

# Seeking Alpha $\alpha$

## Citigroup Q2 2007 Earnings Call Transcript

### Executives

Art Tildesley - IR

Charles Prince - Chairman, CEO

Gary Crittenden - CFO

Robert Druskin - COO

### Analysts

Glenn Schorr - UBS

Guy Moszkowski - Merrill Lynch

Mike Mayo - Deutsche Bank

Jason Goldberg - Lehman Brothers

Steve Wharton - JPMorgan

Ron Mandel - GIC

Dave Hilder - Bear Stearns

James Mitchell - Buckingham Research

Meredith Whitney - CIBC World Markets

John McDonald - Banc of America Securities

### TRANSCRIPT SPONSOR



Citigroup, Inc. (C) Q2 2007 Earnings Call July 20, 2007 10:00 am ET

### Operator

Good morning, ladies and gentlemen, and welcome to Citi's second quarter 2007 earnings review, featuring Citi's Chairman and Chief Executive Officer Charles Prince; Chief Financial Officer, Gary Crittenden; and Chief Operating Officer, Robert Druskin. Today's call will be hosted by Art Tildesley, Director of Investor Relations.

(Operator Instructions) Mr. Tildesley, you may begin.

### Art Tildesley

Thank you very much, operator and thank you all for joining us today for our second quarter 2007 earnings presentation. We are going to walk you through a presentation and that is available on our website, so if you haven't downloaded that, please do so now.

The format we will follow will be Chuck will start the call. Gary and Bob will take you through our presentation. Chuck will have a few concluding remarks, and then we would be happy to answer any questions that you may have.

Before we get started, I would like to remind you that today's presentation may contain forward-looking statements. Citigroup's financial results may differ materially from those statements. Please refer to our SEC filings for a description of the factors that could cause our actual results to differ from expectations.

With that said, let me turn it over to you, Chuck.

### **Charles Prince**

Thank you and good morning, everybody. Thanks for joining our call. I want to begin by thanking everybody on our team for delivering a record quarterly performance, the best we have ever done. I am very pleased with the underlying health and quality of our business.

I am especially pleased this quarter with a couple of particular items. One, the growth in our international franchise; second, the performance in our capital markets related businesses, generally, especially given the market conditions we all saw in June. The benefits we are just beginning to see from Bob Druskin's expense-led initiatives.

Now late last year I set four clear priorities for Citi in 2007, and we are delivering on all of them. Our first priority, as you know, was to grow our U.S. consumer business, and you have seen the progress over the last several quarters as Steve and the team have turned that business. That progress continues this quarter. We had good strong volume and revenues were reported at 3%. Gary will take you through it; it is 5% without last year's one-timer. So I continue to see good turning in the revenue growth in that very important U.S. consumer business.

Credit was a drag on our bottom line results, and Gary will talk about that in more detail as he talks about credit, but I would tell you I am pleased with the continued turn we see in our U.S. consumer business.

Our second big priority for '07 was to re-weight the company's revenue mix towards our faster growing businesses, especially our international franchises. Again, we see very good results there. We generated record international revenues, grew 34% this quarter, and record international net income, up 37%. Really, a tremendous performance by the team.

International revenues were 49% of our total revenues, up from only 43% a year ago and I would say growing strongly across almost all of our businesses. Now I would like to remind you, growth in the international markets is still an enormous opportunity in front of us at Citi. A large portion of our investment spending has been outside the U.S. and that will continue, in addition to our organic investment, building all of the branches. As you know, we have announced ten international acquisitions since October of last year, most recently the transaction with Banco do Chile that we discussed yesterday. I would say that Citi is extremely well-positioned to grow our international businesses, even with the successes we've had so far. I think our second quarter results really are a good measure of the momentum we have in these fast-growing markets.

I'd also like to call out in the reweighting category the growth of our capital markets related businesses, including markets and banking, where Michael Kline and Tom Harris are doing a terrific job. Global wealth management where Sally is really leading the charge; and alternative investments, where Vic has just joined the team to help build that out. In all of these businesses, we had an outstanding quarter with strong revenue and income growth, and I would again say especially overseas.

Our third goal for this year was effective expense management, and my friend and partner Bob Druskin will take you through in a few minutes what we have done in that regard. I am very pleased with the progress the team is making. We generated positive operating leverage, I will say again, this quarter, and our rate of headcount growth slowed reflecting what I think is just the start of what will be an ongoing process of reengineering to improve efficiency and speed in our business and lower our expenses.

Fourth, credit management. Now, we are all watching credit. You are watching credit, we're watching credit, we are all watching it very carefully. Gary is going to take you through that in some detail later, so I won't do the detail here, but I will tell you I feel very good about our processes, about our risk management system and the overall quality of our loan portfolio.

We are building reserves, but net credit losses and loss reserves as a percentage of loans are steady, so we have had some significant credit releases in the past and an unusually low level of net credit losses in the past, and right

now we are increasing our credit costs as we build reserves, as we stay ahead of trends in the credit environment. As I said, we are very focused on managing our credit exposures through the cycle.

A few comments about our recent acquisitions. As you know, we closed the acquisition of Egg in the UK, a transaction which will bolster our card and online banking businesses around the world. We also closed Grupo Cuscatlan, which enhances our banking presence in Central America. And, we've announced the acquisitions of Bank of Overseas Chinese and Taiwan, if Bisys and of ATD; all businesses that will expand our franchise in, again, higher growth markets. As I mentioned, we closed Old Lane early this month and we expect great things from Vikram Pandit and John Haven and that team.

Most significantly, we now own 60% of Nikko Cordial in Japan. I was in Japan just a week or so ago, and Japan is a great market. We've also announced plans to list Citigroup's shares on the Tokyo Stock Exchange.

I think the financial services market in Japan is enormous, and I think that the customers there are hungry for new products. Based on my visit and visits with clients and with our colleagues at Nikko Cordial, I am very excited about the potential for growth in our business in Japan.

So in sum, we are making very good progress. I feel very good about what we are doing. We have strong volume increases, we have strong revenue growth. Bob Druskin is leading the effort to improve our structural expense, and the international markets are very, very robust. That is where our future growth is coming.

Now we still have a lot to do, but that lot to do is really opportunities for us, and I am more and more confident of the path we are on. So with that, let me turn it over to Gary and Bob who will take you through the results, and then I will come back at the end for questions.

### **Gary Crittenden**

Thank you very much, Chuck and good morning to everyone. I am going to start out with slide 1. It shows our consolidated results for the quarter versus the second quarter of 2006.

To summarize our second quarter results, net revenues grew 20%. Net interest revenue is up double-digits for the first time since the third quarter of 2004. Expenses were up 16%. Whether you adjust for the press release disclosed items or look at our results on a reported basis, we had positive operating leverage in the quarter.

The cost of credit was up 50%, and as Chuck said, I will come back and describe that in some detail in a few minutes. Despite the increase in credit costs, pretax income was up 19%, net income from continuing operations was up 18% and EPS increased by 18%. Our return on equity was 20.1% in the quarter.

