" approach, the hedged Effective EPE would be multiplied by the risk weight determined by the double default formula while the unhedged Effective EPE would be multiplied by the risk weight using the PD of the underlying obligor.

  Accordingly, the concept of "effective notional amount" is not relevant to the measurement of EAD for CCR. The critical computation in the use of a CCDS is the decomposition of the EPE profile (over the life of the netting set) into a hedged EPE profile and an unhedged EPE profile. Once each of these has been simulated, the corresponding Effective EPE profiles could then be immediately derived. The decomposition will depend on how effectively the exposure of the underlying OTC derivative transaction (or netting set) is replicated by the exposure of the referenced OTC derivative. As explained above, when the underlying derivative and the referenced derivative have identical terms and conditions, there will be no unhedged residual exposure. In other cases, there may be an unhedged residual exposure, which would give rise to the unhedged EPE profile over time.

- Eligible Credit Derivative Provider
  A bank may recognize the credit risk mitigation benefits of an eligible credit derivative used to mitigate counterparty credit risk only if it purchased the eligible credit derivative from an eligible credit derivative provider.[4] The agencies have noted that "derivatives aren't like other products [and t]rading in these complex instruments...requires highly skilled personnel and advanced technology to support the requisite risk management infrastructure...[with] the critical importance of credit quality to assure performance on contracts..."[5] Accordingly, if the hedged exposure is an OTC derivative contract, or

[4] We suggest that an eligible credit derivative provider be defined as follows: "Eligible credit derivative provider, with respect to an eligible credit derivative obtained by a [bank], means: (i) an entity that is primarily in the business of providing credit protection, actively manages the credit risks from its portfolio, has agreed to be reviewed by one of the agencies, and has been assigned a PD to its rating grade by the bank, such PD to be equal to or lower than the PD associated with a counterparty credit rating in the lowest investment grade rating category, or (ii) an eligible double default guarantor; provided that, in either case, the eligible credit derivative provider is not an affiliate of the [bank] recognizing the credit risk mitigation benefits of the eligible credit derivative."

[5] Dugan, John C. "Derivatives: A Broader Industry Issue." New York Bankers Association. Phoenix, Arizona. 10 Nov. 2006.

multiple OTC derivative contracts subject to a qualifying master netting agreement, and a bank wishes to recognize the credit mitigation benefits of an eligible credit derivative used to hedge this type of exposure, then the eligible credit derivative should be one issued by an eligible credit derivative provider. Consequently, we suggest that the following sentence be added as clause (2)(iii) in Section 33(b) [Rules of recognition] (page 403): "(iii) To the extent the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement, the eligible credit derivative is issued by an eligible credit derivative provider."

- No Cross-default / Cross-acceleration Requirement
  The cross-default/cross-acceleration requirement should not apply if the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement. Although some parts of the debt market (e.g., leveraged loans) have incorporated obligations from OTC derivative contracts in the cross-default/cross-acceleration clauses in the loan/bond documents, that practice is not prevalent in other parts of the market and there are a large number of loan/bond documents that do not include obligations from OTC derivative contracts in their cross-default/cross-acceleration clauses. In addition, unlike failure to pay on borrowed money such as a loan or a bond, failure to pay on an OTC derivative contract would not trigger a credit event with respect to the reference credit – another detail that indicates this requirement may not suitable in the context of counterparty credit risk. Consequently, we suggest that clause (2)(ii) in Section 33(b) [Rules of recognition] (page 403) be revised to read as follows: "(ii) (A) The reference exposure and the hedged exposure share the same obligor (that is, the same legal entity), and (B) except where the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement, legally enforceable cross-default or cross-acceleration clauses are in place; and".

