**Internal FR**

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

# MEMO

DATE: June 12, 2007

TO: Board of Governors

FROM: Mmes. Barger and Snyder, and Messrs. Van Der Weide and Climent

SUBJECT: Capital Treatment of Citigroup's Margin Loan Portfolio

**Action Requested:** Staff is seeking the Board's approval for an exception to the Board's risk-based capital adequacy guidelines for bank holding companies ("guidelines") that would lower the risk-based capital requirement on Citigroup's Regulation T margin loans. Under the exception, the risk weight for these loans would be 10 percent, rather than the 100 percent risk weight set forth in the guidelines.

The exception, if approved, would be conveyed to Citigroup in a letter (see attached draft) that would be made public so that other similarly situated bank holding companies would be made aware of the exception and given the opportunity to request similar relief. Staff is further seeking Board approval to delegate to the BS&R director authority to grant such additional approvals.

**Background:** Citigroup has requested an exception from the guidelines for the Regulation T margin debits ("Reg. T margin loans") of its consolidated, registered U.S. broker-dealer subsidiary, Citigroup Global Markets Inc. ("CGMI"). As noted, the guidelines currently require a 100 percent risk weight for Reg. T margin loans. Specifically, Citigroup has asked for an exception from the guidelines that would permit it to assign a lower (such as 10 percent) risk weight to its Reg. T margin loans.

Citigroup argues that a lower risk weight for its Reg. T margin loans would more closely align the regulatory capital requirement for such loans to the low credit risk associated with such loans, given the high level of collateralization and Citigroup's low historical credit loss rates on such loans. In support of this argument, Citigroup states that its internal economic capital charge for credit risk on Reg. T margin loans is de minimis. Citigroup also argues that a lower risk weight for its Reg. T margin loans would be appropriate in order to, among other things, reduce competitive disadvantages that Citigroup (through CGMI) faces relative to both U.S. broker-dealers that are not consolidated subsidiaries of bank holding companies ("BHCs"), as well as relative to non-U.S. banks and broker-dealers.

**Discussion and Analysis:** A margin account at a broker-dealer registered with the Securities and Exchange Commission ("SEC") is a leveraged account through which securities can be purchased, sold short, carried, or traded using a loan from the broker-dealer and a deposit of cash or securities by the customer. The amount of leverage available to the customer is limited by the Board's Regulation T (12 CFR part 220), the margin maintenance rule of the New York Stock Exchange (NYSE Rule 431), and the lender's internal margin maintenance requirements.[1] For example, under Regulation T, a customer who purchases $100 of equity securities in a margin account may borrow only $50 against those securities from the broker-dealer. If this is the only transaction in the margin account, the loan will be 200 percent collateralized at the time of purchase because the market value of the securities is twice that of the margin loan. If, on a daily basis, the equity in the account falls below the required NYSE margin maintenance of 25 percent – that is, if the value of the collateral falls below 133 percent of the loan – the customer is required to post additional collateral (that is, cash or securities) to eliminate the

[1] If the broker-dealer is not a member of the NYSE, the margin maintenance rule of the NASD (NASD Rule 2520) generally would apply instead. Both rules impose the same leverage limitations.

margin deficiency. If the customer does not meet the margin call within the required time, the broker-dealer must sell sufficient securities in the account to increase the account equity up to the required maintenance level. Citigroup indicates that CGMI applies in most instances (and in all instances where the collateral is equities or non-investment-grade bonds) internal maintenance margin requirements that exceed those contained in NYSE Rule 431.[2]

Citigroup has indicated that its Reg. T margin loans are typically collateralized by liquid and readily marketable securities and are terminable upon demand at any time by Citigroup. Citigroup also has represented that it marks to market the Reg. T margin loans and associated securities collateral on a daily basis and makes daily maintenance margin calls for any collateral deficiencies.

