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EDWARD BENNETT WILLIAMS (1920-1988)
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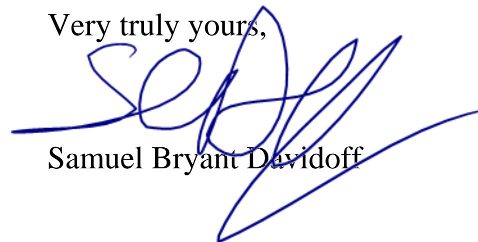
June 23, 2010

Wendy Edelberg
Executive Director
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, N.W., Suite 800
Washington, DC 20006-5614

Dear Ms. Edelberg:

I have enclosed Robert E. Rubin's responses to the questions directed to him in your letter to Brad S. Karp of June 9, 2010.

Very truly yours,



Samuel Bryant Davidoff

Enclosure

cc: Kevin M. Downey, Esq.
Brad S. Karp, Esq.

Responses of Robert E. Rubin to FCIC's June 9, 2010 Questions

(a) Please provide a timeline showing precisely how Citigroup responded to Richard Bowen's concerns regarding underwriting standards and who was involved in the responses.

Mr. Bowen's November 3, 2007 e-mail was addressed to Mr. Rubin, David Bushnell, Gary Crittenden, and Bonnie Howard. The e-mail was subsequently passed on to the appropriate personnel at Citigroup. Citigroup should be able to provide a description of its response to Mr. Bowen's concerns.

(b) With regard to subprime exposure in the fourth quarter of 2007, please explain the discrepancy and delay between the $13 billion subprime figure released to the public on October 15 and the $55 billion presented to Citigroup's Corporate Audit and Risk Committee and Board of Directors. (Please note that according to Page 1 of Citigroup's "Risk Management Review," the $55 billion was comprised of $13 billion subprime exposure, $16 billion in direct super senior debt, and $27 billion in liquidity and par puts.)

I was not involved in drafting the October 15, 2007 presentation to the Corporate Audit and Risk Management Committee. I was not a member of that Committee. To the best of my recollection, I did not review that presentation. I also was not on the October 15, 2007 earnings call. Those at Citigroup who were involved in preparing the presentation for the Audit Committee or who were on the earnings call should be able to provide the analysis responsive to your question.

(c) Please comment on the use of regulatory and capital arbitrage by financial institutions and their role in the financial system.

The term "capital arbitrage," as I understand it, refers to reducing a financial institution's capital requirements by holding assets based in part on the particular regulatory risk assigned to the asset by financial regulators, irrespective of true economic risk. In other words, a financial institution engages in "capital arbitrage" if it holds asset A instead of asset B because, despite having similar real risk characteristics, asset A has a lower regulatory risk weighting and, consequently, holding it requires the financial institution to maintain less capital than it would have to maintain if it held asset B.

The obvious problem with "capital arbitrage" is that it can distort appropriate economic decisions based on true economic risk, resulting in overleveraging of financial institutions, which, as I explained in my testimony before the Commission, was one of the causes of the recent financial crisis. Although I am not familiar with specific examples of this sort of arbitrage, it seems to me that the source of the problem is in the process of modeling risk that must be undertaken in order to assign risk ratings to assets. Mathematical models, to put it bluntly, cannot perfectly capture the complexity of real life. Consequently, regulatory risk ratings will never perfectly reflect real economic risk, and will, standing alone, always be subject to potential arbitrage.

My view is that this problem could be addressed by financial regulation that creates two sets of capital requirements, one contingent on risk weighting and one based on simpler metrics that are not derived from complicated mathematical models.

The term "regulatory arbitrage," as I understand it, refers to the notion that financial institutions had the ability to "shop" for a regulator by selecting the charter under which they operated. I am not familiar with specific instances of this practice, but, to the extent such a practice existed, it can lead to inconsistent regulatory oversight among regulated institutions. Financial reform should attempt to eliminate the jurisdictional overlaps that permit this practice.

(d) Throughout the crisis how was the CDS market still able to function, despite being subject to significant stress? Please provide your opinions on the functioning of the CDS market during the financial crisis.

In my view the markets for CDS and other complex derivatives did not function with the necessary collateral and margin requirements, standardization, transparency, and regulatory oversight needed to properly understand the risks embedded in those instruments. I developed strong concerns about systemic risk related to derivate markets when I was at Goldman Sachs and advocated increased capital and margin requirements, as discussed in my book published in 2003. I continue to support those measures in addition to current proposals for standardization, transparency, and oversight of the derivative markets.

Prior to the financial crisis, the lack of transparency in the derivatives markets enabled financial institutions to accumulate risk without full knowledge of the overall nature of the risks for individual institutions and the financial system more generally. Increasing margin and capital requirements will serve the dual purpose of providing companies with a greater cushion in the event losses are taken on derivative instruments and of discouraging certain types of riskier behavior. Requiring standardized derivatives to be traded on exchanges will also decrease risk by increasing transparency and allowing regulators and users to better evaluate the exposure of market participants. For custom contracts, I support greater disclosure and transparency requirements for those instruments as well, through the use of clearinghouses if feasible.