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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

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

Re: Docket Number 06-09

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

Re: RIN 1550-AB56

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

<u>Foreign Competitors not subject to 10% Aggregate Floor</u>

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,

David C Bushnell

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