Included in these results are three items which impact the results for the quarter. First, in the second quarter of 2006 we had one item. We booked \$163 million pretax gain on the sale of our upstate New York branches to M&T bank. This quarter, we had two items. First we released \$300 million of pretax litigation reserves related to Worldcom and other research matters which was a benefit to our expenses in the market and banking business. Second, we had a \$96 million APB 23 tax benefit in our global wealth management and market and banking businesses.

Let me turn now to slide 2. This shows a five quarter trend of some of the key drivers of our businesses. Strong momentum continued to cross these drivers, which were the underpinnings of our 20% growth in revenues. The momentum was especially strong in our international franchises, which drove revenues up 34%.

Drivers of net interest revenue showed strong growth. Consumer loans were up 8% in the U.S. and 25% internationally. Internationally, organic consumer loan growth was up 17%. Corporate loans were up 23%. Consumer deposits were up 20% in the U.S. and 15% internationally. Internationally, organic deposit growth was up 8%.

Drivers of non-interest revenues also grew nicely. Credit card purchase sales were up 6% in the U.S. and 31% internationally. Internationally, organic card purchase sales growth was 23%. Assets under management were up 35% in international consumer and clients assets under management in CAI were up 55%.

In our global wealth management business, assets under fee-based management grew 40%, 22% of that organically. In investment banking, we ranked number one in global debt underwriting, number two in announced M&A, and number three in global equity underwriting. We had record revenues in equity markets.

Slide 3 shows the year-over-year revenue growth of each of our major businesses in the top half of the chart. The graph at the bottom of the page shows a nine quarter trend of the split between our U.S. and international revenues.

U.S. consumer revenues grew 3% in the quarter. First, the business has sustained a steady growth trend over the last three quarters. Last quarter, adjusting for the gain from the sale of MasterCard shares, revenues grew 4%. This

quarter, adjusting for the gain from the sale of our upstate branches in last year's second quarter, revenues grew by 5%>.

Second, we are pleased to see the relative growth rates of our businesses. Our capital markets and international consumer businesses all grew revenues at double-digit rates. In total, our international revenues grew 34%, and our U.S. revenues grew 6%. We are working to reweight Citi to higher growth opportunities, and the results of this quarter demonstrate significant progress.

This quarter's revenue growth rate also reflects the impact of acquisitions. Combined, they contributed 4 percentage points to the 20% reported revenue growth. The bottom graph shows that our international revenues were 49% of the total company's revenue base, compared to 43% just a year ago. We expect to continue to reweight the company towards the international businesses with a balanced approach of organic as well as acquisition driven growth.

Slide 4 shows the U.S. versus international annualized growth rate of each of our business segments from the second quarter of 2003 to the second quarter of 2007. The graph also shows the percentage of international versus U.S. revenues in each segment.

The trend is very clear, and reflects our continued focus on allocating our resources to the fastest-growing international markets. Overall, the company has grown international revenues at strong, double-digit annualized rates over the last four years, resulting in those businesses comprising 49% of our total revenues versus 38% four years ago.

The bar graph on slide 5 shows the nine quarter sequential change in our net interest revenue. The table at the bottom shows you the net interest margin for the entire company for those same nine quarters. As I mentioned earlier, we have had strong volume growth in all of our businesses, which has resulted in fairly steady improvement in net interest revenue over the last nine quarters. At the bottom of the page, you see the net interest margin decline sequentially by 6 basis points, including and excluding the gray zone impact. The benefit from lower cost of funds was offset by growing and lower-yielding assets in our trading businesses.

Now let me turn the presentation over to Bob to give you an update on our expense performance in the quarter.

#### **Bob Druskin**

Good morning. Slide 6 shows the year-over-year trend of our expense growth as well as the main drivers of that growth. When we discussed our structural expense review back in April, we mentioned that using our public disclosure, you would be able to track our progress in headcount growth and in expense growth relative to revenues. On both structural expense saves and total headcount reductions, we are ahead of our commitments, and so we are pretty pleased so far with the initial results.

GAAP revenue growth as you saw was 20%. GAAP expense growth is 16%. BAU expense growth of 14%, that was referenced, the two items which you can see on the chart. The \$300 million WorldCom litigation reserve release which had a 2 percentage point benefit and acquisitions had a 4 percentage point impact. Nikko was the main driver in there, followed by Grupo Uno and Cuscatlan.

So BAU revenue growth at 16%; BAU expense growth at 14%.

But a little bit more on BAU expenses. Those include expenses from the roughly 530 net new branches over the last 12 months that we have opened. That was about 800 gross; we closed some, but that added about 1 percentage point to expense growth. More importantly, I think, year over year close to 60% of the expense growth was driven by markets and banking. They have a large degree of variability in their expenses; and they had a very impressive revenue growth rate that drove that. So expenses generally look okay, so let's turn the page to headcount.

Slide 7 shows the positive trend in our underlying headcount growth rates. Although the graph indicates significant year-on-year growth, this was driven as you can see predominantly by acquisitions. Excluding acquisitions, first quarter '06 to first quarter '07, just looking back one quarter, the underlying growth rate was 9%; second quarter '06 to second quarter '07, growth rate of 5%, which is indicative of a decelerating rate of growth.

Some of the factors affecting the year-over-year 15%, as you can see, acquisitions contributed 10 percentage points or about 31,000 direct staff. Again, the three big ones were Nikko, Grupo Uno, and Cuscatlan. The other 5% includes a couple of percentage points from branch openings. I mentioned before, we opened about 530 net branches, and so that added a number of heads.

Sequentially, the story is a little better and indicates some of the early effects of the first-quarter strategic expense review. If you break down the quarter-on-quarter rate of 5% and strip out acquisitions which contributed about 6%, the BAU headcount growth was actually down by about 1 percentage point. In April, we said that we would take

headcount down through a number of initiatives by about 17,000. So far, we are tracking ahead of our expectations to this point.

Last word on the expense review. Just to remind everyone, we outlined three major objectives as we went through it. One was to reduce expense growth through levers like headcount management, optimization of IT assets, and expansion of shared services. We are a little bit ahead of our plans, tracking very well, and pleased with that. We wanted to change how we operate to become quicker and more agile. That is a work in progress, but we're making headway everyday.

Lastly, to sustain and enhance our organic investment initiatives. We did not want to take out revenue-producing capacity and as you can see by the growth rates in our revenue, we have been successful in doing that. So, overall, some good progress, more work to do. Let me turn it back to Gary.

### **Gary Crittenden**

Thanks, Bob. I'm going to turn now to slide number 8, which shows the year-over-year growth in the various components of our total cost of credit and the key drivers within each of those components. We anticipated that credit costs would be a difficult comparison for this quarter. While conditions remain generally stable, there are a number of factors that affect the comparisons this year over last year. The combined result of these factors was an increase in our total cost of credit of \$934 million, or more than a 50% increase.

As the chart shows, we had a net release of \$210 million in loan loss reserves last year due to the particularly strong credit environment at the time and lower than expected bankruptcy filings in the US. Net credit losses were up by \$259 million, driven primarily by our global consumer business.