In addition, Citigroup has concluded that the collateral for a Reg. T margin loan should be available to Citigroup for prompt liquidation even in the event of the borrower's bankruptcy. In this regard, staff notes that the Ninth Circuit Court of Appeals held in 1998 that Regulation T securities collateral is exempt from the automatic stay under the Bankruptcy Code.[3] This judicial decision was reinforced by 2005 amendments to the Bankruptcy Code. Section 901(b) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 defined the term "securities contract" – a class of transactions exempt from the automatic stay in bankruptcy – explicitly to include "margin loans." Moreover, the legislative history of the statute clarifies specifically that Congress considered Reg. T margin loans to be "margin loans" exempt from the automatic stay.[4] Therefore, if a Reg. T margin loan borrower were to file for bankruptcy, or

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[2] Regulation T initial margin requirements and NYSE margin maintenance requirements for debt securities and options differ from those applicable to equity securities.

[3] In re Weisberg, 136 F.3d 655, 659 (9th Cir. 1998).

[4] H.R. Rep. 109-31, 109th Cong., 1st Sess., p. 119 (2005).

otherwise become insolvent, Citigroup should be able to promptly liquidate the collateral for the loan.

Staff also understands that CGMI has a long history of very low losses on Reg. T margin loans.

As noted above, Reg. T margin loans held by U.S. BHCs currently are assigned to the 100 percent risk weight category under the guidelines, resulting in a risk-based capital requirement of 8 percent. In contrast, other domestic and foreign firms, including foreign banking organizations that own U.S. broker-dealers, as well as U.S. broker-dealers and consolidated supervised entities ("CSEs") regulated by the SEC, are currently required to hold either no or de minimis regulatory capital against Reg. T margin loans. Citigroup has argued that the much higher regulatory capital requirement U.S. BHCs incur for Reg. T margin loans places U.S. broker-dealers owned by U.S. BHCs at a disadvantage in competing for this low-risk business.

Subject to certain conditions listed below and set forth in the attached draft letter, staff believes that the Board should approve an exception to the guidelines that permits Citigroup to treat Reg. T margin loans in a manner that differs from that set forth in the guidelines. More specifically, staff believes that the Board should allow Citigroup to apply a 10 percent risk weight to its Reg. T margin loans. The Board could approve this exception under the reservation of authority provision contained in the guidelines. This provision permits the Board, on a case-by-case basis, to determine the appropriate risk weight for any asset or off-balance sheet item that imposes risks on a BHC that are incommensurate with the risk weight otherwise specified in the guidelines.[5]

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[5] 12 C.F.R. part 225, App. A, § III.A.

Staff believes that the Reg. T margin loans should meet the following conditions to qualify for the capital treatment outlined above:

1. The securities collateral for the Reg. T margin loans is liquid and readily marketable;
2. The Reg. T margin loans and associated collateral are marked to market each business day;
3. The Reg. T margin loans are subject to initial margin requirements under Regulation T and daily margin maintenance requirements under NYSE Rule 431; and
4. Citigroup has a reasonable basis for concluding that it would be able to liquidate the collateral for the Reg. T margin loans without undue delay, even in the case of bankruptcy or insolvency of the borrower.

The capital treatment set forth above for Reg. T margin loans would provide a more risk-sensitive treatment for these transactions than that set forth in the guidelines. The combination of initial margin requirements under Regulation T, ongoing margin maintenance requirements under NYSE regulations, generally higher ongoing margin maintenance requirements under Citigroup's internal policies, Citigroup's daily mark to market and margin call policies, the high liquidity of the collateral, Citigroup's typical right to terminate the loan at any time, and Citigroup's protection from bankruptcy automatic stay provisions, makes these loans a low-credit-risk product that warrants a 10 percent risk weight.

