21

Citigroup Inc.
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National Bank Examiners
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Supervisory Letter 2008–05

Dear Mr. Lyons:

We welcome the opportunity to respond to Supervisory Letter 2008-05, issued by the Office of the Comptroller of the Currency ("OCC") on February 14, 2008 (the "Letter"). As you know from our recent discussions, it is a priority for Citigroup Inc. ("Citi" or the "Company") to maintain an independent and robust risk management and corporate governance infrastructure devoted to identifying, assessing, monitoring and controlling risk both within and across Citi's various businesses, products and regions.

We divide our response to the Letter into two parts. First, we address the Matters Requiring Attention and the specific recommendations identified by the OCC. We describe the steps we are taking both to respond to your concerns and, more broadly, to ensure that we have state-of-the-art risk management and governance functions. Second, we respond to certain findings and conclusions set forth in the Letter that we believe to be unfair or erroneous.

I.

CORPORATE GOVERNANCE AND RISK MANAGEMENT RECOMMENDATIONS

The Letter identifies two principal Matters Requiring Attention— "Corporate Governance and Risk Management" and "CDO Valuation and Risk Management in the Capital Markets & Banking Group." The OCC makes several specific recommendations with respect to each, including principally that the Company strengthen its risk management and corporate governance processes, enhance business

oversight controls in the Capital Markets and Banking Group, and improve its CDO valuation practices. We already have addressed or have taken steps to address many of the concerns identified by the OCC, and provide below responses to the specific recommendations set forth in the Letter.

A. Corporate Governance and Risk Management

1. ***Strengthen the company's risk management, control, and governance processes.*** (Letter at 2.)

As Vikram Pandit, the Company's Chief Executive Officer, has communicated to our Board, senior executives, shareholders and regulators, we believe that having a strong, independent risk management function is essential to the Company's long-term success. Risk management is vital not just as a control function, but also to enable our senior business managers to make informed decisions about risk and reward. We are committed to ensuring that strong risk management becomes one of our key strategic assets and one of our competitive advantages.

As described in more detail below, in the wake of the recent market dislocations that adversely affected the Company, we have undertaken numerous steps to enhance our risk management function: the Company's Chief Risk Officer is working closely with the Audit and Risk Management Committee (the "Audit Committee") on an in-depth review of the risk function; we have hired four new senior-level risk managers; we are developing new tools to monitor, aggregate and evaluate risk exposures within and across our businesses, products and regions; and we are enhancing the data we collect and the reports we use to communicate about risk with our senior executives and our Board. We are confident that these and other initiatives described below will strengthen our risk management, control and governance processes, and address the OCC's concerns.

2. ***Raise the stature of risk management in the organization. Perform a thorough, top-down, assessment of the risk management function, its roles and responsibilities, staffing levels, management competencies, and risk tools to ensure it can be effective as a control function.*** (Letter at 3.)

As noted above, Citi's Chief Executive Officer has made risk management a key strategic priority. In his recent town hall meetings in the United States, Latin America, Europe and Asia, Mr. Pandit has emphasized the critical importance of a strong, independent risk management function. To that end, Mr. Pandit has been taking affirmative steps to strengthen the risk management function, better define risk strategy and more effectively communicate about risk with employees. In February, Mr. Pandit appointed a new Chief Risk Officer, Brian Leach, who has been working closely with the Audit Committee to evaluate Citi's risk function. The Company also has added four additional senior-level risk managers. Collectively, this group brings extensive risk

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management experience that significantly enhances the depth of talent in the risk organization, as set forth below:

- Suneel Bakhshi, formerly Head of the Global Commercial Bank, Citi Markets & Banking, is now Chief Risk Officer of the Global Consumer Group, reporting to Mr. Leach. He also will be appointed Chief Risk Officer of Citibank, N.A. on March 27, 2008, in which capacity he will report to William Rhodes, Chief Executive Officer of the Bank. Mr. Bakhshi is responsible for managing risk, including market, credit and operational risks, within these entities. Mr. Bakhshi, a 25-year employee of Citibank, brings a wealth of relevant experience to this role, having held a number of high-level positions in corporate and commercial banking as well as risk treasury.

- Charles Monet is now responsible for Risk Oversight of Capital Allocation. Mr. Monet has extensive quantitative analysis experience, having served as advisor to the co-chairmen of the Basel subcommittee on regulatory capital requirements for default risk in banks' trading books, and as chairman of the subcommittee's technical working group, which prepared quantitative analyses of risk and capital issues. Previously, Mr. Monet headed Credit Risk Methodology at Morgan Stanley and Risk Methodology at JP Morgan.

- Greg Hawkins is now responsible for Risk Oversight of Real Estate and Mortgage Exposure. Previously, Dr. Hawkins was an Assistant Professor in Finance at the University of California, Berkeley, Haas School of Business. Dr. Hawkins was among the first in the fixed income markets to develop a new generation of mathematical models to value, trade and manage large relative-value portfolios, which form the basis of today's most widely used tools in fixed income.

- Adil Nathani is now responsible for Risk Oversight of Structured Credit. Mr. Nathani previously served as Managing Director, Group Executive, and as a Board Member at IXIS Capital Markets, where he also led the Asset Securitization and Finance, Credit Products, Stable Value Programs, and Structured Credit Products groups.

(*See* exhibit 1 (Citi Press Release (Feb. 27, 2008)).)

As Chief Risk Officer, Mr. Leach reports directly to the Chief Executive Officer, serves as an Executive Officer of Citigroup and as a member of the Business Heads Committee, and reports to the Audit Committee at every meeting. As described below (*see infra* Section I.A.3), Mr. Leach meets privately with the Audit Committee at each meeting, ensuring him an opportunity to raise any issues that may be of concern, without the presence of senior management.

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Working closely with Mr. Pandit, Mr. Crittenden and other members of Citi's senior management, Mr. Leach is developing strategic risk parameters to ensure that the Company focuses on those opportunities that meet appropriate risk-return and capital-allocation standards. Specifically, under Mr. Leach's direction, the Company is fine tuning its capital model and embedding that model into risk control. Going forward, Citi will consider in connection with its business/investment decisions how much capital will be at risk in stress/shock scenarios, and those stress/shock scenarios will regularly be reevaluated. Liquidity stress and sensitivity analyses will be incorporated into the Company's business and investment decisions.

As an additional element of its risk enhancement program, the Company is assessing the feasibility of developing internal capital allocation and pricing mechanisms that will encourage individual businesses to moderate activities that otherwise might lead to significant balance-sheet growth or unexpected capital reductions. This initiative, when adopted, will ensure that business lines that create contingent liquidity exposures—as identified by stress/shock testing—will be charged appropriately to reflect the cost of obtaining liquidity, or be subjected to capital reductions.

As part of the risk-enhancement initiative, the Audit Committee has instructed management to initiate an in-depth review, to be overseen by Audit Committee member Robert Ryan, the former CFO of Medtronic, to ensure that the Company has industry-leading risk management. Mr. Ryan has directed management to concentrate specifically on risk, capital and liquidity issues, with the goal of ensuring that senior management and the Board are fully apprised of these critical issues and how they impact franchise-wide risk exposure. This review also will focus on more closely aligning treasury functions with risk management processes, so that data from all businesses are considered in global-liquidity planning, including assessing actual and contingent liquidity risk. Mr. Ryan also indicated to the Audit Committee that he will request that management focus efforts on recruiting and developing talent in the Company's independent risk function. We expect this risk review will be completed by September 30, 2008, at which time Mr. Ryan and management will report the results to the Audit Committee.

As you know, the Company also maintains a centralized treasury function, which provides the Company with better visibility into its funding needs, global cash position and liquidity management. The Company is continuing its efforts to strengthen this function as it assesses its liquidity risk management processes.

The Company has a great deal of confidence in its new risk management team and approach, and believes these appointments and initiatives are responsive to the OCC's concerns and will enhance Citi's risk-management function.

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OCC3-00008496

3. ***Review the content of information provided to senior management and directors to ensure it is meaningful and relevant. It should include a strengthened and systematic discussion of sensitivity to various risk factors across business segments, compliance with limits and controls, and the evaluation of risk versus allocated capital.*** (Letter at 3.)

As discussed more fully below, we believe that the Company's Board and, in particular, its Audit Committee will continue to be well informed of risks and exposures arising out of Citi's $2.3 trillion balance sheet. In carrying out its risk-oversight mandate, the Audit Committee relies on a broad network of over 2,700 independent risk staff, with risk management committees resident in each of the Company's various business segments. The information flow to the Audit Committee focuses on those issues that business management and independent risk management believe to be significant, based on their professional judgment and various objective metrics, supplemented by reports from the Company's internal and external auditors as well as other internal and external sources.