In consumer, key drivers are higher balances from organic portfolio growth and acquisitions; continued deterioration in the second mortgage portfolio; and the impact of the gray zone in Japan. In markets and banking, we continued to see a stable credit environment.

The third component is a \$465 million net increase in the loan-loss reserve. There were two major drivers of this increase. First in the U.S. Cards business, the increase was driven by a change in the estimate of loan losses that are inherent in the portfolio. It is important to note that the underlying credit metrics have remained largely stable in our cards business. This reserve build reflects our focus on staying ahead of the visible credit trends, by considering as many factors as possible in establishing our reserves.

Second, in the international cards business, portfolio growth and seasoning and the impact of recent acquisitions resulted in higher reserve levels. I will give you a sense of how to think about these overall credit costs in the third quarter in just a few minutes.

Slide 9 provides an update on portfolio trends and quality. The top two graphs show consumer and corporate net credit losses and loan loss reserves as a percentage of loans. The bottom grids are an update on our portfolio, showing the loan to value and FICO comparisons of our first and second mortgage portfolios in the U.S. consumer business.

Let me talk about the consumer business, which is on the top left box on the page. The graph demonstrates that loan-loss reserves and NCLs as a percentage of the consumer loan portfolio have held steady. Excluding the impact of gray zone, the ratio of NCLs to average loans has been fairly stable until this quarter, where you can see a sequential improvement of 12 basis points.

A comment on this: the second-quarter NCL ratio is affected by the number of acquisitions that were closed in the quarter. When loans are acquired, they're booked on our balance sheet at the estimated net realizable value, which results in lower NCLs in the early months following the close of a transaction. In our organic portfolio, the underlying NCL ratios continue to be stable.

Loan loss reserves as a percentage of loans are sequentially higher; but they're in line, as you can see, with our year-ago levels. Looking back to the first quarter of 2006, this ratio was 1.44% and has consistently declined since then, until last quarter when we started to see it pick up. The declines were a reflection of a particularly favorable credit environment over the last several quarters. The increase now is a reflection of the current environment, which warrants the addition to our reserve levels.

On corporate credit, which is the graph on the top right-hand box of the page, you can see the NCL ratio has been very stable and the loan loss reserve has declined. Here, the loan book has grown substantially over the course of the last several quarters, but our losses remain at very low levels. On a cash basis, corporate loans were \$599 million in the quarter on a total corporate loan portfolio of \$192 billion. The credit environment for corporate loans remains stable.

In both our first and second mortgage portfolios, as you can see from the grids on the bottom of the page, the quality of our portfolios continue to be very good. There are no meaningful changes from the results that we presented to you in this same format in the last quarter. Additionally, in our consumer lending first mortgage portfolio, we have seen approximately \$3 billion or approximately 4% of our portfolio of adjustable rate mortgages reset in the first half of the year. 85% of our resets have been in higher FICO and lower LTV categories. As we look to the remainder of the year, we see similar levels of resets in the portfolio.

Slide 10 shows a number of key capital ratios and the return on common equity for the quarter. The Tier 1 capital ratio for the second quarter was 7.9%, down from 8.3% in the first quarter. The TCE to risk weighted managed assets is at 6.3%, down slightly from last quarter. As we said before, we target to keep our Tier 1 capital ratio above the 7.5% level and the TCE to RWMA ratio above the 6.5% level. Both the Tier 1 capital ratio and the TCE to risk-weighted managed assets ratio reflect the impact of acquisitions that we have done over the course of the last few quarters.

The leverage ratio, which is the ratio of Tier 1 capital to average leveraged assets, stands at 4.4% this quarter, down from 4.8%, driven by acquisitions and organic asset growth. As we said in last quarter's earnings call, given the pace of acquisitions recently and the opportunities that we saw ahead at the time, we did not anticipate any further buybacks for the remainder of this year. That view has not changed. Our return on equity was 20.1%, driven by improved performance and increased leverage.

Now I will take you briefly through the results of each of our major business lines.

Slide 11 shows the results in our U.S. consumer business. Revenues were up 3% as we continued to see good volume growth from our strategic actions. Last year's second quarter included a \$163 million pretax gain from the sale of our upstate New York branches. Excluding the gain from last year's results, revenue growth this quarter is 5%. Expenses in the U.S. consumer remained in check and grew by 3%, in line with the rate of reported revenue growth and below the rate of revenue growth when adjusted for the gain on sale of our upstate branches. The reported margin improved 3%. This is the third consecutive quarter of positive operating leverage in the U.S. consumer business, adjusted for press release disclosed items.

However, earnings were down as credit costs increased by \$677 million, including the impact of \$274 million in releases in the second quarter of 2006, and the reserve build we booked in U.S. cards, which I previously discussed, and a difficult year-over-year comparison on our U.S. consumer lending business.

On slide 12, which you have seen before, we show a 14-quarter trend of revenue growth in our U.S. consumer business. The graph shows the emerging momentum over the last four quarters, both year-over-year and sequentially. This quarter, while reported revenue growth is 2.7%, if you adjust for last year's second quarter gain on the sale of our upstate New York branches, the growth rate is 5%. While we have a lot more work to do, we're pleased to see the continued positive trends in this business.

Slide 13 shows our results of the international consumer business which have been significantly affected by the results in Japan consumer finance. So let me start with the impact on gray zone this quarter. We had a loss in the Japanese consumer finance business this quarter of \$33 million, which reflects higher refunds and credit costs. In January, we had said that while there was a significant uncertainty in the consumer finance business in Japan, we expected it to break even in 2007 and return to profitability thereafter.

However, the situation remains unpredictable; and given our recent experience with the level of gray zone related refund claims, our best estimate now is that the business will have net losses in 2007. We continue to analyze the profitability prospects for this business thereafter. Now let's put Japanese consumer finance aside and look at the remainder of the results.

As you can see from the middle section on this slide, excluding Japanese consumer finance, international consumer revenues are up 24% and pretax income is up 5%, net income down 3% as the change in tax rates due to the absence of prior-year tax benefits caused a 7 point negative impact on net income growth.

At cards, average net receivables grew 44%, reflecting both strong organic growth and the impact of acquisitions. Organic revenue growth in cards was evident in all regions outside of Japan.

Retail Banking revenues were up 19%, driven by strong loan deposit and investment product sales growth. However, continued investment spending, higher credit cost, and the impact of a reserve release in last year's second quarter, and lower tax benefits this quarter drove net income down 6%. Outside of Japan, consumer finance receivables were up 20% and revenue was up 23%.

International consumer expense growth reflected the acquisitions that closed during the year and the continued investment in our distribution network. We opened 220 retail bank branches and 316 consumer finance branches in

the last 12 months. Credit costs outside of Japan consumer finance were \$948 million, reflecting the results from acquisitions, organic portfolio growth and seasoning, and the absence of prior-year releases at \$105 million in our international retail banking business. Now for the total business, the net impact on gray zone, the higher credit costs, and the continued investment spending resulted in a decline in net income of 16%.

Slide 14 shows the results of our markets and banking business. The business had a record quarter with revenue growth of 33%, with outstanding international results. International revenues grew 50% and comprised two-thirds of the total markets and banking revenues, reflecting the strength of our franchise outside the U.S. Our emerging markets business was particularly strong in the quarter.