- No Restructuring Requirement
  A bank seeking to recognize an eligible credit derivative that does not include a restructuring as a credit event should not have to reduce its recognition of this instrument by 40 percent if the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement. The current rule basically encapsulates the idea that to the extent the hedged exposure (e.g., a term loan) is different from the reference exposure (e.g., a bond issued by the same issuer), the term loan is still considered fully hedged if, among other things, legally enforceable cross-default/cross-acceleration clauses are in place in the documents governing both the term loan and the bond. However, for reasons noted in the prior paragraph, cross-default/cross-acceleration requirement is not appropriate if the hedged exposure is an OTC derivative contract, or multiple OTC derivative contracts subject to a qualifying master netting agreement. In addition, unlike a restructuring of the term loan, a restructuring of an OTC derivative contract would not trigger, all other things being equal, a credit event with respect to the reference credit – a detail that already renders restructuring as a credit event in an eligible credit derivative ineffective in terms of capturing a restructuring of an OTC derivative contract. Consequently, we suggest that the phrase "Except where the hedged exposure is an OTC derivative contract, or multiple

OTC derivative contracts subject to a qualifying master netting agreement," be inserted at the beginning of the preamble of Section 33(e) [Credit derivative without restructuring as a credit event] (page 408).

Wholesale and Retail Lease Residuals

The agencies are proposing a treatment for wholesale lease residuals that differs from the New Accord. A wholesale lease residual typically exposes a bank to the risk of a decline in value of the leased asset and to the credit risk of the lessee. Although the
New Accord provides for a flat 100 percent risk weight for wholesale lease residuals, the agencies believe this is excessively punitive for leases to highly creditworthy lessees. Accordingly, the proposed rule would require a bank to treat its net investment in a wholesale lease as a single exposure to the lessee. There would not be a separate capital calculation for the wholesale lease residual. In contrast, a retail lease residual, consistent with the New Accord, would be assigned a risk-weighted asset amount equal to its residual value (as described in more detail above).

Comment Lease Residuals (Retail and Wholesale)

Citigroup supports the treatment of all Commercial lease residual investments in lease contracts as part of one single exposure to the lessee (for both Retail and Wholesale).

On August 11, 2005, Citigroup sent a proposal on treatment of Commercial lease residuals to regulators (see attached), which was equally applicable to Commercial Retail and Wholesale exposures. Consequently, Citigroup advocates a single weighting of PD, LGD and EAD for all leases, as for all loans, regardless of how the lease exposure is managed or the level of residual value. EAD should include, apart from the updated value of the flow of contractual rentals, the amount of the residual value, because LGD already integrates the losses on residual value. Citigroup believes that this approach, as outlined in NPR Wholesale leasing transactions is appropriate for all Commercial Wholesale and Retail leases.

In summary, the benefits of including lease residual value as part of the total lease exposure, as cited in the proposal, are:

- The end-of-lease realization and the Obligor Risk correlate to the pricing of the total lease transaction, which is both "ability to pay" and "recovery amount" dependent.
- Historical Credit/Residual experience is already built into the PD/LGD framework and should be applied to the whole lease transaction, not a fraction of it (total net investment due includes residual value) (1).
- GAAP requires that residual value in a lease or portfolio of leases reflects the lower of cost or fair value, when impairment is determined during the Lease Term.
- Asset Ownership of the collateral by the lessor provides additional coverage that actually mitigates credit risk more than if the collateral is owned by the borrower as in a loan transaction (2).

- Achieves the Goals of Basel II for well-developed and comprehensive in-house Asset Management with greater risk sensitivity.
- Fairly aligns capital with product risk thereby enabling banks to fairly compete with non-financial institutions while protecting their financial stability.
- Provides a system that is implementable by all Lessors using the IRB approach.

Citigroup believes the case for a consistent treatment for retail lease exposures is compelling since (a) separating the lease into components would be inconsistent with the risk management of such exposures and (b) allocating more risk weight to the residual value in a lease is a more conservative treatment than that for a loan, despite the fact that in the lease investment actual ownership of the collateral indicates it to be less risky. Thus, to level the playing field in funding borrowers or lessee's assets and to better align such exposures with the risk in such businesses, Citigroup recommends that all lease exposures (Wholesale and Retail) should be treated and assigned risk the same manner as loan exposures.