Citi's Board and Audit Committee have remained active and engaged throughout this period of unprecedented market dislocation. (*See infra* Section II.B.) Throughout 2007, the Audit Committee has significantly increased its focus on risk issues. In addition, over the past several months, the Board has been meeting almost every other week. The Chairman of the Audit Committee, C. Michael Armstrong, has frequent meetings and calls with senior management, regulators, and internal and external auditors, and reports all material developments to the Board and the Audit Committee. And the Company is scheduling an in-depth risk tutorial for the Audit Committee on risk management issues, further underscoring the importance to Citi of risk and the new risk-management initiatives. All Board members are invited to attend such tutorials.

Citi will ensure that senior management and the Board continue to receive relevant and accurate information concerning material risks facing the Company. To this end, as noted above, the Chief Risk Officer, supported by four new and experienced senior Risk Managers, meets regularly with senior management and participates in the Business Heads Committee to enhance the flow of information.

Among other initiatives, the Company is undertaking efforts to improve its management information systems to ensure that risk management has access to a number of tools that draw on differing underlying assumptions and analytics to assess risk. The Company also is developing more dynamic risk-measurement processes and systems that permit the rapid modification of risk assumptions (particularly stress/shock assumptions) to reflect current circumstances and thus allow the risk management team and senior business management to customize forward-looking scenario analyses to address rapidly changing market conditions.

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OCC3-00008497

Mr. Leach has developed a new format for reporting to the Audit Committee and senior management. The new reporting format employs a more objective and less subjective view of the Company's largest risks, in part by emphasizing stress/shock testing scenarios. For example, the format will employ scenario stress testing to evaluate the economic impact of risk across the Company for a variety of historical and prospective stress shocks. In addition, the format will employ factor stress testing, to evaluate the impact of a variety of factors—including interest rates, credit spreads, home price appreciation, among others—on the Company's trading and banking book. Together, these stress tests will permit the Company to consider the impact specific economic scenarios might have on the Company's positions, and evaluate whether steps should be taken to reduce exposures to particular risks.

The new format also will permit Mr. Leach to report on the Company's largest credit exposures for particular types of securities, including Government, Financials and Corporate securities, as well as exposure to higher-risk counterparties. In addition, the new report will provide a value-at-risk analysis using a four-standard-deviation stress, a risk/capital analysis by business group, deeper analysis of a select group of correlated trades, and a statistical analysis of P&L volatility. By analyzing risk from a number of different perspectives, the new format will permit a more in-depth understanding of the particular risks faced by the Company at any particular time. We anticipate that the new reporting system will be in place by May 1, 2008.

In addition, senior management is expanding its universe of risk metrics to gather deeper information and apply different analytics to the same exposures. The Company is developing processes to permit better integration of various measures of market risk and counterparty risk across businesses, products and regions to enable management to obtain a comprehensive picture of the Company's exposures. We are fine-tuning our quantitative and qualitative measures of risk to obtain greater insight into, and permit more fluid communication about, rapidly evolving market conditions.

For example, and consistent with past practice, as recent market events unfolded, risk management, working closely with the businesses and finance, provided enhanced periodic updates to senior management and the Board addressing significant potential exposures across Citi arising from risk concentrations (*e.g.*, residential real estate), financial market participants (*e.g.*, monoline insurers), and other systemic issues (*e.g.*, commercial paper markets). These risk assessments are forward looking, and are intended to advise senior management and the Board about potential economic impacts to Citi that may occur as a result of various stress scenarios. These periodic updates supplement the Company's standard limit-setting and risk-capital activities and help direct risk-management and mitigation strategies. (*See* exhibit 2 at 39 (Citigroup's 2007 Form 10-K (filed Feb. 22, 2008)).)

Senior management, as it develops and refines its risk-management programs and initiatives, will collaborate with the Board and Audit Committee at every step. We have every confidence that the Company's new senior management team and

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OCC3-00008498

Board possess the experience, expertise and commitment to navigate the Company through these difficult times and ensure that the Company's risk-management function is state of the art in all respects. Indeed, as recent events developed, we believe the Company already has demonstrated an ability to respond rapidly and to generate enhanced information.

4. ***Evaluate Citibank, N.A. Board process to ensure it incorporates a full discussion and evaluation of risk implications of globally run businesses on Citibank, N.A.*** (Letter at 4.)

As explained below (*see infra* Section II.B), while the Company is proud of its Board processes—both at the parent level and at the bank level—it is reviewing the manner in which information that is shared with the parent Board and Audit Committee is shared with the Citibank Board. Audit and financial results have long been reported to the Citibank Board, and this practice will continue. In a new initiative intended to improve communication with the Bank's directors, Citibank, N.A. now will have a dedicated Chief Risk Officer, who will report to the Citibank Board at every regular meeting, starting with the meeting on March 27, 2008. While Citi's Chief Risk Officer previously served as the senior risk officer for Citibank, and regularly provided risk reports to the Citibank Board, we believe that the appointment of Mr. Bakhshi to serve in this role will improve the quality of the reports provided and ensure better communication concerning significant risk issues. In addition, going forward, the Company intends to invite an outside director of the Citigroup Board to attend each Citibank Board meeting. The Company is committed to improving firm-wide communication concerning risks that may present themselves across a variety of businesses, products and regions.

B. CDO Valuation and Risk Management in the Capital Markets & Banking Group

1. ***Strengthen Business Oversight Controls in the Capital Markets & Banking Group.*** (Letter at 4.)

As described above, the Company is pursuing a number of initiatives to strengthen its independent risk function. As described below, the Company also is pursuing a number of improvements specifically within the Capital Markets and Banking group related to valuation issues, particularly in times of market stress and illiquidity.

2. ***Ensure that independent risk management has complete authority and/or executes its responsibility to restrain businesses when appropriate.*** (Letter at 4.)

We are confident that the new initiatives outlined above will ensure that independent risk management has the necessary authority, independence and expertise to identify, assess, monitor and control the Company's risk across Citi's businesses, products and regions. As Chief Executive Officer Vikram Pandit recently reaffirmed in a

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memorandum to all employees, "Risk is not only an essential part of our control infrastructure; it is a crucial component of how we make money. In our business, we cannot avoid risk—we must constantly make sensible, informed decisions balancing risk and reward. Independent Risk Management plays a vital role in that process." (*See* exhibit 3 (Memorandum from Vikram Pandit to All Employees (Jan. 23, 2008)).)

3. Eliminate inconsistencies across business units. (Letter at 4.)

The Company has modified its risk processes to strengthen its firm-wide perspective on risk, which takes into account risk aggregation and the evolving risks of new markets and new products. To this end, as noted above, Mr. Leach and the Audit Committee, as part of an initiative led by Mr. Ryan, are actively developing processes to ensure a firm-wide perspective with respect to the Company's balance sheet, liquidity and capital positions.

Thus, going forward, under the direction of the Chief Risk Officer, the risk function will reside not in one dimension but in three: in business sectors (Institutional Clients Group, Global Wealth Management and Consumer); in products (*e.g.*, U.S. Residential Mortgage); and in regions—with each risk unit having its own matrix that ties to other risk unit matrices. By way of illustration, the Company announced in January the formation of an end-to-end U.S. residential mortgage business, which includes origination, servicing, and capital markets securitization under one senior manager. This structure ensures a comprehensive view of the mortgage business across the firm and enhances risk management and consistency across disparate business units.

4. Consistently apply risk limits and ensure risk aggregation is effective. (Letter at 5.)

As described above, the Company is developing procedures designed to enhance consistency in the creation and application of risk limits, so as to permit a Company-wide perspective on risks that may affect different business units and different operations. To this end, as discussed above, the new Chief Risk Officer recently announced the enhancement and expansion of a franchise-wide risk management matrix established in the fourth quarter of 2007. (*See* exhibit 4 (Minutes of Citigroup Audit and Risk Management Committee (Dec. 11, 2007)).) The enhancements will permit the Company to apply a more standardized stress test across the Company's risk exposures. The enhanced matrix will permit the Company to strengthen its ability to monitor and control major risk exposures and concentrations across the Company.

5. Control product expansion and evolution across trading desks. (Letter at 5.)

Through initiatives such as the risk management matrix and franchise-wide risk updates, the Company is actively reviewing and evaluating exposures and risk limits related to particular strategies and products across all desks that engage in related activities.

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OCC3-00008500

6. *Strengthen CDO valuation processes and practices.* (Letter at 5.)

The Company is fine tuning its practices with respect to the valuation of complex or potentially illiquid securities, and has enhanced its extensive in-house expertise to assess the credit quality of assets underlying such complex securities. Among other steps, the Company is evaluating whether and to what extent collateral-based approaches may be appropriate to value subprime exposures. In addition, the Company is working to obtain Level 2 validation of the DCF model. We expect this will be achieved by late April.