Equity markets had record revenues, up 67%, driven primarily by our derivatives, cash and equity finance businesses. Fixed income revenues were up 24% driven by strength in credit products, securitized products, and commodities, despite the recent events in sub-prime and leveraged finance markets, which I will come back to in a minute.

In our investment banking businesses, we remain number one in combined global equity and debt underwriting for the 23rd consecutive quarter. We had record revenue results in equity underwriting, up 90%. Our advisory business was up 34%. Our transaction services business posted record revenues and net income with key drivers growing at double-digit rates.

Expenses increased 19%, driven primarily by compensation and benefits costs, which were up by 29%. Expenses also reflected a \$300 million benefit from a release of litigation reserves related to the WorldCom and other research matters. Adjusted for this benefit, expenses were up 26%, still well below the growth rate in revenue.

Record revenues in many products and regions, and stable expenses and credit conditions, drove net income higher by 64% over last year's second quarter. The investment banking pipeline increased during the quarter to or at near record levels. The pipeline is higher than at the beginning of the year, even after achieving the two best revenue quarters ever in the first half of this year.

Now, let me spend a minute talking about two topics, the sub-prime secured lending market and our leveraged lending activities. Our sub-prime exposure in Markets and banking can be divided into two categories, which together account for 2% of the Securities and Banking revenues in 2006. The first is secured lending and the second is trading.

With regards to secured lending, we have been actively managing down our exposure for some time. We had \$24 billion in assets at the end of 2006. It was at \$20 billion at the end of the first quarter and \$13 billion at the end of the second quarter, while adjusting at the same time collateral and margin requirements.

As for our trading activities, we continue to be an active market maker and as such, we hedge our risks, using a variety of methods to monitor the health of our counterparties very carefully. We monitor every aspect of our sub-prime business daily and we have a rigorous process in place for marking our book using fundamental valuation techniques, market references, and liquidity analysis.

Let me now turn to leveraged lending, which accounted for roughly 5% of our securities and banking revenues in 2006. As of June 30, there were four committed transactions which required repricing. For those transactions, we took marks on our commitments and positions which flowed through our revenues in the second quarter. Looking ahead, we have committed to finance other similar covenant-like transactions which will likely require an adjustment to price and terms. Fundamentally, we believe these are high-quality loans which when once repriced will get sold. Were we to retain these loans on our balance sheet, we would be comfortable with the credit quality. In a small subset of these transactions we have equity bridge commitments, which we take on selectively for top tier clients in connection with our leveraged financing.

The strength of our balance sheet, our capabilities, and our ability to deliver for clients in tough conditions are the primary reasons that some of the largest sponsors with the best track records do business with Citi.

Slide 15 shows the results in our global wealth management business. Revenues were up by 28%, driven by strong customer activity and the inclusion of Nikko and Quilter. Assets under fee-based management were up 40%, driven primarily by the consolidation of Nikko and an increase in market values. Net interest margin increased over last year, benefiting from the introduction of a bank deposit tiering program which helped offset yield pressures on loans. Expenses were up 25%, driven by an increase in compensation costs on higher revenues and the addition of Nikko and Quilter.

One point to note, we completed the integration of Citigroup Investment Services, which previously managed and was reported in retail distribution into Smith Barney. This resulted in a transfer of 686 FAs and \$47 billion in clients' assets into wealth management during the quarter. Results also include an APB tax benefit of \$65 million in our

international private bank. Strong revenue growth, good expense control, and the integration of Nikko and Quilter drove an increase in net income of 48%. Net income for the quarter was a record. Adjusting for the APB tax benefit, net income grew by 29%.

Slide 16 shows results in the Alternative Investments and corporate and other business. In Alternative Investments the performance was very strong in the quarter. Revenues and net income each increased by 77%, driven by proprietary investment activity revenues, up 87%, and growth in client revenues, up 26%. Revenue growth reflected both realized and mark-to-market gains across private equity, hedge fund, and other portfolios. Client capital under management increased by 55%. Lastly, corporate and other income declined, primarily reflecting higher corporate level costs which were partially offset by improved treasury results.

Now on slide 17, I look ahead to the results in the third quarter. I would like to discuss those in the context of the third quarter of 2006. The third quarter of 2006 poses a number of unique year-on-year challenges which will impact our results in the third quarter of 2007. So there are a few items that are important to consider with relationship to revenues. We expect the pressure on the Japanese consumer finance business to continue, resulting in challenging year-over-year comparisons.

Second, while I can't predict revenues in our markets and banking business, in four out of the last five years, the third quarter of the year in the markets and banking business has shown a 14% sequential decline on average in revenues, reflecting the impact of slower summer months.

Third, in our alternatives investment business, we said last quarter that, based on realized gains in the fourth quarter of last year, we expected total gains to be lower than in recent history in this business and for the remaining quarters of this year. While this quarter's results underline the earnings potential of this business, our fundamental outlook remains unchanged for the remainder of the year.

Finally, as you likely know, we sold nearly 42 million shares as part of the Redecard IPO on July 11, which will result in an after-tax gain of approximately \$400 million, which will be recorded in our third-quarter 2007 results.

Expenses in the third quarter of 2006 were the lowest in the last six quarters, primarily reflecting reductions in advertising and marketing spend in U.S. consumer and lower compensation expense in markets and banking.

As you saw on slide 6, which Bob took you through, expenses in last year's third quarter were 6.5% lower than in the second quarter of 2006, and 14.5% lower than in the fourth quarter of 2006. This quarter's expenses are up 24% versus last year's third quarter. As we continue to invest in our businesses, we expect our expenses to grow sequentially and year over year, which will make next quarter's comparisons challenging.

As we had talked about in the last earnings call, the first two quarters of 2006 had over \$350 million in combined net credit releases which made our first and second quarter comparisons difficult. In the third and the fourth quarter, we didn't have any meaningful net builds or releases, which all else equal, will make the comparisons better.

Let me talk about three specific items to keep in mind as you consider credit costs for the third quarter. First, while the credit environment still remains good, we continue to expect deterioration in credit as the year progresses, as the industry is coming from extremely low loss levels in the last two years.

Second, if the market evolves in line with our expectation of continued deterioration in the credit environment, and it reverts to a more normal historical level, we would likely make meaningful additions to our loan loss reserves in the second half of the year, as we did in the first six months of this year.

Third, net credit losses and reserves should continue to grow in line with our portfolio growth. To the extent our portfolio has grown through acquisitions, we expect to see higher credit costs in the third quarter of 2007 versus last year's comparable quarter, as the number of these acquisitions will be reflected in the results.

Finally, we had a \$254 million tax benefit in the third quarter of 2006, which resulted in a lower than normal effective tax rate of 27.4%.

In summary, while we are very pleased with our revenue momentum in the second quarter, we expect expenses, credit, and taxes will be a challenging comparison in the next quarter. To wrap up, we had a very strong quarter. We had double-digit revenue growth on strong underlying business drivers; good expense leverage; and excellent performance in our international franchise.

Let me now turn it back to Chuck for his closing remarks.

