Citigroup: Year in Review

(January 11, 2007)

This briefing note highlights significant events related to Citigroup that took place during 2006. The Citi CPC team thought a discussion of these issues may serve as useful background information for the LFI vetting of Citi's ratings to take place on February 13th. So as not to duplicate the content of the upcoming LFI vetting, this note does not attempt to frame the issues in the context of the RFI rating system. Where relevant, the appropriate monthly report (available on BOND) has been identified should additional detail on a given topic be of interest.

<u>Formal Actions Lifted</u>

- **Board Order - Restricting Significant Expansion**: As a result of the 2005 assessment of Citigroup's condition, the risk management component was upgraded from 'fair' to 'satisfactory.' Accordingly, Citigroup was considered 'well-managed' by the Federal Reserve for the purposes of Regulations K and Y. On April 4, Citigroup issued through an 8-K disclosure correspondence from Bill Rutledge to CEO Chuck Prince indicating that Citigroup's progress in implementing its new compliance risk management program was sufficient to lift the restriction on significant expansion.
  - Since the Order was lifted, Citigroup has kept the FRBNY informed of significant expansionary activity, which they have emphasized is of an international flavor stating that the premium on significant domestic targets it too high. Major international investments have included Guangdong Development Bank (China) and Akbank AS (Turkey), as the firm focuses on a model of seeking partial ownership opportunities in emerging markets, which it has discussed with the CPC team. Supervisory attention is being placed on the potential compliance pressures associated with such a partial ownership model. Further, FRBNY examinations and visitations of international operations (focusing on areas of organic growth) have been highlighted as part of the CPC team's 2007 supervisory efforts.
- **C&D - CitiFinancial**: On June 22, the Federal Reserve terminated the May 27, 2004 Cease and Desist Order (C&D) against Citigroup Inc. and CitiFinancial Credit Company. The C&D was executed after a consumer compliance exam conducted by the FRBNY at CitiFinancial identified violations of law, safety and soundness concerns, and control deficiencies. The Order required management to implement remedial measures at CitiFinancial related to audit, compliance, internal controls, managerial oversight and training. Based on examination work conducted during 2004 and 2005, examiners from the FRBNY determined that CitiFinancial was in full compliance with the C&D Order. The examiners also determined that the compliance culture at CitiFinancial, from senior levels of management to entry-level employees, had improved significantly.
  - Several consumer finance related exams (including HMDA controls and fair lending) conducted during 2006 revealed weaknesses in consumer compliance in the Puerto Rico (PR) business. Citi was requested to resubmit its HMDA data, and at the consent of FRBNY and Board staff the firm is currently investigating the root cause and potential means of remediating the Reg B violations in PR which had been identified by examiners. The outcome of the PR Fair Lending exam will be factored into the OCC's CRA evaluation for Citibank NA.
- **Written Agreement - Structured Finance**: On July 28, 2003, Citigroup entered into a Written Agreement with the FRBNY in response to the firm's risk management deficiencies associated with the Enron-related transactions. The enforcement action was coordinated with similar actions taken by the New York County District Attorney, the SEC and the OCC. The Agreement required the firm to revise its credit risk management program, and create a legal and reputational risk management framework, particularly for complex structured finance transactions (CSFT). On December 21, 2006, the Agreement was terminated. The Federal Reserve's decision to lift the Agreement was based on the results of examination work conducted in 2004 and 2005 and monitoring conducted during 2006. Examiners concluded that Citigroup was in full compliance with the provisions of the Agreement. More specifically, individual businesses and corporate control functions have enhanced the transparency, accountability and overall effectiveness of risk management controls concerning complex transactions, particularly CSFTs. The Federal Reserve's efforts were coordinated with those of the OCC, which also lifted its Enron-related Agreement with Citibank on December 21.

- As a result of the Agreement, Citigroup scaled back its Structured Finance business and has carefully controlled the growth of this business since. The firm has; however, sought to identify opportunities for distributing complex products to its retail customer base, utilizing its Underwriting, Distribution, Conflicts and Structured Products (UDCS) process for discussing the risks associated with retail distribution of all CSFTs (irrespective of whether manufactured by Citi). The risks associated with CSFTs continue to be vetted through the Capital Markets Approval Committee (CMAC) and Business Practices Committee (BPC) processes. The BPC process is meant to force cross sector discussions of potential practices that give rise to heightened reputational risk. The CPC team reviews CMAC logs on a regular basis, and recently met with BPC representatives (and reviewed cases) at the corporate level and across four business sectors. The CPC team concluded that Citigroup's BPC processes are effective with strong corporate coordination and risk tolerances (including senior management input) broadcast in each decision.