7. *Factor in collateral-based valuation results into the overall valuation process.* (Letter at 5.)

As described in greater detail below, and as noted by the OCC in its Letter, "events during the year produced tremendous pressure on the business to deploy a new valuation model on short notice." (Letter at 6.) To respond to the market crisis, the Company has developed valuation models that provide reasonable means of valuing its illiquid exposures in a market where there are no or very few observables to use as valuation touchstones. As part of that process, the Company has explored using a variety of approaches and methods, including collateral-based valuation methods.

Although in past periods the Company has determined that employing a strictly collateral-based approach to value its super-senior positions would not be appropriate, the Company has continued to explore the extent to which such an approach may inform its efforts to value its illiquid positions. The Company will proceed in this manner as it accurately marks all of its positions, including its Level 3 inventory.

8. *Fully engage all control groups.* (Letter at 6.)

Each control group plays a defined and distinct role, while working together to ensure a complete and robust valuation process. Citi's independent control groups, including audit, risk and compliance, will continue to review various valuation processes and methodologies, with the objective of developing the most rigorous and reliable methods available for valuing the Company's Level 3 inventory, including its super-senior CDO positions.

9. *Improve Discounted Cash Flow (DCF) model controls and transparency.* (Letter at 6.)

The Company's business, product control, risk and model valuation teams are working together to obtain Level 2 validation of the current DCF model. That model is part of a broader mortgage-prepayment model that the Company has used for more than a decade. During that time, the prepayment model—which itself is a suite of over fifty individual models, each corresponding to a distinct type of mortgage loan—has withstood multiple economic and market cycles, having been adjusted over time as new data become available or market conditions change. In response to market changes and

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OCC3-00008501

the proliferation of mortgage-backed securities, the Company began to develop new models, including the default and loss-severity models, in mid-2006. This combination of models—both old and new—collectively is referred to as the Default model.

The Default model was completed in December 2007 and used for the Company's fourth-quarter valuation, replacing the empirical model used for the third quarter. While the Company believes its third-quarter valuations were reasonable, it moved to the Default model as part of a continuing effort to enhance its valuation processes.

We enclose a memorandum by the model developer that addresses certain attributes of the model, its testing and the control environment in which it is maintained. (*See* exhibit 5 (Memorandum regarding the Mortgage Default and Loss Severity models (Mar. 17, 2008)).) Notably, with respect to documentation, the Company's Analytics and Infrastructure team has established a central directory to store and maintain all documents relating to the formulation, development and testing of these models. Within the central directory, subdirectories have been created for different loan types (*e.g.*, agency, subprime), model types (*e.g.*, prepayment, default, loss severity) and model versions. Likewise, other aspects of the model are being placed in a controlled environment. The Company will continue its efforts to validate these models, and to maintain them within a controlled environment.

* * * * *

It is a critical priority for the Company to strengthen its independent risk and control functions so that it can identify, assess, monitor and control risk across Citi's various businesses, products and regions. As noted, the Company already has taken steps to address the concerns you have identified in the Letter, but we welcome the opportunity to discuss our risk initiatives further and to hear whatever additional thoughts you may have with respect to particular risk enhancements. The Company will keep you fully apprised of our progress in each of the areas outlined above, and appreciates your assistance.

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II.

RESPONSE TO OCC FINDINGS AND CONCLUSIONS

Indisputably, there are lessons to be learned from the events of this past year, and our desire to improve our performance, including our risk-management function, is reflected in the steps we already have taken and our readiness to implement the specific recommendations you suggest.

With great respect, however, there are a number of findings or conclusory statements in the Letter that are simply incorrect. The Company made available to the OCC a large number of documents as well as board minutes and related materials that contradict many of the Letter's findings. The OCC also failed to speak to many key Citi personnel with knowledge of the relevant issues, who we believe would have offered additional information and details to correct many of the errors in the Letter. Finally, the Letter's criticisms appear premised on the Company's failure to anticipate market events that were both unprecedented and, we believe, unforeseeable and unforeseen both by financial institutions and regulators.

A. Unfairness in the OCC's Approach

Before addressing certain of the Letter's factual errors, we wish to describe at the outset why the Company believes that the Letter applies 20/20 hindsight in a manner that is unfair.

Specifically:

1. ***The Letter fails to acknowledge the unprecedented and unforeseeable nature of the market events that led to the Company's write-downs—events that surprised both market participants and market regulators, including, specifically, the OCC.***

As with many of its peers, the bulk of the Company's recent write-downs were taken in connection with its super-senior CDO positions—CDO tranches ranking above tranches rated AAA. These positions were widely considered as the least risky. That market reality notwithstanding, the Letter concludes that "[r]isk was insufficiently evaluated" by the Company throughout 2007, and that "[o]ver-reliance was placed on credit rating agency ratings without considering the appropriateness of these ratings to specific products or the true risk of the underlying collateral." (Letter at 2.)

It is unfair, we submit, to suggest that the Company should have anticipated the rapid and unprecedented ratings deterioration of subprime-backed mortgage securities and the corresponding deterioration of the accounting valuation of super-senior CDO tranches. For one thing, many market participants did not anticipate this cataclysmic market collapse. Nor did the Federal Reserve or the OCC, or any other regulator of which we are aware.

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For example:

Statements by Market Participants

- In October 2007, Tom Wurtz (CFO, Wachovia), describing write-downs associated with Wachovia's super-senior exposure, stated that "**we never would have expected that you would see AAA securities trade so far, so quickly from par.**"[1]

- In early November 2007, Colin Kelleher (CFO, Morgan Stanley) called the collapse of super seniors so extreme that "**no stress model in the world would ever have had it.**"[2] In fact, Morgan Stanley believed that the super seniors were so safe that the firm used a $14 billion long position in super-senior and mezzanine securities to hedge and finance its $2 billion short position in lower-rated subprime securities. The short was successful, but was overwhelmed by unanticipated losses on the "safe" super-senior position.[3]

- In December 2007, Marcel Ospel (CEO, UBS) reported that "[I]n spite of [UBS's] conservative appetite for risk, the current credit market has hurt us. . . . It's no comfort that UBS is not alone in losing money as a result of the falling value of fixed income securities that almost everyone in the financial industry had come to believe carried almost no risk of default. . . . **Th[ere] has never in financial history been an AAA rated bond that fell so far, so fast.**"[4]

Statements by Market Regulators

- Federal Reserve Vice Chairman Donald Kohn, testifying before the U.S. Senate Committee on Banking, Housing, and Urban Affairs on March 4, 2008, acknowledged that the Fed did not foresee the risks underlying the recent market dislocations, stating, "**I don't know that we fully appreciated all the risks out there. I'm not sure anybody did, to be perfectly honest.**"

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[1] *See* exhibit 6 (WB – Q3 2007 Wachovia Corporation Earnings Conference Call Final Transcript (Oct. 19, 2007)).

[2] *See* exhibit 7 (David Wighton, *Morgan Stanley Peers through Looking Glass*, FINANCIAL TIMES (Nov. 8, 2007)).

[3] *See* exhibit 8 (MS-Morgan Stanley Q4 2007 Earnings Call Transcript (Dec. 19, 2007)).

[4] *See* exhibit 9 (UBS Business Update Call, Bloomberg Transcript (Dec. 11, 2007)).

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OCC3-00008504

- Mr. Kohn further stated: "We probably didn't end up recognizing [the risk] to the extent it ended up existing. These were very unusual events . . . there are no excuses here, but **I think it would've been hard to see a year ago where we are today**. But it doesn't mean that both the Federal Reserve and the institutions that regulate shouldn't have been taking steps to ensure against the **remote possibility** of a very adverse event and it's very obvious we didn't."[5]

- Likewise, Comptroller of the Currency John C. Dugan, in remarks to the Global Association of Risk Professionals on February 27, 2008, described super-senior tranches of CDOs backed by subprime mortgages as "the least risky parts of the subprime securities pyramid."

- Mr. Dugan further acknowledged that "regulated firms . . . thought they had conservatively purchased 'safe' securities." And Mr. Dugan recognized that **"all market participants made [the] mistake" of "grossly underestimating the risk of super-senior tranches of ABS CDOs**."[6] This statement is consistent with the OCC's interactions with the Company throughout the relevant period: notwithstanding the fact that Citi senior management, including its Chief Risk Officer, met with OCC personnel frequently, the OCC did not inquire as to the Company's subprime or CDO exposures until late this past fall.