**Charles Prince**



Gary, thank you very much. You've heard Gary focus on the year-over-year considerations for the third quarter. Let me look just ahead a little bit. We are making very, very good progress on the four priorities we set for this year. As I said, the turn in our U.S. consumer business is sustaining. I'm very happy with the reweighting of our mix of revenues towards our international consumer, towards our capital markets and our wealth management businesses. Again, and, I'm very happy with the 35% growth in international net income. I'm especially happy with the 68% ownership in Nikko Cordial.

Bob's effort on expense management and efficiency are beginning to show good progress, and there is a lot of runway there ahead of us. Gary has talked at length about how we are managing credit very carefully.

Our geographic and product diversity distinguishes the opportunities we have from those of our competitors. Our ability to execute on our strategic plans, which should be evident this quarter, distinguishes our results from our competitors. We are on the right track, and we are delivering results. We are getting it done, as our new advertising slogan says; and I'm very optimistic about our future growth plans.

So with that, Art, I think we are ready for questions.

### **Art Tildesley**

Thanks, Chuck. Operator, we are ready to begin the question-and-answer session. Before we do, if I may just ask for those of you on the call if you could limit your questions to one question and one follow-up it would be much appreciated. So operator, we are ready to begin.

### **Question-and-Answer Session**

#### **Operator**

(Operator Instructions) Your first question comes from Glenn Schorr - UBS.

#### **Glenn Schorr - UBS**

Gary, I appreciate the extra color on the hot risk topics. I wonder if we could drill a little bit more. On the leveraged loan side, can you talk a little bit of about the process? Last quarter I think there was a \$286 million reserves built inside C&B but on page 35 you have provision for unfunded lending commitments at zero for the last three quarters and you have a \$1.1 billion allowance. Can you talk about how big the leveraged loan book is? How you think about the hedges, and what you're thinking model-wise as you move forward on that reserve front? As you mentioned, you had four deals repriced by June; but things have gotten worse since then. That would be helpful.

#### **Gary Crittenden**

There are a couple of different factors I think that are embedded in your question, Glenn. Let me try and kind of separate them out a little bit if I can. I went through one chart that showed a little bit about what our corporate credit performance had been for the last few quarters. There is a slide on page 9 in the deck that we showed.

We have had extraordinarily strong loan loss performance over the last few quarters. As you know, we added \$300 million to our loan loss reserve in the quarter that we just completed. We actually had net recoveries in this quarter, rather than losses, so we feel very, very good about the strength of our current loan loss reserve in our corporate business for both the on-balance sheet activities as well as for the unfunded commitments that we have. We feel very comfortable with that.

The issue with regards to the loans that have not yet been syndicated is not really a credit issue for the most part. It is really a pricing question. So as I mentioned, at the end of the second quarter we had four transactions that were essentially in-flight. With those four transactions, we took reductions; we took marks essentially against those in anticipation of the fees that we would recognize during the course of the third quarter on those four transactions.

We have other transactions which have been worked on during this time period where the market has been somewhat in dislocation. As a result of that, our current expectation for the revenues that were realized there -- not the credit losses, but the revenues that were realized there -- are lower than it was at the time that those were initially priced. That is going to have an impact on our revenue growth rate. I underlined overall that this high-yield and leveraged loan business together accounts for about 5% of our securities and banking revenues. So although it is an important business for us, it is not a huge business for us in the overall scheme of things.

We are comfortable with the underlying credit quality of these credits. We underwrote those as part of the normal process. But we will see some revenue effect likely from the deals that are underway.

The final element of this is we do have the transactions which have happened since the environment has changed. Those are now being done with a different set of terms, with a different level of pricing than existed before perhaps a month or so ago. I think this is a return to the kind of normal activity that you would see in the market. So we have seen a change in the market. It happens in markets all the time. We have seen a change in the market; and one of the reasons people do business with us is we have an ability to have staying power as we go through a market dislocation like this.

**Glenn Schorr - UBS**

Just making sure, from your comments, I read in that the four that happened last quarter you took marks on, so that means everything else on the books is still marked as a loan. In other words, they are not marked-to-market on a day-by-day basis? As they come, you get more visibility on a deal by deal, do you take marks to the revenue line?

**Gary Crittenden**

Essentially correct. What we do is we anticipate what the pricing is going to be at the time that we make a judgment about what that is and we mark those loans then appropriately, anticipating what the pricing is going to be. That may be higher or lower than the actual fees that we have committed on those loans when they actually go through syndication.

**Glenn Schorr - UBS**

On slide 2, all the key revenue growth drivers, are those organic numbers or is it a blend, meaning all the acquisitions add in there as well?

**Gary Crittenden**

It is a blend, Glenn. But to make it useful for you, on the international side, roughly a third of those growth rates come from acquisitions. That is not exactly accurate, but just for simplicity's sake about a third of the growth rate is acquisitions.

**Glenn Schorr - UBS**

Good enough, still big growth. Okay, thank you.

**Operator**

Your next question comes from Guy Moszkowski - Merrill Lynch.

**Guy Moszkowski - Merrill Lynch**

I hate to beat a dead horse, but on the loan syndications front can you give us some idea of the extent to which, despite the very robust capital markets and banking revenue results, you actually did take some of the hits that you were describing? I look at the combination of advisory fees, debt underwriting fees, debt trading revenues, and lending revenues. When you add them all up, they are down about \$500 million from the first quarter. Is a good chunk of that some of these reserves that you took? Or not reserves; loan pricing hits?

**Gary Crittenden**

The marks that you talked about were not nearly of that order of magnitude in our results overall. So they were much smaller than that on the four deals that I talked about at the time that we ended the second quarter.

**Guy Moszkowski - Merrill Lynch**

Thank you. On U.S. consumer, there was a big increase in the loss ratio and about a \$0.5 billion upswing in delinquent balances. You did add a couple hundred million dollars in specific reserve build in the first quarter but only about \$39 million additionally added this quarter, even though you did see the swing in delinquencies. This quarter you have about \$57 billion, I think, of sub-prime assets. Could you give us a little bit more color on the process in thinking about what those reserve additions should have been?

**Gary Crittenden**

As you might guess, we go through this and look at quarter by quarter; and we make our best estimate as we go through each quarter about how we think the losses that are inherent in our portfolio will evolve over time. We did that in the first quarter, took some charges in the first quarter. We took additional charges in the second quarter that we just came through that were primarily, in this particular case, related to the U.S. card business. So you won't

necessarily see in lockstep additions to reserve in each business that tie directly to the delinquencies as they are evidenced in that quarter, because we may have in a prior quarter anticipated that and expected that that would be apparent in future quarters, and have already taken actions on that.

You can't draw a one-to-one relationship between change in delinquency or improvement in delinquency and changes that we make in the loan loss reserve on a particular line item. I think you really have to focus on the overall reserving process as we go through and look at each of the individual lines of business. I think the important thing here is that our expectation continues to be that we're going to see some deterioration as we go through the year. As I said in my earlier comments, if that expectation is true then it is very likely that we will have the similar barely material additions to our credit reserves as we go through the remainder of the year.

