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Head of Risk Oversight
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153 East 53rd Street, 22nd Floor
New York, NY 10022

Dear Messrs. Parratt and Garnett:

This letter summarizes Citigroup-specific recommendations from the Federal Reserve Bank of New York's examination of overall economic capital practices, conducted from February 23, 2007 to March 23, 2007. This examination is part of a horizontal review scheduled over the course of 2007 at large financial institutions. At the end of the horizontal exercise, we will return to Citigroup and the other institutions included in the review to provide peer conclusions, supervisory observations and any further observations and comments specific to your institution. We also note that over the course of the horizontal exercise, we may return to your institution for further clarifying information.

Overall, we found that management has incorporated Risk Capital as a useful and consistent tool for performance measurement and risk management purposes. Further, Citigroup's processes for Risk Capital measurement and the supporting framework are consistent with the broad goals of SR Letter 99-18. Your approaches to identify, measure, and calculate capital relative to risk are sound and reasonable; and comprehensive and formal control and governance processes around Risk Capital are in place. We also note that management continues to develop and enhance Risk Capital methodologies, and we encourage your efforts to revisit the methodologies regularly. Nonetheless, our review identified certain specific areas where further efforts would strengthen your overall Risk Capital practices. A discussion of our recommendations and observations is provided below.

Recommendations

Corporate-level Risk Capital Model Validation

The model that calculates cross-sector diversification and Citigroup-level Risk Capital currently is not subject to formal and independent validation. We find that validation of the individual Risk Capital component models (e.g. wholesale credit, operational risk) is not sufficient to guarantee a sound corporate-level calculation, given that there are additional transformations and assumptions in the corporate-level model.

Further, it is important to ensure a sound Risk Capital calculation from that model as the Risk Capital benefit derived by diversification is significant. Thus, management should make certain that the corporate-level Risk Capital model is subject to formal and independent validation.

Scaling for Market Risk Capital

Scaling a 1-day VaR measure to one year, and a 99% confidence level VaR to a 99.97% confidence level, for Market Risk Capital potentially understates Risk Capital as it relies on the assumption that the future P&L distribution is normal. Portfolios with options will, in general, have a standard deviation that scales at a faster rate than square root of time, and may exhibit "fatter tails" than a normal distribution. This implies that the scaling factors could be larger than what are being used currently. Management should reevaluate the scaling factors for Market Risk Capital, and adjust and validate them, if necessary, given the characteristics of the portfolios in question.

"Wrong-Way Risk" in Counterparty Credit Risk Capital

The counterparty credit Risk Capital methodology does not incorporate the potential effects of dependence between exposure and default likelihood ("wrong-way risk"). The effects of wrong-way risk can be significant for certain products or counterparties, given that in some cases, as the exposure increases, the counterparty's default likelihood also grows. We note that Citigroup has already identified this risk and taken steps to address it in the counterparty credit risk management process. Management should explore the modeling and inclusion of the co-dependence between default and exposure in the counterparty credit Risk Capital methodology for those cases where appropriate data is available.

Risk Capital Models on Spreadsheets

Certain key models (e.g. Diversification/Allocation model) are currently maintained on spreadsheets. Spreadsheet implementation introduces increased likelihood of error, decreased ability to uncover such errors, and size limitations that would be avoided in a more robust programming/database environment. While controls currently are in place, management is encouraged to assess regularly the strength of controls for addressing those potential deficiencies and also should consider alternative, more robust implementations for these Risk Capital models to better ensure security, availability, and effectiveness of controls over inputs and outputs.

Comments related to your firm's application of Risk Capital in management decision making processes have been reserved for the end of the horizontal exercise. However, at this time we offer for your consideration one observation with respect to prospective investment evaluations conducted in Citigroup Alternative Investments (CAI). While return on Risk Capital is only one of several tools management employs to evaluate prospective deals in CAI, the use of generic Risk Capital estimates, but with investment-specific returns, may distort risk/return comparisons. This investment evaluation method will make riskier-than-average investment opportunities appear more attractive, whereas less risky ones will seem less favorable for similar returns.

Messrs. Parratt and Garnett
August 1, 2007

Please provide a written response to the matters discussed above within 45 days of receipt of this letter. In closing, please note that this letter contains confidential bank examination material and should be treated accordingly by your organization as described in the footnote.¹ We would like to express our sincere appreciation for the courtesies and cooperation extended to the review team by Citigroup's management and staff. Should you have any questions, please feel free to contact Katheryn Van der Celen at (212) 720-1373, or me at (212) 527-0217.

Very truly yours,



John J. Ruocco
Assistant Vice President

Cc: D. Bushnell G. Crittenden M. Helfer B. Howard L. Kaden T. Rollauer M. Zuckert

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