- On March 6, 2008, the Senior Supervisors Group—an international group of senior financial supervisors, including the OCC—issued a report acknowledging that supervisory oversight had proved ineffective during the recent market crises. Among other things, the report acknowledges the specific need to "strengthen the efficacy and robustness of the Basel II capital framework by . . . ensuring that the framework sets sufficiently high standards for . . . increase[d] capital charges for certain securitized assets and ABCP liquidity facilities . . . ."[7]

The Company, as noted, readily acknowledges that it should attempt to learn from recent market events, and do better going forward. Our acceptance of the OCC's recommendations reflects our desire to improve. But Citi's failure to anticipate the sudden and unforeseeable market collapse—a failure we shared with virtually every

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5 *See* exhibit 10 (The State of the Banking Industry, Hearing before U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 4, 2008)).

6 *See* exhibit 11 (Remarks of John C. Dugan before the Global Association of Risk Professionals (Feb. 28, 2008)).

7 *See* exhibit 12 at 6 (Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence (Mar. 6, 2008)).

Confidential & Non-public OCC Information OCC3-00008505

market participant and regulator—does not mean, as the Letter suggests, that the risks associated with our subprime exposures were not closely and appropriately monitored by risk management.

2. ***The Letter's conclusion that the Company's risk management and control functions were ineffective simply because the Company incurred significant losses reflects a failure to appreciate that business decisions made knowingly and carefully may sometimes prove unsuccessful.***

A basic premise of the Letter seems to be that because the Company took large write-downs in connection with its holdings of super-senior rated tranches of CDOs, as well as other exposures, risk management must have been ineffective. Citi, like all financial institutions and other business enterprises, places a "strong emphasis on generating income" and "achieving top industry rankings." (Letter at 4.) It goes without saying that generating income in the financial world carries with it risk exposure. The key, of course, is balancing risk and reward. As part of this process, senior management and risk personnel, among others, work together to consider available information in an effort to make informed and reasoned decisions about how best to balance risk against reward.

Prior to the market dislocations, the Company made a number of strategic decisions to grow certain aspects of its business. Specifically, with the knowledge of risk and the involvement of the Company's control groups, the Company determined to grow its high-margin structured-finance business as well as its leveraged-lending business.

With the benefit of hindsight, it is easy to characterize these decisions as mistakes. That, however, does not fairly lead to the conclusion that the Company's risk and other control functions failed. At the time these strategic decisions were made, management considered the relevant risks, and determined that, given the conditions in the market and the Company's mix of business strategies, the risks were outweighed by the potential for growth in these areas. With respect specifically to the Company's structured-finance business and its increased activity in originating CDOs, the business, in conjunction with risk, assessed the risks associated with retaining super-senior CDO tranches and determined those risks to be minimal. This was a reasonable conclusion based not just on the better-than AAA ratings assigned to these positions, but also the significant subordination below the super-senior tranches as well as the waterfall provisions, which typically protected the super seniors.

Notably, as the Company expanded its activities in these areas, the safety and soundness of Citibank, N.A. were never in jeopardy. Throughout 2007, as a result of the strength of the Company's business and risk management and its franchise-wide commitment to maintaining the fiscal health of Citibank, the Company protected Citibank by downstreaming capital to ensure that the bank's capital ratios at all times remained above the levels established in Citibank's capital plan. (*See* exhibits 13 (Memorandum

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OCC3-00008506

from Robin Stuart to Gary Crittenden and Firoz B. Tarapore (Mar. 28, 2007)); 14 (Memorandum from Gregory C. Ehlke to Gary Crittenden and Firoz B. Tarapore (June 26, 2007)); 15 (Memorandum from Gregory C. Ehlke to Gary Crittenden and Zion Shohet (Sept. 25, 2007)); and 16 (Memorandum from Gregory C. Ehlke to Gary Crittenden and Zion Shohet (Dec. 26, 2007)).)

The OCC has broadly criticized the Company's overall risk structure, without reference to specific decisions to expand certain businesses and without reference to how those decisions played out in the current credit crises. These specific strategies and the risk considerations that were made with respect to each, however, should be assessed on their own terms. The business and risk considerations that led to an expansion of the Company's leveraged-lending operations played out separately from the business and risk considerations that led to the expansion of the Company's structured-finance activities. These are distinct businesses that faced distinct issues as the unprecedented market events of 2007 unfolded—and with respect to each, the Company undertook its best efforts to balance the potential for risk and reward, and manage those decisions as the market evolved. With all respect, it is unfair to group these and other activities together that have had adverse financial results as a basis to conclude that the Company's risk management function must have been broken.

3. ***The OCC fails to acknowledge the fact that the Company's super-senior CDO write-downs are accounting driven (based on FAS 157)—and the actual losses on these assets, if any, will not be known for years.***

Application of market-value accounting under FAS 157 to the valuation of super-senior CDO assets has led to tens of billions of dollars in accounting-driven write-downs, not just at Citi, but throughout the financial system. While we do not contend that there will be no losses, the actual losses on the super-senior positions will not be known until the market returns to normal, or the instruments mature in accordance with their terms. In fact, Standard & Poor's recently confirmed that "the magnitude of some write-downs [of subprime securities] is greater than any reasonable estimate of ultimate losses." (*See* exhibit 17 (Standard & Poor's, More Subprime Write-Downs to Come, But the End Is Now in Sight for Large Financial Institutions (Mar. 13, 2008)).) As noted, we are continuing our efforts to improve our valuation process for these positions, as the market continues to evolve.

* * * * *

We analyze below a number of specific errors in the Letter concerning Citi's Board of Directors (Part B), Risk Management and Business Activities (Part C), and Valuation Methodologies (Part D):

Confidential & Non-public OCC Information OCC3-00008507

B. Board-Related Matters

1. ***The Board and senior management have not ensured an effective and independent risk management process is in place.*** (Letter at 2.)

The Letter criticizes the Board and the Audit Committee, in particular, for failing to ensure the existence of an effective risk-oversight function. (Letter at 2.) This criticism is misplaced. Most important, as described above, it is unfair to conclude after the fact that the Company did not have effective and independent risk management simply because certain of the Company's strategic business plans resulted in significant losses as a result of the unanticipated and unprecedented market crises.

First, as already noted, Citi has structured its risk management function to ensure its independence. Independent risk is comprised of over 2,700 highly qualified and experienced staff members. Risk management reports independently up to the Chief Risk Officer, who in turn reports directly to the Company's CEO. Compensation for our independent risk professionals also is determined independent of the business. These structural features help ensure that risk is not beholden to the business. Notably, in the reports of examination for the year ended December 31, 2006, provided to senior management and signed by each of the directors, the Fed and the OCC rated all components of risk management satisfactory. In fact, the Fed noted that the "Board and senior management are actively engaged in decisions regarding how best to measure, monitor and mitigate risks." (Exhibit 18 at 1 (Federal Reserve Bank of New York, Summary of Supervisory Activity and Findings (period ending Dec. 31, 2006)).) Similarly, the OCC recently concluded that management of Citibank, N.A. is satisfactory and that "significant progress was made in 2006 to strengthen controls and repair the company's reputation." (Exhibit 19 (OCC Report of Examination (Apr. 5, 2007)).)

Second, as detailed below, the record demonstrates that, over the course of 2007, as major market events occurred, senior management and independent risk evaluated the Company's risks and exposures, and elevated issues when they thought appropriate to the Board and the Audit Committee.

We summarize below the industry-leading quality of Citi's Audit Committee and Board, as well as the active role played by directors with respect to risk oversight generally and the Company's subprime exposures in particular.

Thus:

- The Audit Committee consists of seven independent outside directors of Citigroup, each with a variety of experience and each a financial expert within the meaning of Sarbanes-Oxley and its implementing regulations. The Chairman is a former CEO of several major companies; three other members are sitting CEOs, one of whom served as CFO of his company before becoming CEO; one is an academic with extensive Audit

Committee experience; one is President of the Rockefeller Foundation; and one is the former CFO of Medtronic.

- The Audit Committee has two subcommittees, one for institutional businesses and one for consumer-facing businesses. Subcommittee meetings include business managers and the relevant chief risk officers, chief financial officers, internal auditors and other control function executives, as well as representatives of Citi's outside independent auditors who cover those businesses. We believe that these long-standing subcommittees are unique to Citi, and a best practice that allows independent directors to focus on the specific risk factors for each of the institutional and consumer-facing businesses.

- The full Audit Committee meets at least seven times a year to review financial information, confer with inside and outside auditors, and review risk issues. The full Audit Committee meets four additional times a year to review Citi's quarterly financial filings. In total, the Audit Committee met twelve times, and an additional six Subcommittee meetings were held, during 2007.