**Guy Moszkowski - Merrill Lynch**

If I could just ask a question operating leverage in the consumer businesses. It does seem, if you drill down business by business, it does seem like it is still weak. We saw positive operating leverage in the U.S. and international cards business, although the U.S. cards business basically better because it has got declining revenue. But in the other consumer businesses globally, it really did seem like the operating leverage was still kind of weak. Should we expect those metrics to improve over the remainder of the year, given Bob's cost management programs?

**Bob Druskin**

It could be, although I would tell you that we're still opening branches at a pretty healthy rate and branch openings have a negative impact on operating leverage as you ramp those up. We are still pending pretty heavily too, especially internationally, as we grow those businesses. We could ratchet those marketing and advertising numbers up and down. We could slow or quicken the rate of branch growth, which we are looking at. But as we open branches, and we are doing it in significant numbers, that is going to have a depressing impact on operating leverage. But again, that is a dial we can ratchet up or down.

**Guy Moszkowski - Merrill Lynch**

Are you still operating pretty much within the context of the 50% or so reduction in that investment spending that you had outlined late last year?

**Bob Druskin**

The answer is yes.

**Operator**

Your next question comes from Mike Mayo - Deutsche Bank.

**Mike Mayo - Deutsche Bank**

Good morning. Could you provide more color on the expense program? You have had two quarters in a row of positive operating leverage. How far along are you in this program?

**Bob Druskin**

We laid out some numbers in the April review, post the first quarter strategic expense initiative and we are tracking pretty much right along the path we thought we would be. I expect that over the second half of the year, we will continue to move forward and hit the numbers we outlined in April. We are a little bit ahead. I wouldn't say we are materially ahead, but we are ahead both on expense initiatives and headcount reduction.

Again, we are tracking this with great specificity. We have a few hundred projects underway. For each one we know how we are tracking along a month-by-month timeline, which ones are ahead, which ones haven't started yet because some of them have a longer tail to them. But I would also just say that what we did say we would do is slow the rate of expense growth, which we are comfortable that we will do. Other than the kinds of variable expenses that you see in Smith Barney and in markets and banking in particular, which are heavily revenue driven or pretax, pre-comp driven. But in terms of how I feel about where we are, we are right on target so far.

**Mike Mayo - Deutsche Bank**

What percent of the savings have you achieved?

**Bob Druskin**

It is less than half.

**Mike Mayo - Deutsche Bank**

That helped this quarter get positive operating the leverage, or not yet?

**Bob Druskin**

Yes, it did help, Mike.

**Mike Mayo - Deutsche Bank**

A related question as it relates to revenue growth. International consumer revenues are growing almost 40% annualized. Even if you take off one-third, that is kind of a high pace. Is there anything seasonal in that? Why such an acceleration?

**Gary Crittenden**

We have enormous success in emerging markets in the markets and banking business. It really is a distinctive competence of the company and is really the primary engine behind that revenue growth. So obviously on the consumer side, we did well. If you adjust for the Japanese gray zone impact that was up 24%. But the number that is really powering the number that you're seeing is the enormous success that we have seen in emerging markets with the markets and banking business.

**Mike Mayo - Deutsche Bank**

Is there anything seasonal, though, or something that is temporary?

**Gary Crittenden**

Well, there always is a seasonal pattern where on average, four out of the last five years, there has been a reduction of about 14% or so in revenues from the second quarter to the third quarter. That doesn't mean it will happen this year, but historically that has been the case, so there is a bit of a seasonal pattern. Obviously, those are very hot markets today with lots of equity underwriting opportunities. You saw our equity underwriting was up 90% in the quarter. A lot of that is coming from these markets where there is a lot of entrepreneurs coming to market for the first time.

**Mike Mayo - Deutsche Bank**

Gary, your ROE is above your target this quarter. I thought at American Express you were pretty ROE focused. Any thoughts on changing the ROE target?

**Gary Crittenden**

The 20.1% came together both because of the performance of the company and the leverage. As we talked about in the material that I prepared, we anticipate actually bringing our leverage down a little bit. We are a little higher than we typically would target. That will bring our ROE more in line I think with where we have been from a target perspective.

**Operator**

Your next question comes from Jason Goldberg - Lehman Brothers.

**Jason Goldberg - Lehman Brothers**

I was hoping for a bit more color in terms of the reserve build or changing methodology in card, I guess given the fact that just card losses have been running below where we would have thought they would have over the last several quarters.

**Gary Crittenden**

Again, I think it is very similar to what I had said a little bit earlier. So, when we established these reserves, we obviously have an underlying methodology that we rigorously adhere to but we also exercise management judgment to a certain degree. We try and look forward and anticipate what losses would actually emerge in these portfolios as we look forward into the coming months. We went through that process in U.S. cards and decided that we were low this quarter and needed to add to that reserve relative to what our expectations are. So even though you don't

necessarily see it show up in the 90 days past due, for example, in the U.S. card business, it is our expectation that we will see it over time. The result of that is we add it to the reserve.

Again, that is the exact process that we continue to do in each business in each quarter. Our overall assumption is that things are going to continue to deteriorate somewhat during the remainder of the year, and we will take reserves as appropriate as that materializes.

#### **Jason Goldberg - Lehman Brothers**

Secondly, you had a litigation release, reserve release in the quarter. I think your reserve is still at around \$3 billion or so. Should we expect continued releases? Where are we in that cycle?

#### **Gary Crittenden**

I'm the least qualified person to speak on that topic; so we have a very careful process that the General Counsel's group goes through to make these decisions. They are usually event-driven, and that was the case in this particular circumstance. They are event-driven when we have either a court case decided or some specific event happened and it results in either a reserve build or a reserve release. In this particular case we had an event happen that triggered this particular release.

#### **Operator**

Your next question comes from Steve Wharton – JP Morgan.

#### **Steve Wharton - JP Morgan**

Gary, could you just elaborate a little bit? I think you said that you were down about \$13 billion in the investment bank in sub-prime-related assets. Can you just maybe characterize a little bit more, does this consist of residuals, loans themselves that have yet to be securitized? Just to give us a little bit more comfort around that number.

#### **Gary Crittenden**

Think about this as the CDOs, the CLOs, and the secured assets that we hold on our balance sheet. I think our risk team did a nice job of anticipating that this was going to be a difficult environment, and so set about in a pretty concentrated effort to reduce our exposure over the last six months. It was at \$26 billion as we ended the year last year; and we stand at about \$13 billion today. Embedded in that \$13 billion are our residuals. The residuals now are around \$800 million, something like that. That number will be in our 10-Q when we publish it; but around \$800 million. That will be down from about \$1 billion or so, I think, roughly at the end of the first quarter.

This is something obviously that we have our eye on, that we're watching very closely and that over time we have brought down to a lower level to reduce our exposure there. As I mentioned, this exposure has come down while we at the same time have been working on ensuring that we have the right terms and covenants and conditions associated with that that we hold. So I think we are on a track that is a positive track. But I underline that this is a very uncertain environment right now. It is very difficult, I think, for anyone to say exactly how this market evolves over the next few quarters.

#### **Operator**

Your next question comes from Ron Mandel - GIC.