More specifically,

a) Within Citigroup, risk exposures on all leases are reviewed at the net investment amount, which is inclusive of residual value, so that risk management evaluates the total lease exposure as one single exposure in default scenarios. While Commercial leases are differentiated into Wholesale and Retail exposures based upon how these leases to Commercial customers are managed (Classified versus Delinquency Managed), risk in default scenarios in both cases are managed as one exposure or net investment amount including residual value.

   Thus, while estimates of Commercial Retail PDs are determined by transactions, products and multiple risk factors of key underlying obligations, as mentioned earlier for Commercial Wholesale exposures, the total amount due implicit in Commercial Retail LGDs also integrates the unpaid portion of the principal amount of the lease (including the residual value) plus unpaid accrued interest.

   The IRB approach justifies considering the ability of banks' internal risk rating systems to adequately capture the differences between different loans and different types of assets, and the methods used to calculate the relevant risk measure.

b) Citigroup believes that leases have less risk than loans at the time of default due to the ownership of the collateral by the lessor mitigating credit risk more than if the collateral was owned by the borrower as in a loan transaction.

The LGDs for lease exposure, as for loans, are based upon the total net investment amount. For leases, this total amount integrates the unpaid portion of the principal amount of the lease (including the residual value) plus unpaid accrued interest. The LGDs for lease exposures therefore include changes in realized collateral value (i.e. positive values for losses and negative values for net gains on the realized collateral value versus the un-recovered lease exposure amount). Moreover, considering the timing between the default and recovery dates is expedited

for a lessor (who legally owns the asset) as compared to a lender (or one who has security in an asset owned by the borrower) actually lowers the risk in a defaulted lease exposure.

(1) If the lessee defaults before the end of the contract and the equipment loses value more rapidly than initially estimated, the LGD already integrates that risk. Imposing a weighting at 100% of the residual value in addition to the weighting stemming from the LGD from the lease exposure, amounts to a punitive residual value risk capital on a component basis.
(2) A lender who receives an asset belonging to the borrower may rank behind creditors for secured debts, in leasing on the other hand:

- Lessor remains the owner of the asset throughout the contract term and can, in the case of lessee default, repossess his asset without ranking behind any creditor of the customer.
- Right of ownership of the lessor relates to the entire selling price and allows him to rank before all creditors in respect of the said selling price and not only the lenders who have a claim on the asset, as is the case of a credit secured by the asset.
- Procedures for the recovery of an asset whose owner is the lessor, are much more rapid and flexible than those relating to the seizure of an asset given as security by a borrower.

March 19, 2007

COMMENTS ON QIS 4 RESULTS

For the reasons given below, we believe that the QIS-4 survey results do not justify, and should not be the basis for, the modifications to the Accord proposed by the Agencies.

A. The Survey Examined The Impact Of Pillar 1 Only And Not The Entire Accord

The Accord is a three-part framework, and the QIS-4 survey examined the impact of only one part of that framework, Pillar 1. It is inappropriate for the federal banking agencies to base major changes to the Accord upon such a partial test. Pillar 2, in particular, is integral to the operation of the Accord. Pillar 2 provides regulatory input and oversight for each bank's implementation of Basel II and assures that the appropriate regulatory agency is comfortable with the results derived under the framework. The Pillar 2 supervisory process was not captured in the QIS-4 survey.