- Prior to each regular Audit Committee meeting, Citi's Chief Risk Officer sends a detailed written Risk and Compliance Update to the Audit Committee, and at the meeting the Chief Risk Officer reviews that report with the Committee. The same report also is provided to the full Board. In addition, the Audit Committee meets privately (without management present) with the Chief Risk Officer at each meeting to ensure that the Chief Risk Officer can freely share any concerns or problems with the Audit Committee. (*See*, *e.g.*, exhibit 20 (Risk and Compliance Updates to Audit Committee (Apr. 16, 2007)).)

- Prior to each Subcommittee meeting, the Chief Risk Officer covering the business sends a detailed written Risk Management Update to the Subcommittee, and reviews that report at the Subcommittee meeting. (*See* exhibits 21 (Risk Management Review (Jan. 16, 2007)); 22 (Risk Management Review (Apr. 16, 2007)); 23 (Risk Management Review (Oct. 15, 2007)); 24 (Global Consumer Group Risk Management Update (Jan. 16, 2007)); 25 (Global Wealth Management Risk Management Update (Apr. 16, 2007)); 26 (Global Wealth Management Risk Management Update (Oct. 15, 2007)); and 27 (Global Consumer Group 3Q07 Risk Management Update (Oct. 17, 2007)).)

- At each regular Audit Committee meeting, the Chief Auditor and outside independent auditors meet privately with Audit Committee members as well as presenting written and oral reports. The Chief Auditor reports

Confidential & Non-public OCC Information

directly to the Chairman of the Audit Committee, rather than to anyone in management.

- Audit Committee members also conduct site visits to learn more about the businesses. We believe that the frequency of site visits conducted by Citi's Audit Committee is a leading practice among peers. During 2007, the Chairman of the Audit Committee and the Chairman of the Subcommittee covering institutional businesses conducted three site visits with executives of our Capital Markets and Banking sector to discuss developments in structured finance, leveraged lending, and related matters.

- The Audit Committee also conducts tutorials, which provide an opportunity for Committee members to dive deeply into important topics. All of the Company's directors are invited to attend, and the sessions typically last two to three hours, or more. Tutorials have covered such topics as the Company's litigation exposure, derivatives and acquisition integration. Looking forward, the Audit Committee has scheduled a tutorial on Citi's new risk initiatives.

- The Audit Committee has driven important initiatives to improve controls. For example, the Committee has focused on improving controls over derivative financial instruments for several years. In fact, we believe the Committee's focus on trade confirmation issues helped to drive industry-wide resolution of issues related to confirmations. Since 2005, the Subcommittee covering Citi's institutional businesses has received quarterly briefings from business managers, internal audit, and control functions regarding complex derivative businesses. In 2006, private briefings were held with the Audit Committee Chair and the Subcommittee chairs to provide more extensive information regarding the challenges of complex derivative instruments.

- The Audit Committee is by no means a passive recipient of information. Our records show that in 2007 there were close to 100 separate follow-up items that stemmed from Committee instructions to management, on items ranging from the provision of additional peer data, to further analyses of ALLL, to audit cycles, to enterprise risk management, and to the tracking of regulatory issues. (*See* exhibit 28 (2007 Follow-Up Items and Call Logs).)

- The Audit Committee has been extremely active in driving improvements in controls and culture at Citi, particularly through the use of Risk and Control Self-Assessments ("RCSA") for all businesses and functions. In 2004, the Audit Committee initiated a requirement that each business's RCSAs be audited by our independent internal audit function and the

Confidential & Non-public OCC Information

results reported to the Committee quarterly. Steady improvement in RCSA ratings has been achieved; in 2007, the Audit Committee set a target of 90% effective RCSA ratings for all businesses. Progress was monitored quarterly, and the target was reached as of December 31, 2007.

Specifically with respect to the subprime market, the Audit Committee was kept apprised of developments and took a number of affirmative steps, including, by way of example, the following:

- Citi has long been a major participant in the subprime mortgage business, and that business has performed quite well over time. Citi decided several years ago that it would not originate so-called "exotic" subprime mortgages—particularly interest-only and negative-amortization mortgages—in its Consumer sector, notwithstanding the expected growth and high returns available from these loans. Citi continued—and continues today—to provide mortgage financing in other parts of the subprime market.

- As part of its risk-oversight function, the Audit Committee reviewed and supported this decision not to originate "exotic" subprime mortgages. This decision ultimately was beneficial to the Company, even though the Company was criticized at the time for slow growth in its mortgage business.

- At the end of February 2007, the Audit Committee Chairman expressed to management a concern about possible forthcoming credit weakness. Specifically, Mr. Armstrong e-mailed Bonnie Howard, head of Citi's internal audit, asking how the Audit Committee appropriately should evaluate indications by press, analysts, and regulators that credit weaknesses might challenge bank reserves and impact earnings. (*See* exhibit 29 (E-mail from C. Michael Armstrong to Bonnie Howard (Feb. 28, 2007)).) At the next Audit Committee meeting, in March 2007, management provided a briefing on subprime exposures in both the Consumer and Corporate business and followed up with another presentation on subprime exposure in April 2007.

In the future, we should request correspondence between directors & mgmt (except for personnel)

- As described in greater detail below (*see infra* Sections II.B.2 and II.C.2), during 2006 and 2007, business management and independent risk management reviewed and presented the Audit Committee with information about risks in the Company's mortgage-related activities. Subprime exposures in the securitization and structuring business that management considered significant, such as direct exposures to subprime-mortgage originators, were significantly reduced prior to the credit crisis, at little loss to Citi, and this was reported to the Audit Committee. As 2007 progressed, the Committee arranged to receive near-monthly reports

concerning the deterioration in the subprime-housing market from the Chief Risk Officer. (*See* exhibits 30 (Risk and Compliance Update: Sub-Prime Mortgages (Mar. 19, 2007)); 31 (Risk and Compliance Update: Non-Prime and Sub-Prime Exposures (Apr. 16, 2007)); and 32 (Risk and Compliance Update: Non-Prime and Sub-Prime Exposures (July 26, 2007)).)

Of course, not every exposure or position, simply by dint of its size, is "material" in terms of the risks it poses. The Company manages a $2.3 trillion balance sheet. The Audit Committee and the Board cannot possibly be informed of every large position. Accordingly, as reflected above, management and independent risk focus their reports to the Audit Committee and the Board on those issues that business and risk believe are significant based on their experienced professional judgment, supplemented by reports from the Company's internal and external auditors as well as other internal and external sources (*e.g.*, analyst and regulatory reports). Nonetheless, as noted, the Company is undertaking efforts to improve its information reporting systems, including the manner in which information is reported to the Audit Committee and the Company's Board, as well as to the Citibank Board.

2. ***We found no direct evidence that directors challenged management's statements regarding the risk of subprime exposure to the bank.*** (Letter at 3.)

The Board and members of the Audit Committee engaged in an active dialogue with management throughout 2007 regarding developments in credit markets, leveraged lending and subprime mortgages. As events progressed in 2007, at the request of the Board, management evaluated and quantified its exposures to subprime mortgages—and discussed those exposures with the Board. As part of these discussions, Board and Audit Committee members routinely inquired as to the Company's exposures in these areas.

The most effective "challenges" of management by directors typically occur face to face, and are not necessarily found in file memos, minutes or Board or Audit Committee materials—though, as detailed below, a review of such materials provides numerous examples of an active dialogue with management. In fact, Mr. Armstrong told the OCC about instances where he had directly challenged management—a fact not mentioned in the Letter.

The Company's Board and Audit Committee minutes and related materials, which were provided to the OCC, detail numerous instances where risk and business management raised relevant issues, directors pressed risk and business management, and these groups together engaged in active discussions concerning risks and evolving market conditions.

Confidential & Non-public OCC Information

For example:

- On December 11, 2006, as part of a required, regular report to the Audit Committee on Special Purpose Entities, Hans Morris, then-Chief Financial Officer of the Corporate and Investment Bank, addressed CDO transactions, describing them as "[l]ow risk" and stating that Citi's "retained interests tend to be AAA." (Exhibit 33 (Special Purpose Entities – Corporate and Investment Banking Update (Dec. 11, 2006)).)

- On January 16, 2007, Mr. Bushnell provided the Board with an overview of developments in structured credit products, such as synthetic CDOs with cash-flow waterfalls and leveraged super-senior swaps. (*See* exhibit 34 (Citigroup Board of Directors Risk Overview (Jan. 16, 2007)).) The next day, Lewis Alexander, Citigroup's chief economist, addressed the Board and advised that he saw the housing decline as reaching its bottom. (*See* exhibit 35 (Minutes of Citigroup Inc. Board of Directors (Jan. 17, 2007)).)

- Also on January 16, 2007, in response to a request from the Consumer Subcommittee, Steven Freiberg addressed the quality of Citi's own loan portfolio and potential exposure to the weakening housing market. (*See* exhibit 36 (Consumer Lending Group: Real Estate Update (Jan. 16, 2007)).)