<u>Other Topics of Interest</u>

- **Bank Consolidation:** On October 1, Citigroup completed the consolidation of its banking organizations from twelve to three major banks acting as the principal retail/corporate bank, credit card bank, and thrift, respectively. Citibank NA remains the flagship bank comprising retail banking assets (including auto and student loans and most mortgage assets) and corporate banking activities. Citibank (South Dakota) NA was spun out from Citibank NA to become a direct subsidiary of Citigroup Inc., consolidating all credit card activities into one bank. Citicorp Trust Bank fsb now houses the remaining mortgage assets originated by the Primerica sales agent business. Management's goals with respect to the reorganization were to ease restrictions on sharing customer information across legal entities; enhance oversight of banking operations; maximize capital deployment; and increase regulatory investment and lending limits (e.g. related to Regulations K and W). As part of this reorganization, management also decided to liquidate its Miami Edge Corporation, which occurred on January 1, 2007.
  - Consolidation of several bank entities into Citibank NA both increased its capital base as well as enhanced its capital adequacy, as the entities that merged into Citibank NA had exceptionally strong capital adequacy ratios. The increase in the capital base permitted greater use of Regulation K limits for acquisition activity in its Edge Corporation, Citibank Overseas Investment Corp (COIC). As such, Citigroup began to move on its plans to make targeted acquisitions outside of the US, including the investment in Akbank in Turkey, acquisitions of Grupo Financiero Uno and Banco Cuscatlan in Central America, as well as several other significant acquisitions in the pipeline in Asia and Latin America. As part of the applications process, the CPC team has shared its view on the financial, managerial, and supervisory implications of the proposed activity, particularly as they relate to global and regional AML practices.
- **Financial Highlights:** During 2006, Citigroup faced significant scrutiny from the press and analysts with respect to its operating leverage and stock price performance.
  - Throughout 2006, Citigroup has been producing less than anticipated revenues and higher than expected costs resulting in continued negative operating leverage. Citigroup management characterizes the situation as primarily a revenue generation problem, specifically in its US Consumer business where revenue growth has been flat. In response, the firm is looking to broaden the core US Consumer businesses while continuing to re-weight the firm towards international consumer and corporate and investment banking activities. Further, with an eye toward greater expense control and on-going efforts towards attaining long-term positive operating leverage, newly appointed Chief Operating Officer, Bob Druskin, has been tasked with completing by first quarter-end 2007 a structural review of expenses with a focus on back- and middle-offices looking for long-term efficiencies. (See July and December 2006 Monthly Reports)
  - Over the year, Citigroup's stock price has been performing below expectations, with some investors calling for large-scale management changes or breakup of the company. CEO Price equally has expressed frustration with the stock price, believing that its performance is not a fair reflection of the firm's financial position and potential. In spite of these concerns, Citigroup's stock climbed to a six-year high by year-end. The 14.8 percent annual increase in stock price comes as the firm drives to cut costs (solidified by the appointment of COO Druskin) and accelerate international expansion.

- **Basel II Home/Host Collaboration:** Foreign regulators appear to be re-visiting their Basel II requirements / timetables and are increasingly looking to the FR and OCC as home country supervisors for assistance regarding how to approach their Basel II exam activities, as well as leverage where possible any relevant risk management work we have completed. (An extended discussion of current outreach is provided in the November 2006 Monthly Report)

- **Consolidated Supervision:** Citigroup's broker/dealer subsidiary, Citigroup Global Markets Inc. (CGMI), was the first bank affiliated financial services firm to receive approval from the SEC for alternative net capital treatment. CGMI filed its first focus report reflecting alternative net capital treatment dated as of September 30, 2006, wherein CGMI's excess net capital increased substantially from $2B to $6B. Under the new rules, CGMI has applied VaR methodologies for all desks currently receiving market risk approval from the Federal Reserve. Currently, CSE approval covers only market risk, including both marketable and non-marketable securities. As credit risk modeling comes under consideration, the SEC will, as they did for market risk, meet with FR staff to talk about our work program and views. At this point, CGMI continues to apply a conservative haircut approach to derivative exposures. In conversations with the SEC, we understand the firm may look to move certain fixed income derivatives products from the bank to the broker/dealer. (See November 2006 Monthly Reports)

- **Hedge Fund Exposure:** Over the past 10 years, Citigroup has been building its prime brokerage (PB) capabilities in fixed income, equities and foreign exchange mostly to service hedge funds clients. The head of Citigroup's Corporate and Investment Bank describes the firm as a late entrant into the US and European PB arenas due to a conservative stance taken by Citi's senior most management in response to LTCM. Growth of PB is a strategic objective of the firm as publicly announced by CEO Prince early in 2006. Citi management describes its US and European share as small relative to that of Goldman and Morgan Stanley but that growth has been above average recognizing Citi was starting from a very small base. Citi has identified Asia as a growth opportunity given the rate of expansion of hedge funds into that market. Their existing presence in Asia and that all firms will be new entrants in providing PB services they should be able to attract a large market share. (See Prime Brokerage memo)

- **Sub-Prime Lending:** Rapidly rising delinquencies in the sub-prime mortgage market continue to be publicized for various firms. However, the CitiFinancial sub-prime mortgage portfolio, representing 24% of Citigroup's overall mortgage portfolio and 6.5% of the entire Global Consumer Group exposure, has demonstrated relatively stable to slightly increasing delinquency rates. The performance of the subprime mortgage portfolio is consistent with that of all of Citi's subprime exposures, which represent approximately 15% of the firm's total consumer outstandings. While sub-prime mortgage lending has received much recent discussion, the CPC team is focusing on other products (such as unsecured or auto lending) as early indicators of deterioration in credit quality. The rationale being that when confronted with difficulty, consumers would be inclined to miss making a payment on an auto loan rather than a mortgage. Citi's Auto portfolio is now starting to show a deteriorating loss trend. In addition, delinquency rates are above current seasonal expectations, resulting in efforts to increase monitoring of recent vintages and overall collection activities. (See November and December 2006 Monthly Reports)