Staff also notes that lowering the risk-based capital requirement for Reg. T margin loans is fully consistent with the intent of the Gramm-Leach-Bliley Act of 1999 ("GLBA"), which allowed for the creation of financial holding companies ("FHCs") and which greatly expanded the scope of permissible activities for BHCs that meet the criteria to become FHCs.[6] In the formulation of GLBA, Congress envisioned that the Board would, where appropriate, tailor its

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[6] 12 C.F.R. 225.81.

regulatory and supervisory framework, including risk-based capital standards, for FHCs that engage in a significant amount of securities-related activities.[7] Congress also expected the Board, to the extent feasible and consistent with safety and soundness, to make the risk-based capital requirements for BHCs that own significant broker-dealers more consistent with the capital standards applied by the SEC to broker-dealers.[8]

This exception would accommodate Citigroup's broker-dealer activities in a risk-sensitive manner, help remove an artificial and anachronistic constraint on certain of Citigroup's securities-based lending operations, and bring Citigroup's risk-based capital requirement for Reg. T margin loans more in accord with the capital requirement for such loans that the SEC imposes on broker-dealers and CSEs.

Staff believes that the best way to communicate an approval for an exception would be in the form of a letter responding to Citigroup's request that would be signed by the Secretary of the Board and posted on the Board's public website. Steps would be taken to ensure that the letter becomes known more broadly within the margin lending industry. Staff believes that for competitive equity purposes it is important that this risk-based capital treatment be available to all U.S. BHCs that make Reg. T margin loans under the same terms and conditions as those employed by Citigroup. To obviate the need for Board approval of similar requests from other BHCs, staff is further recommending that the Board delegate to the BS&R division director authority to grant such additional approvals.

**Conclusion:** Staff recommends that the Board (i) approve issuance of the attached letter that would permit Citigroup to risk weight its Reg. T margin loans at 10 percent; and (ii) delegate to

7 See, e.g., H.R. Conf. Rep. 106-434, 106th Cong., 1st Sess., p. 159 (Nov. 2, 1999).

8 Id.

the division director of BS&R the authority to grant similar exceptions from the capital guidelines to additional BHCs that have Reg. T margin loan portfolios.

Attachment

**BOARD OF GOVERNORS**
OF THE
**FEDERAL RESERVE SYSTEM**
WASHINGTON, D.C. 20551

June 12, 2007

John C. Gerspach
Controller and Chief Accounting Officer
Citigroup Inc.
399 Park Avenue
3rd Floor
New York, NY 10022

Dear Mr. Gerspach:

This is in response to your letter dated May 17, 2007 (the "request"), with regard to the regulatory capital treatment of the Regulation T margin debits ("Reg. T margin loans") of Citigroup Inc.'s ("Citigroup") consolidated, registered U.S. broker-dealer subsidiary, Citigroup Global Markets Inc. ("CGMI"). In the request, you ask that Citigroup be granted an exception from the Board's risk-based capital adequacy guidelines for bank holding companies (the "guidelines") (12 C.F.R. part 225, App. A). The guidelines require a 100 percent risk weight for Reg. T margin loans. The request specifically asks for an exception from the guidelines that would permit Citigroup to assign a lower (such as 10 percent) risk weight to its Reg. T margin loans.

In the request, you argue that a lower risk weight for Citigroup's Reg. T margin loans would more closely align the regulatory capital requirement for such loans to the credit risk associated with such loans, given their high level of collateralization and Citigroup's low historical credit loss rates on such loans. In support of this argument, the request mentions that Citigroup's internal economic capital charge for credit risk on Reg. T margin loans is de minimis. Your request also argues that a lower risk weight for Citigroup's Reg. T margin loans would be appropriate in order to, among other things, reduce competitive disadvantages that Citigroup (through CGMI) faces relative to both U.S. broker-dealers that are not consolidated subsidiaries of bank holding companies ("BHCs"), as well as relative to non-U.S. banks and broker-dealers.