- On January 17, 2007, following discussion and debate, directors approved Citi's proposed acquisition of ABN AMRO Bank's U.S. residential-mortgage business. (*See* exhibit 35 (Minutes of Citigroup Inc. Board of Directors (Jan. 17, 2007)).)

- At the end of February 2007, Mr. Armstrong requested that the Audit Committee be presented information on Citi's subprime-related exposures; in response, on March 19, 2007, Mr. Bushnell provided the Audit Committee with a briefing concerning the Company's exposures to subprime mortgages through consumer lending, securitizations, and extensions of credit to originators. (*See* exhibit 30 (Risk and Compliance Update: Sub-Prime Mortgages (Mar. 19, 2007)).). In addition, prior to the March 19 subprime briefing, Mr. Armstrong requested specific information regarding the impact of Citi's subprime holdings on the Company's portfolio and reserves. (*See* exhibit 37 (E-mail from C. Michael Armstrong to Bonnie Howard (Mar. 18, 2007)).)

- On April 16, 2007, Mr. Bushnell followed up on his March 19 report to the Audit Committee and was pressed at the Board meeting about Citi's subprime portfolio. (*See* exhibit 31 (Risk and Compliance Update: Non-Prime and Sub-Prime Exposures (Apr. 16, 2007)).) Directors specifically

Confidential & Non-public OCC Information

asked Mr. Bushnell about potential subprime contagion on Citi's other business activities.

- On July 26, 2007, Mr. Bushnell again updated the Audit Committee on Citi's subprime and other credit exposures. Audit Committee members discussed with Mr. Bushnell the subprime impact within Citi Markets and Banking and the projected future impact both on that business and on other businesses within Citi. (*See* exhibit 32 (Risk and Compliance Update: Non-Prime and Sub-Prime Exposures (July 26, 2007)).).

- Also during the July 26 meeting, Mr. Armstrong questioned whether management's second-half forecast was achievable in light of current market conditions. Specifically, Mr. Armstrong inquired about the Company's loan loss reserves and rapid build up of leveraged loans, among other issues, and suggesting that the Company consider instituting a hiring freeze, re-evaluating the second-half budget, and adopting other measures to control costs. In response, management noted the strength of the Company's distribution model in the leveraged lending area—the area that, at that time, appeared to face vulnerabilities, given the tightening of credit markets. More generally, management assured the Audit Committee that it was monitoring developments in the credit and subprime markets, and was positioned to handle potential adverse market developments in the second half of 2007.

- On September 17, 2007, Board members received a tutorial from Gary Crittenden on the relationship between subprime mortgages and various aspects of Citi's business, including CDOs and SIVs. (*See* exhibit 38 (Review of the Current Environment (Sept. 17, 2007)).)

- Also on September 17, 2007, Mr. Bushnell presented the Audit Committee with a risk tutorial on Allowance for Credit Losses, during which he described the assignment of risk ratings, expected loss calculations, the role of Citi historical data, the management adjustment process, and enhancements in the methodologies that management plans to adopt in response to regulatory concerns. (*See* exhibit 39 (Allowance for Credit Losses Tutorial Presentation (Sept. 17, 2007)).)

- More generally, the Board regularly received written and oral updates on the economy and housing markets from Citi's chief economist, Lew Alexander, to ensure that it was apprised of overarching market trends. (*See* exhibits 40 (Lewis Alexander, Economic & Market Analysis, Prospects for Financial Markets (Nov. 22, 2006)); 41 (Lewis Alexander, Economic & Market Analysis, Economics/Strategy (Mar. 1, 2007)); 42 (Resurgence of Volatility (Mar. 2007)); and 43 (Lewis Alexander, Economic & Market Analysis, Citi Markets and Banking (Oct. 2007)); *see*

also exhibits 35 (Minutes of Citigroup Inc. Board of Directors (Jan. 17, 2007)); 44 (Minutes of Citigroup Inc. Board of Directors (Mar. 19, 2007)); and 45 (Minutes of Citigroup Inc. Board of Directors (Oct. 15, 2007)).)

3. ***Directors are not routinely provided peer information, so the extent to which they were aware of Citigroup's relative capital position is unclear.*** (Letter at 3.)

The Company's directors routinely are provided with detailed peer information, including specifically information concerning the Company's relative capital position.

For instance:

- On a monthly basis, the Board receives an Investor Relations Newsletter, which includes peer data on price-earnings ratios and implied-growth rates. (*See* exhibit 46 (Investor Relations Newsletters (2007)).)
- Earnings reviews presented to the Board include peer information, such as comparative total stock return, payout and dividend yield, dividend changes, and valuation. (*See* exhibit 47 (4Q06 Earnings Review (Jan. 16, 2007)).)
- In a March 19, 2007 presentation, the Audit Committee was provided with a competitor comparison of loan loss reserve trends, which reflected that "[t]he Citi trend and overall level in 'Loan Loss Reserve as a % of Total Loans' is consistent with that of other large banks/bank holding companies." (*See* exhibit 48 at 4 (Risk and Compliance Update: Loan Loss Reserve Trends (Mar. 19, 2007)).)
- At a July 2007 Strategy Offsite, the Board discussed Citi's shareholder return and strategic steps that could be taken to enhance market value. The Board focused on comparative peer information, including data reflecting the return above cost of capital and the price-to-book ratio of the largest financial services companies. (*See* exhibit 49 (Drivers of Value Memo).)
- During a September 17, 2007 Audit Committee tutorial, the Audit Committee was provided with peer information showing that "Citi's credit reserve-to-loans ratio is comparable to its competitors." (*See* exhibit 39 (Allowance for Credit Losses Tutorial Presentation (Sept. 17, 2007)).)
- In an October 15, 2007 presentation, the Corporate Audit and Risk Management Subcommittee was provided with peer comparative data reflecting holdings of Level 3 inventory. (*See* exhibit 50 (CMB – Unverified Inventory (Oct. 15, 2007)).)

Confidential & Non-public OCC Information

OCC3-00008515

- Also on October 15, 2007, the Board received a "Credit and Markets Discussion" presentation, which included a summary of how Citi's losses compared to those of its competitors. Peer data presented included, among other metrics, EPS growth (comparing Q307 vs. Q306), third-quarter operating income losses, and historic consumer cost of credit versus that of Citi's competitors. (*See* exhibit 51 (Credit and Markets Discussion (Oct. 15, 2007)).)

- On October 31, 2007, the Board received a presentation that discussed the October market dislocations. This presentation discussed Merrill Lynch's CDO and subprime-related write-downs and its super-senior valuation methodology, and data reflecting issuance of ABS CDOs by major market participants. (*See* exhibit 52 (Discussion of October CMB Performance (Oct. 31, 2007)).)

- More generally, the Audit Committee and, in particular, Mr. Armstrong routinely requested analyses of key capital ratios, including peer comparisons. (*See*, *e.g.*, exhibit 53 (E-mail from Bonnie Howard to C. Michael Armstrong (Mar. 13, 2007) attaching Tier 1 Capital (as of Dec. 31, 2006)).)

C. Risk Management and Business Related Matters

1. ***Independent risk management needs to have the same level of authority and influence as the business units. To date that has not been the case. Our review indicated that independent risk management had insufficient authority and/or failed to exercise its authority to restrain the business. While the desk level market risk management staff seemed to appropriately escalate issues, decisions on risk were routinely deferred to the senior business unit management's wishes. For example, when the Asset Backed Securities (ABS) Correlation desk asked independent risk management for new limits to support their shift in business strategy, risk "stood down" when senior business management was in support of the increase. Additionally, senior management needs to ensure that independent control groups—specifically, independent risk management and product control—have the requisite staff, analytics, and expertise to understand and monitor the business.*** (Letter at 4.)

We agree that senior management and independent risk should have the same level of authority and influence within the Company. That said, the Letter draws certain conclusions with which we disagree.

Taking the specific example cited, we believe the Letter is mistaken concerning the role played by risk in the shift in business strategy by the ABS correlation

Confidential & Non-public OCC Information

OCC3-00008516

desk. Specifically, the Letter appears to overlook both the development of structuring activity on the ABS Correlation desk and the purpose served by establishing limits.

As the ABS Correlation desk moved into the structuring business during 2006, market risk, in fact, did review limit requests and set limits related to the warehousing activity necessary to accommodate the expanding business. As this business developed, independent risk determined that it was not necessary to set limits on the ABS Correlation desk for its super-senior exposure. Market risk establishes limits based on the specific goals of the business and evaluates those decisions as the business develops and matures. When the business indicated an interest in expanding its structured-finance activity in late 2006, market risk determined that a super-senior limit for the ABS Correlation desk was not necessary in the early stages of the business, based on risk's experience with super-senior positions. This decision did not reflect lack of risk oversight; nor does it indicate that risk "stood down" in the face of pressure from the business. Rather, this decision reflects a considered judgment by risk based on the nature of the business and its understanding of super-senior risk.