B. The QIS-4 Survey Was A "Best Efforts" Exercise Since Sufficient Guidance Was Not Available

When the QIS-4 survey was conducted, the federal banking agencies were unable to provide the participating institutions with adequate guidance given the state of Basel II development. The NPR acknowledges that, at the time of the QIS-4 data collection, neither an NPR with associated supervisory guidance nor final regulations implementing the Basel II framework had been issued in the United States. Instead, the institutions participating in the survey had to make submissions based solely upon survey instructions that did not fully address many interpretive issues. As a result, each participating institution submitted data based upon its own interpretation of the instructions. Additionally, as the NPR acknowledged when the survey was conducted, "The agencies had not qualified any of the participants to use the Basel II framework and had not conducted any formal supervisory review of their progress toward meeting the Basel II qualification requirements." [1]

C. The Federal Banking Agencies Did Not Attempt To Resolve Sizable Divergence In The Results

The QIS-4 survey found that different institutions reported significantly different risk parameters for similar types of loans. A certain degree of dispersion is to be expected under the Accord. Loans that may be considered similar in the abstract may still have different risk parameters for different institutions. Any extraordinary dispersion should be, and under the Accord is designed to be, addressed in Pillar 2. Attempting to address outlier situations using blunt tools and aggregate capital floors in Pillar 1 undermines the risk sensitivity of the Accord and addresses the issue of outliers at the expense of all other Basel II banks. Under Pillar 2, the federal banking agencies have the authority to assess an institution's risk methodologies and processes and require the institution to make capital adjustments as necessary. This process was not part of the QIS-4 survey

[1] 71 Federal Register 55839, Sept. 25, 2006.

D. The Survey Was Conducted At A Benign Point In The Credit Cycle, And Our Data Indicates That If The Survey Had Been Conducted During An Economic Downturn, Minimum Capital Levels Would Have Increased Over The Basel I Minimum

The QIS-4 survey was conducted at a time when the economy was strong and credit problems minimal. Under the Accord, minimum capital levels can be expected to decline in good economic periods to reflect the decreased risk during such periods. In other words, when the economy is strong, a risk-based capital system should indicate that less regulatory minimum capital is necessary. On the other hand, when signs of economic weakness appear, a properly functioning, risk sensitive capital system should require banks to hold more capital.

Various academic studies, and the results of our own internal analysis, indicate that had the QIS-4 survey been conducted during a recessionary period, the Accord would have required Basel II banks to hold significantly more capital than Basel I.[2] Attachment A indicates that the average increase in minimum capital from a benign economic period to an economic downturn would be 23 percent under the Accord. This translates to an increase in minimum capital during a recession of 12.5 percent over Basel I minimums. Other studies have found the increase in minimum capital from a benign economic period to an economic downturn could be as much as 35 percent.

E. It Is Inappropriate To Use The Basel I Minimum As A Basis For Comparison

The Basel I levels were set in the late 1980's and were not based upon the calibration techniques in common use today. Both the federal banking agencies and the banking industry agree that Basel I is no longer appropriate for large, sophisticated banking institutions. Thus, there is no inherent safety and soundness basis for the federal banking agencies to assume that the Basel I capital levels are the "right levels," and that any decreases in capital from those levels are inappropriate. The goal of this exercise should be to determine the *correct* minimum capital requirement in light of the risks presented by each individual bank's assets, and not to artificially constrain that determination by a desire to maintain aggregate capital to a pre-determined non-risk based number.

F. The Federal Banking Agencies Have Recognized The Limitations Of The QIS-4 Survey

Several of these limitations listed above have been acknowledged by the federal banking agencies. For example, in September 2005, Federal Reserve Board Governor Susan Bies stated that "... [the] QIS-4 does not represent the final version of Basel II in the United States and we realize that bank data and risk-management systems required by Basel II are not yet fully developed and implemented as expected by the framework."[3] Similarly, in testimony before the Senate Banking Committee, November 2005, Comptroller Dugan noted that "We have concluded that some of the weaknesses identified in QIS-4 are attributable to the fact that no

[2] Pillar 1 only.

[3] Speech by Governor Susan Bies before Institute of International Bankers, September 26, 2005.

"live" Basel II systems have been built – in large part because we have not yet fully specified all the requirements for such a system."