A margin account at a broker-dealer registered with the Securities and Exchange Commission ("SEC") is a leveraged account through which securities can be purchased, sold short, carried, or traded using a loan from the broker-dealer and a deposit of cash or securities by the customer. The amount of leverage available to the customer is limited by the Board's Regulation T (12 CFR part 220), the margin maintenance rule of the New York Stock Exchange (NYSE Rule 431), and the lender's internal margin maintenance requirements.[1] For example, under Regulation T, a customer who purchases $100 of equity securities in a margin account may borrow only $50 against those securities from the broker-dealer. If this is the only transaction in the margin account, the loan will be 200 percent collateralized at the time of purchase because the market value of the securities is twice that of the margin loan. If, on a daily basis, the equity in the account falls below the required NYSE margin maintenance of 25 percent – that is, if the value of the collateral falls below 133 percent of the loan – the customer is required to post additional collateral (that is, cash or securities) to eliminate the margin deficiency. If the customer does not meet the margin call within the required time, the broker-dealer must sell sufficient securities in the account to increase the account equity up to the required maintenance level. Your request also explains that Citigroup applies in most instances (and in all instances where the collateral is equities or non-investment-grade bonds) internal maintenance margin requirements that exceed those contained in NYSE Rule 431.[2]

You have indicated that Citigroup's Reg. T margin loans are typically collateralized by liquid and readily marketable securities and generally are terminable upon demand at any time by Citigroup. You also have represented that Citigroup marks to market the Reg. T margin loans and associated securities collateral on a daily basis and makes daily maintenance margin calls for any collateral deficiencies.

In addition, you have concluded that the collateral for a Reg. T margin loan generally should be available to Citigroup for prompt liquidation even in the event of the borrower's bankruptcy. In this regard, the Board notes that the Ninth Circuit Court of Appeals held in 1998 that Regulation T securities collateral is exempt from the automatic stay under the U.S. Bankruptcy Code.[3] This judicial decision was reinforced by 2005 amendments to the U.S. Bankruptcy Code. Section 901(b) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 defined the term "securities contract" – a class of transactions exempt from the automatic stay in bankruptcy – explicitly to include "margin loans." Moreover, the legislative history of the statute clarifies specifically that Congress considered Reg. T margin loans to be "margin loans" exempt from the automatic stay.[4] Therefore, if a Reg. T margin loan borrower were to file for bankruptcy, or otherwise become insolvent, Citigroup generally should be able to promptly liquidate the collateral for the loan.

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[1] If the broker-dealer is not a member of the NYSE, the margin maintenance rule of the NASD (NASD Rule 2520) generally would apply instead. Both rules impose the same leverage limitations.

[2] Regulation T initial margin requirements and NYSE margin maintenance requirements for debt securities and options differ from those applicable to equity securities.

[3] In re Weisberg, 136 F.3d 655, 659 (9th Cir. 1998).

[4] H.R. Rep. 109-31, 109th Cong., 1st Sess., p. 119 (2005).

The Board also understands that Citigroup has a long history of very low losses on Reg. T margin loans.

As noted above, Reg. T margin loans held by U.S. BHCs currently are assigned to the 100 percent risk weight category under the guidelines, resulting in a risk-based capital requirement of 8 percent. In contrast, other domestic and foreign firms, including foreign banking organizations that own U.S. broker-dealers, as well as U.S. broker-dealers and consolidated supervised entities ("CSEs") regulated by the SEC, are currently required to hold either no or de minimis regulatory capital against Reg. T margin loans. You have argued that the much higher regulatory capital requirement U.S. BHCs incur for Reg. T margin loans places U.S. broker-dealers owned by U.S. BHCs at a disadvantage in competing for this low-risk business.