There are other examples in which limit requests were rejected or approved only after modification, and where risk overrode the wishes of the business.

For example:

- In 2006, the business requested an AAA/AA warehouse limit increase from $5 billion to $7.5 billion, and a $5 billion par put limit. Risk questioned the need for these limit increases and sought further information before approving the warehouse limit increase, and ultimately proposed a "more modest limit" of $2 billion for the par put limit. (*See* exhibit 54 (E-mail from Murray Barnes to Nestor Dominguez and Andy Feigenberg (Apr. 12, 2006)).)

- In January 2007, the US Cash CDO business requested a $60 billion super-senior limit. (*See* exhibit 55 (E-mail from Nestor Dominguez to Murray Barnes, et al. (Jan. 11, 2007) attaching 2007 CDO Limit Increase Request).) This request was verbally denied by risk, and substantially lower temporary exceptions of $40 billion (net) and $45 billion (gross) were subsequently provided. (*See* exhibit 56 (E-mail from Murray Barnes to Jason Alfano and Michael Silvestri (Feb. 27, 2008)).)

- In the third quarter 2007, based in part on its ongoing discussions with the OCC regarding Citi's loan loss reserve processes and methodology, risk management determined to increase Citi's ALLL by almost $1 billion. Despite opposition by some business managers, independent risk management held its ground because it perceived the increase to be warranted in light of new acquisitions, deterioration in the credit markets, and other trends. (*See* exhibits 57 (Minutes of Citigroup Audit and Risk

Confidential & Non-public OCC Information

Management Committee (July 26, 2007)); and 58 (Risk and Compliance Update: Loan Loss Reserve (July 26, 2007)).)

- In October 2007, the business sought a $14 billion to $16 billion financing of a basket of financial stocks. Risk denied the request and said that it would entertain a request for only a $3 billion non-recourse facility. (*See* exhibit 59 (E-mail from Ramesh Gupta to Jason Alfano (Feb. 22, 2008)).) The business's proposal for the $3 billion facility ultimately was not approved by risk.

Risk continually monitored the business and elevated issues in light of market developments. For example, Risk Manager Estimates ("RMEs") that stressed the CDO and other businesses with subprime exposures increased significantly in the first quarter of 2007. Those RMEs were brought to the attention of the CMB risk management committee. The businesses put in place efforts to reduce risk, not just in mortgages as the OCC references, but also in the structuring business. To that end, no new warehouses were opened for mezzanine-level deals after February 2007 and the business aggressively sought to shed lower-rated exposure by actively distributing deals in the marketplace. As a result, subprime exposure (excluding super seniors) decreased materially through the first half of 2007 and the quality of the retained CDO tranches improved materially with the overwhelming majority of the retained CDO exposure by July being rated AA or better.

It also is important in this context to consider the appropriate relationship between risk and business. Independent risk does not set the risk appetite for the Company; nor ultimately does it run the business. Risk management engages in a dialogue with the business to understand its goals, it sets limits and monitors risk within those constructs, and it escalates issues as they arise and as deemed necessary in the independent judgment of risk management personnel. Independent risk reviewed structured-credit exposures within the framework set by the business—a framework in which the business wished to expand its market share.

In September 2007, risk expressed a preference for using a collateral/correlation-based approach to value the Company's super-senior positions rather than an intrinsic cash-flow model. After representatives of risk, finance and the business discussed the matter at length, finance and the business, which had responsibility for valuing the positions, decided to use the cash-flow model.

The Letter cites no instance in which independent risk "stood down" when it believed it should "stand up," and no such instances were ever reported to the Audit Committee by independent risk or anyone else. At all critical junctures—including at times when the business requested limit increases and when illiquid exposures needed to be valued—risk voiced its perspective and engaged in a dialogue with the business. In certain instances, the business prevailed; in others, risk prevailed. But consistently, there was a candid, constructive dialogue between independent risk and business management.

Confidential & Non-public OCC Information

OCC3-00008518

2. ***Directors do not appear to have been informed or questioned the impact of market indications of weaknesses in subprime mortgages on other aspects of the company's business or Citibank. . . . By focusing on a specific sector (consumer) as opposed to overall risk levels in the corporation, the Board was not provided a sense of the full exposure to subprime real estate until very recently.*** (Letter at 3.)

As detailed *supra* in Section II.B, it is not correct that directors were not informed of, and did not question, subprime-related market weaknesses, or how market developments might affect the Company's businesses or the Bank. Nor is it accurate that reports to the Board and Audit Committee were focused solely on the Consumer business. The Audit Committee was updated on both Consumer-side and Corporate-side subprime exposures, and risk reviews presented to the Corporate Subcommittee included subprime updates at every meeting in 2007. The focus of these updates and reports was not on a particular sector, but rather on those areas that were considered the most significant.

Thus:

- In January 2007, Ms. Bebe Duke, co-Head of Risk Management of Corporate and Investment Banking, informed the Corporate Subcommittee of significant declines in the ABX indices. (*See* exhibit 21 (Risk Management Review (Jan. 16, 2007)).)

- On March 19, 2007, Mr. Bushnell presented to the Audit Committee a risk and compliance update on subprime mortgages, in which he reported nonprime and subprime exposures in both the Consumer and Corporate businesses. (*See* exhibit 30 (Risk and Compliance Update: Sub-Prime Mortgages (Mar. 19, 2007)).) The report of subprime exposure on the Corporate side focused on exposure arising out of the securitization of interest-only and negative-amortization mortgages originated by third parties.

- At the next Audit Committee meeting, on April 16, 2007, Mr. Bushnell again presented an update on subprime exposures, both in Consumer and Corporate. (*See* exhibit 31 (Risk and Compliance Update: Non-Prime and Sub-Prime Exposures (Apr. 16, 2007)).) A $2 billion increase in exposure on the Corporate side was reported, attributable to Citi's financing of Ameriquest. Also on April 16, 2007, Ms. Duke updated the Corporate Subcommittee on credit and market risks associated with subprime and noted that Citigroup had escaped significant losses in the bankruptcy of New Century, a leading subprime mortgage originator to which it had exposure. (*See* exhibit 22 (Risk Management Review (Apr. 16, 2007)).)

- In July 2007, as broader potential subprime exposure on the Corporate side first began to emerge, Mr. Bushnell's regular update on subprime

Confidential & Non-public OCC Information

OCC3-00008519

exposures included discussion of Citi's exposure to the Bear Stearns hedge funds through the Company's financing desk and through positions in ABS CDOs. By July, Corporate's counterparty exposure had been actively managed downward, from $4.2 billion to $0.6 billion. (*See* exhibit 32 (Risk and Compliance Update: Non-Prime and Sub-Prime Exposures (July 26, 2007)).)

- In August 2007, in a letter accompanying July materials circulated to the Board, former-CEO Charles O. Prince discussed credit market dislocations, including subprime, which he described as likely to "play out over a broader set of participants and over an extended period of time." Mr. Prince went on to explain that while "we consciously did not originate these aggressive products in our U.S. Consumer Group," Citi did have some exposure due to portfolio acquisitions and underwriting of RMBS collateralized by subprime products originated by third parties. (*See* exhibit 60 (Letter from Charles O. Prince to Franklin A. Thomas (Aug. 15, 2007)).)

As can be seen, the updates to the Board followed the arc of the developing subprime story. In response to requests from the Board for updates on Citigroup's subprime exposure, management focused on those areas that it believed were most risky. Indeed, while the Board tasked management relatively early on with identifying the Company's subprime exposures, this was no simple task. For example, CDO subprime exposure was not readily ascertainable in part because of the product's inherent structural protections, and in part because CDOs include a variety of different asset-backed securities, including prime and subprime ABS, and cannot, therefore, be defined simply as "subprime." (*See* exhibits 61 at 2 (Memorandum regarding September 30, 2007 Valuation of Super Senior Tranches of CDOs); and 62 at 2 (William Bozarth, December 31, 2007 Valuation of Super Senior Tranches of CDOs (Jan. 25, 2008)).))

Thus, in the early part of 2007, management briefed the Board on the most direct exposure to subprime borrowers, either through Citi's own loan portfolio in its Consumer business or as a result of financing activities in the Corporate business of subprime mortgage originators. Later updates focused on exposure to counterparties with significant subprime exposure and CDO tranches below super senior in the structured-credit business.