#### **Ron Mandel - GIC**

Just in regard to bridge loans, you responded about the magnitude was considerably less in the write downs than the drop in revenue in the second quarter. I was just wondering if the third quarter had ended yesterday, what comments you would make in regard to the writedowns that you anticipate for the quarter.

#### **Gary Crittenden**

Well, it is really hard to say because it will depend obviously on the environment here. The month of August is a slow month, generally, for this kind of activity. So it is very difficult to say. I think everybody everyone will have a better idea when September comes around and just a more normalized level of activity than we know today.

#### **Ron Mandel - GIC**

But if the quarter had ended yesterday, what would be your expectation?

**Gary Crittenden**

The total size of the activity that we have is larger than the four that I had mentioned just a few minutes ago. The total size of activity that we have that will get priced in this quarter is larger than that.

**Ron Mandel - GIC**

By how much is it larger?

**Gary Crittenden**

We didn't quantify that, but it is larger than what I talked about before. The best way, I think, for me to quantify this is that this type of activity, the leveraged loan business and the high yield business represents about 5% of our total revenues. This would be a revenue-related impact if we have to change the terms on these loans. Again, as I mentioned before, it was a relatively small portion of the \$500 million reduction that was mentioned earlier on the call, on the four loans that we took at the end of the second quarter.

What I am really reflecting here is that it is just very difficult right now to reflect what that revenue impact will be. It just would be hard. Anybody who would be making that kind of a forecast would be trying to rely on things that simply have not yet happened.

**Ron Mandel - GIC**

But the related dollar amount is larger, so possibly the dollar amount of the writedowns could be larger?

**Gary Crittenden**

Yes, it certainly could.

**Ron Mandel - GIC**

Just in regard to Steve's question, in regard to the reduction in the sub-prime exposure, were there losses or writedowns taken in those reductions?

**Gary Crittenden**

Well, for the most part, those are loans that we obviously try and market appropriately for whatever the market conditions are. So the answer is certainly yes. We use third-party benchmarking wherever we possibly can. We look at analogous types of structures. We do everything we can to ensure that those loans are marked at the appropriate market environment rate. So the answer is surely yes.

**Ron Mandel - GIC**

Those losses would have been reflected in fixed-income trade?

**Gary Crittenden**

Yes.

**Ron Mandel - GIC**

Can you give any idea as to what the amount of those were?

**Gary Crittenden**

We have not broken it out specifically.

**Ron Mandel - GIC**

Do you think that getting from \$13 billion to wherever you are going, you will have losses of a similar amount? Or might they be lower ahead? How should we think about that?

**Gary Crittenden**

Impossible again for me to say. As I mentioned, this is an uncertain market right now and it is very difficult to forecast exactly where the market is going to go. If we knew that, we would be making bets on it, obviously. But we don't know exactly where that is going to go. What we do is we have excellent risk management capabilities around this. It

is monitored very carefully. We really do try to reflect the market value of these things by going through a careful process to ensure that their carrying values are correct. We are completely confident that the carrying values were as correct as they possibly could have been at the end of the second quarter. Depending on how things evolve in the third quarter, the number will change.

**Ron Mandel - GIC**

Is 13 going to zero or do you have some other number in mind? Just how should we think about that aspect?

**Gary Crittenden**

It is much more complex than that. You know, there is no specific number that we're targeting. It depends on what the market conditions actually are during the time period.

**Operator**

Your next question comes from Dave Hilder - Bear Stearns.

**Dave Hilder - Bear Stearns**

Just a question about balance sheet growth. Obviously, earning assets have gone up a lot both organically and from acquisitions. Given your comments about leverage, what might we look for over the next couple of quarters?

**Gary Crittenden**

Well, we are obviously very focused on our balance sheet. We have done some things that you can see in some of the line items of the balance sheet so if you look in the supplement itself and look at some of the balance sheet line items -- for example, our investment line item on the balance sheet is down by 6% this quarter and down by more than that if you look at it compared to the first quarter of 2007, reflecting a reduction in the mortgage securities that we hold on the balance sheet; reflecting that change.

We are focused broadly on the productivity of the balance sheet. I think versus the end of last quarter, we had roughly \$199 million, \$200 million increase in the balance sheet. About \$111 million of that was attributable to the acquisitions that we did. About \$20 billion of that was related to an issue that we had in our GTS business on the last day of the quarter. So the organic growth in the balance sheet was about \$70 billion on what at the time was a roughly \$2 trillion balance sheet, just to try and put things into context.

**Dave Hilder - Bear Stearns**

I know that it is not always useful to look at it this way, but since you do report a net interest margin number, any thoughts on where that might be headed over the next couple of quarters?

**Gary Crittenden**

Well, I can tell you that I feel pretty good about the performance this quarter, and without being overly confident about where that goes, over the next couple of quarters. But as you saw, we had this 6% reduction. A big part of this was impacted by Nikko, frankly, both on the funding side as well as on the asset side. So the funding side was helped by the way we did our funding at Nikko and the pricing that we got on the funding for doing that transaction. At the same time, most of the deterioration on the trading side came from the blend of assets that we picked up from Nikko.

So if you normalized for all of that noise that came in from Nikko, then the actual sequential change in the quarter was relatively modest. The elements that were non-Nikko-related looked pretty good in terms of what had happened on the funding side, and obviously the reduction in exposure on MBS book that we have taken over the course of the quarter helps that volatility a little bit as well.

So I think there are positive signs here, but we are far from declaring victory on seeing a turn in NIM and forecasting that is going to move the other direction for us. But if you just take some of the underlying dynamics that existed in this quarter it felt pretty good. I feel particularly good about the turnaround in net interest revenue. In prior quarters, I think we have said that there is a lot of volatility in this number and that is true, there is a lot of volatility. But what is undeniable is that the underlying deposit and loan growth has been strong. That has now offset for the last few quarters in a pretty powerful way the underlying deterioration in NIM.

As I mentioned in my first comments at the start of the call, this is the first time I think since the third quarter of 2004 that we have had double-digit growth in net interest revenue. There has been a lot of hard work on the part of the team to make that all come together, and I think it is a good sign.

**Dave Hilder - Bear Stearns**

Thanks, that is very helpful. Just one clarification. You are suggesting that excluding the impact of Nikko, the sequential net interest margin compression would have been less than the 6 basis points shown on page 33?

**Gary Crittenden**

Yes, it was pretty modest.

**Dave Hilder - Bear Stearns**

Even more modest than 6 basis points?

**Gary Crittenden**

Even more modest than 6 basis points.

**Operator**

Your next question comes from James Mitchell - Buckingham Research.

**James Mitchell - Buckingham Research**

Just a quick question on fixed income trading. Could you talk a little bit about the progression during the quarter? We have heard from some others that June was a particularly strong month, and just wanted to see if you feel that way as well. Maybe specifically talk to what products were strongest and weakest sequentially and maybe specific comments on MBS. Thanks.