After consideration of the request and subject to certain conditions listed below, the Board approves an exception to the guidelines that permits Citigroup to treat Reg. T margin loans in a manner that differs from that set forth in the guidelines. More specifically, the Board is allowing Citigroup to apply a 10 percent risk weight to its Reg. T margin loans. The Board approves this exception under the reservation of authority provision contained in the guidelines. This provision permits the Board, on a case-by-case basis, to determine the appropriate risk weight for any asset or off-balance sheet item that imposes risks on a BHC that are incommensurate with the risk weight otherwise specified in the guidelines.[5]

To qualify for the capital treatment outlined above, the Reg. T margin loans must meet the following conditions:

1. The securities collateral for the Reg. T margin loans is liquid and readily marketable;
2. The Reg. T margin loans and associated collateral are marked to market each business day;
3. The Reg. T margin loans are subject to initial margin requirements under Regulation T and daily margin maintenance requirements under NYSE Rule 431; and
4. Citigroup has a reasonable basis for concluding that it would be able to liquidate the collateral for the Reg. T margin loans without undue delay, even in the case of bankruptcy or insolvency of the borrower.

The Board believes that the capital treatment approved above for CGMI's Reg. T margin loans provides a more risk-sensitive treatment for these transactions than that set forth in the guidelines. The combination of initial margin requirements under Regulation T, ongoing margin maintenance requirements under NYSE regulations, generally higher ongoing margin maintenance requirements under Citigroup's internal policies, Citigroup's daily mark to market and margin call policies, the high liquidity of

[5] 12 C.F.R. part 225, App. A, § III.A.

the collateral, Citigroup's typical right to terminate the loan at any time, and Citigroup's protection from bankruptcy automatic stay provisions, makes these loans a low-credit-risk product that warrants a 10 percent risk weight.

The Board also notes that lowering the risk-based capital requirement for Citigroup's Reg. T margin loans is fully consistent with the intent of the Gramm-Leach-Bliley Act of 1999 ("GLBA"), which allowed for the creation of financial holding companies ("FHCs") and which greatly expanded the scope of permissible activities for BHCs that meet the criteria to become FHCs.[6] In the formulation of GLBA, Congress envisioned that the Board would, where appropriate, tailor its regulatory and supervisory framework, including risk-based capital standards, for FHCs that engage in a significant amount of securities-related activities.[7] Congress also expected the Board, to the extent feasible and consistent with safety and soundness, to make the risk-based capital requirements for BHCs that own significant broker-dealers more consistent with the capital standards applied by the SEC to broker-dealers.[8] This exception accommodates Citigroup's broker-dealer activities in a risk-sensitive manner, helps remove an artificial and anachronistic constraint on certain of Citigroup's securities-based lending operations, and brings Citigroup's risk-based capital requirement for Reg. T margin loans more in accord with the capital requirement for such loans that the SEC imposes on broker-dealers and CSEs. Citigroup should, however, be aware that the Board may in the future impose a regulatory capital treatment for Reg. T margin loans that differs from the treatment described in this letter, depending in part on the outcome of the current efforts to implement the Basel II Capital Accord in the United States.

This determination is conditioned on Citigroup's compliance with all the commitments and representations it has made in connection with the request. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the request and, as such, may be enforced in proceedings under applicable law. Further, this determination is based on the specific facts and circumstances described in the request and in your discussions with Federal Reserve staff. Any material change in those facts and circumstances or any failure by Citigroup to observe any of its commitments or representations may result in a different view or in a revocation of the regulatory capital treatment permitted under this determination.

The capital treatment set forth in this letter for Reg. T margin loans will be made available to similarly situated institutions that request and receive Board approval for such treatment.

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[6] 12 C.F.R. 225.81.

[7] See, e.g., H.R. Conf. Rep. 106-434, 106th Cong., 1st Sess., p. 159 (Nov. 2, 1999).

[8] Id.

If you have any questions with regard to this letter, please direct them to Norah Barger, Associate Director in the Division of Banking Supervision and Regulation, at (202) 452-2402, Juan C. Climent, Supervisory Financial Analyst in the Division of Banking Supervision and Regulation, at (202) 872-7526, April Snyder, Senior Attorney in the Legal Division, at (202) 452-3099, or Mark Van Der Weide, Senior Counsel in the Legal Division, at (202) 452-2263.

Sincerely yours,

Jennifer J. Johnson
Secretary of the Board