**Gary Crittenden**

Well, about the best color I can give is that we ended the quarter with a very strong pipeline. So we feel good about all the activities that we have across the house, but the pipeline was very strong. We actually had three very solid months, is the way I would frame it. So if I think about June specifically, June started out a little weak for the first few days of the month, but came back near the end of the month very, very strongly but was consistent, really, with the performance that we had in the months prior to that. So it would be hard for me to kind of say that June was any different than the prior two months.

**James Mitchell - Buckingham Research**

Can you talk specifically though to fixed income and what products were stronger or weaker this quarter? And any comments on the MBS business on a sequential basis?

**Bob Druskin**

What Gary said is something I would echo. We don't normally talk about month by month but we did have very consistent performance in our fixed income businesses across the quarter.

Generally, there was strength in almost all of our products. Rates is a tough business, as it has been for some time but that is nothing new. But some of the areas that we have been investing in, actually, over the last couple of years have been very strong: derivatives, structure products, those kinds of things, where we have devoted resources to building and those have been very good.

Additionally, we have had very good results in our emerging markets trading. You know, we have trading desks in 65 or 70 countries around the world. Part of the growth in the international marketplace has been reflecting itself in our trading results around the world. So I would say we had very good results in emerging markets and international, generally.

**James Mitchell - Buckingham Research**

Fair enough. Maybe I will try one more tack. On the MBS business, you guys are obviously talking about risk management. There is obviously dynamic credit default swap hedging that you do against the residuals and the other sub-prime stuff on the balance sheet. It seems to me that the underlying asset values have declined less than the appreciation and default swaps. Is there any kind of comment you have on how that hedging has worked, if that is a fair statement or not?

**Bob Druskin**



Well, it is a complicated question, and I am not sure that we would normally get into that level of detail. I would just tell you that the strong results we had in the quarter are indicative, I think, of a pretty good risk management approach by our trading desks and generally effective hedging. So we were pleased with their results, but I don't we can go into more detail than that.

#### **Operator**

Your next question comes from Meredith Whitney - CIBC World Markets.

#### **Meredith Whitney - CIBC World Markets**

Hi, Gary. I just have a couple of cleanup questions. I understand what you said about Japan; and that was consistent with Chuck's guidance even at the beginning of the year in terms of really no net new income out of the area. But can you extend further into what that means into 2008? When would you be able to tell us that? Then I have just a couple of follow-ups.

#### **Gary Crittenden**

If you think about the dynamics here a little bit, we took a charge in the fourth quarter of last year that was not insignificant. It is hard to know exactly how the business will trend over the next few quarters because to say that the parameters around that business are stable I think would be an overstatement. It is a fluid situation there, and both the judicial process and the regulatory process continue to be in flux. That changes your view of things as things move over time.

So I guess that is a long way of saying that we have taken obviously one significant charge. We have been adding to our credit reserve as we have gone through this quarter; and we did that again in the quarter that we have just come through. We have a large charge that we are up against from a positive perspective in the fourth quarter of this year. But it would be hard to say exactly how that business will evolve as we go into 2008.

Now, what we have done is we have refocused the business on the so-called white zone pricing part of the market. That is a normal evolving business. If you could kind of slice off the gray zone piece and look at only the white zone piece, that is a normally evolving business, but obviously a much smaller market than the market that we used to address. Roughly two-thirds of the addressable market, historically, has been above a white zone type of interest rate pricing.

Those needs are either in some way going to go unmet in Japan or some other structure is going to evolve to service those needs. But much of the primary market that used to be served by consumer finance companies can no longer be served by consumer finance companies because of the way the regulations have evolved.

I think the way I would think about it is, assuming that the regulatory environment stabilizes it is likely to be a smaller business in the future than it has been in the past. We are going to be working, obviously, to work through whatever credit exposure that we have there over the next few years, and hopefully growing slowly on the white zone side. But as I mentioned, that is a smaller market. It is a considerably smaller market than the older, higher interest rate market used to be.

#### **Meredith Whitney - CIBC World Markets**

On the guidance that you are giving or caution that you're giving for the third quarter, is that vis-à-vis what expectations are out there or vis-à-vis just relative to the strong quarter that you had this quarter?

#### **Gary Crittenden**

As you know, we don't provide guidance. What I was trying to do was kind of reflect on third quarter of last year. There are just a number of factors about the third quarter of last year that made that quarter a quarter that is different than where we are today. I tried to reflect that as I went through the various elements. I think as you just kind of go down through that list, I have got them on the slide at the end of the deck. It will highlight for you the things –

#### **Meredith Whitney - CIBC World Markets**

No, no, that is understood. The Street wasn't expecting a gangbuster third quarter anyway, so I was just curious as to why explicitly point out that slide, that is all my question was.

#### **Gary Crittenden**

I wanted to make sure everybody was focused on last year's third quarter.

**Meredith Whitney - CIBC World Markets**

Then the last question is, we get your master trust data obviously monthly. There is nothing in that that would lead us to believe that credit will turn on cards. So is what you are seeing the on-balance sheet stuff that gives you concern? The private-label stuff that gives you concern? Could you elaborate on that?

**Gary Crittenden**

Well, I think, it honestly is what we try to do is we try to sit back and say, if we think about the losses that are likely to occur in our credit card business over the next X number of months, have we properly reflected what those losses are going to be in the reserve that we have at the moment that we close our books, on June 30, in this particular case.

As we go through that, we go through that process obviously in all of our businesses. We do it each quarter. As we did that for our card business in this quarter, our belief was that we needed to add to the reserve by the \$242 million, I think, or so that it was that we added in this quarter. So it really is that process. It is, obviously reflecting on what losses we have experienced historically, what our current loss rates are, what we anticipate those loss rates to be as we go forward, and ensuring that we're properly reserved at the time we close our books. The net of that was the decision that we made in the quarter to add to the credit card loan loss reserve.

**Operator**

Your final question comes from John McDonald - Banc of America.

**John McDonald - Banc of America**

Just on the cost saves clarification from Bob. You got less than half of what you are targeting for this year. I think the target for this year was \$2.3 billion, \$1.7 billion from the Druskin plan and \$400 million in IT saves. Is that right, Bob?

**Bob Druskin**

Yes, that is exactly right.

**John McDonald - Banc of America**

So in the first quarter, you said you got the \$400 million in IT. So that left \$1.7 billion for the next three quarters.

**Bob Druskin**

Right.

**John McDonald - Banc of America**

You're not saying how much you got this quarter?

**Bob Druskin**

No, I would just say that what I told to is that it would really start to pick up in the second quarter and then track through the end of the year. We are a little less than halfway through it.

**John McDonald - Banc of America**

Okay, so less than half of the \$2.3 billion?

**Bob Druskin**

Yes.

**Art Tildesley**

Operator, I think that concludes our session. For all of you on the call, thanks for joining us today. Any other questions you have, please contact us in investor relations. Otherwise, that concludes our call. Thank you.

**Copyright policy:** All transcripts on this site are the copyright of Seeking Alpha. However, we view them as an important resource for bloggers and journalists, and are excited to contribute to the democratization of financial information on the Internet. (Until now investors have had to pay thousands of dollars in subscription fees for transcripts.) So our reproduction policy is as follows: **You may quote up to 400 words of any transcript on the**