It is true that the Board was not provided with information about potential risks to it's super-senior positions as a result of the subprime market weakening until much later. Throughout the first half of 2007, independent risk and business management genuinely believed that the Company's super-senior positions were safer and more secure than AAA structured-credit exposures. Contemporaneous documents corroborate the Company's state of mind. In June 2007, as part of its Consolidated Supervised Entity presentation to the SEC, the Company presented its "Overall CDO Business and Subprime Exposure." (*See* exhibit 63 (Presentation to the Securities and

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OCC3-00008520

Exchange Commission Regarding Overall CDO Business and Subprime Exposure (June 2007)).) In that presentation, the Company referenced its super-senior "book," but stated that "[d]ue to the extremely small probability of default, this exposure has been excluded" from the Company's overall subprime-exposure evaluation. (*Id.* at 11.)

Likewise, the majority of Citi's super-senior exposure arises from its so-called liquidity-put agreements with CDO entities that financed their super-senior positions with asset-backed commercial paper. That ABCP had successfully rolled as late as July 2007 and an analysis by the business determined in late 2006 that it would take more than a five-standard-deviation event for the ABCP market to become sufficiently stressed to cause spreads on the ABCP to hit the liquidity-put triggers.

As the above facts demonstrate, risk and business management promptly elevated subprime-related exposures as they surfaced, and actively managed those exposures in a prompt and diligent manner.

3. ***[W]ith the removal of formal and informal agreements, the previous focus on risk and compliance gave way to business expansion and profits.*** (Letter at 2.)

As set forth above, Citi has maintained a strong, independent risk function. Following implementation of the formal and informal 2003 agreements to which the Letter refers—agreements that had the effect of temporarily constraining the Company's mergers-and-acquisitions activity—the Company enhanced its risk and compliance infrastructure. The Letter's suggestion that, with the lifting of the restrictions on Citi's business activities, the Company abandoned its focus on risk and instead began to pursue riskier business activities with the sole goal of enhancing profits, is in error.

As described in detail above, the Company made several strategic business decisions prior to the market dislocations to enhance its presence in certain markets, including leveraged lending and structured finance. In making those business decisions, the Company carefully evaluated the risks associated with expanding those areas of its operations. In the end, and with its eyes wide open, the Company made an informed decision to expand these businesses—a decision that was made with full consideration of the attendant risks and rewards as they were then understood by experienced management. Contrary to the implication in the Letter, the Company did not move forward with these business activities in response to the lifting of any restrictions on the Company's activities.

In fact, many of the transactions that led to the recent write-downs were implemented prior to and during the time when those formal and informal agreements were in place. (*See, e.g.*, exhibits 64 (Grenadier Funding Indenture (July 14, 2003)); 65 (Klio Funding Indenture (Apr. 16, 2004)); and 66 (Klio III Funding Indenture (Oct. 24, 2005)).) Additionally, the Company's current challenges do not relate in any way to the types of transactions that Citi agreed to forgo or constrain as a result of the 2003 agreements. The recent write-downs by the Company were caused by the unprecedented

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credit and subprime crises that arose suddenly in the latter part of 2007. There is simply no connection between the 2003 agreements and the credit and subprime crises that led to write-downs by Citi (and by all other market participants).

D. Valuation-Related Matters

1. ***While the current valuation method is broadly within the range of current market practice, collateral-based valuation results need to be factored into this analysis. . . .***

An alternative method that starts by valuing collateral and then building up to CDO value, using a correlation model for some positions, has proponents within the bank and would have led to larger write-downs. It is more of a market-based approach and better aligns with how risk is hedged. It also involves substantial judgment, since the market for the instruments is not trading. However, it is consistent with current marking procedures for the collateral. Collateral based valuation results should be part of regular reporting and factored into the assessment of final value. This includes use of the correlation model, an important analytical tool even if its results are not used for official valuation. (Letter at 5–6.)

As the Letter acknowledges, "events during the year produced tremendous pressure on the business to deploy a new valuation model on short notice." The Company first employed a model to mark its super-senior book for the close of the third quarter. At that time, and based on then-available valuation tools, the Company concluded that the intrinsic cash-flow model developed by the Fixed Income Research group was the most appropriate valuation method, given the lack of market observables.

The Company has so far determined that a collateral-based approach would not fairly reflect the value of its super-senior exposures. (*See* exhibit 61 (Memorandum regarding September 30, 2007 Valuation of Super Senior Tranches of CDOs).) Among other reasons, the values for the underlying collateral (more than 8,000 distinct CUSIPs) are based on *subjective* trader judgments—not market observables—and thus are not independently verifiable. This is not to say, however, that Citi made no use of the collateral-value approach. In arriving at the write-down estimates reflected in the Company's 8-K filed on November 5, 2007, the Company employed a collateral-based approach to calculate the high end of the range, reflected in that announcement. (*See* exhibit 67 (Memorandum from Paul Smith to Files (Nov. 26, 2007)).)

Since November 2007, the Company has continued to refine its valuation methodology. Thus, in marking its super-senior positions for year-end 2007, the Company employed a more sophisticated model that had been in development for approximately a year. (*See* exhibit 62 (William Bozarth, December 31, 2007 Valuation of Super Senior Tranches of CDOs (Jan. 25, 2008)).) This model, known as the Default

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model, reflected a number of significant improvements, including the use of sophisticated projections concerning prepayment, default rates and loss severity. Its loss projections are as (or more) severe than those generated by published models of other firms and rating agencies. During this year-end process, the Company revisited whether it might be appropriate to employ a collateral-based valuation approach. That approach was rejected, for the reasons outlined above.

Notably, when the Company compared the results of the Default model with the results obtained using a collateral-based valuation model, the fourth-quarter marks were merging—a fact referenced in your Letter. It is worth noting in this regard that on March 13, 2008, Standard & Poor's stated that "[b]ased on available information, we believe that the largest players [specifically including Citi] can be seen as having undertaken a rigorous valuation methodology to come up with conservative valuations" for super-senior positions. (*See* exhibit 17; *see also* exhibit 68 (Standard & Poor's, Subprime Write-Downs Could Reach $285 Billion, But Are Likely Past the Halfway Mark (Mar. 13, 2008)).) The Company regards the valuation of its super-senior positions as a dynamic and iterative process, and is continuing to draw upon all available expertise to formulate the best possible valuation methodology, going forward.

2. ***Product Control does not have sufficient staff or quantitative resources to evaluate the various components of the valuation model. [Product Control] is set up for checking marks directly against market observables, and has not adapted to situations where there are no direct quotes. . . . In addition to being disjointed from the business, control groups were inadequately engaged with each other at a time when they should have been active partners.*** (Letter at 6.)

While we continue to seek to improve our product-control function and other control groups, we believe the OCC's criticism is unfair.

First, as the OCC is aware, on May 22, 2006, the Fed issued findings commending "Citigroup's valuation and measurement practices with respect to complex and illiquid exposures. . . ." (*See* exhibit 69 at 1 (Letter from Federal Reserve Bank of New York to Paul Smith (May 22, 2006)).) Among other conclusions, the Fed determined that the Company "exhibited a high degree of discipline with respect to valuation." (*Id.*) The Fed also concluded that Citi's practices exceeded those of other firms in terms of its processes "to identify and monitor exposures that are difficult to price verify using third-party data." (*Id.*) The Fed also noted that Citi's "processes seek to quantify and control the associated valuation risk by classifying exposures according to level of risk, stress testing them, setting limits and escalating exceptions to the Risk Committee." (*Id.*) With respect to VaR, the Fed concluded that Citi has a "well-disciplined process[] to ensure the timeliness and completeness of exposure and historical data. . . . [The Company] relied less on proxies (e.g., indices) for cash instruments; utilized data that was more closely reflective of security-specific attributes; and updated historical time series more frequently." (*Id.* at 2.)

In the period since the Fed issued its favorable findings, the Company has enhanced its product-control function. Among other things, it is a priority at Citi to staff Product Control with experienced individuals. To that end, Citi has maintained a staff of three to five PhDs in this group, which we believe represents one of the largest such staffs maintained among our peers. The Company continues to seek similarly highly qualified candidates. As the Fed noted, Citi's product control staff "is well-informed of the direction of prospective fair value pronouncements and [is] well-positioned to implement standards when they are finalized." (*Id.* at 1.)

In addition, since late 2006, product control managers have met on a weekly basis with their counterparts in risk to review the prior week's P&L in each business, new transactions, market developments, business issues and business-risk measurements, among many other issues. These weekly meetings provide an open forum for both product control and risk to discuss any issues that may be of concern.

Second, the Company's Model Control Policy for the Corporate and Investment Bank sets forth the roles and responsibilities of the various personnel involved in the model-validation process. (*See* exhibit 70 (The Model Control Policy for the Corporate and Investment Bank and Emerging Markets – Consumer (Jan. 2006)).) That policy states that independent pricing groups and the financial division shall "[p]erform independent verification of observable inputs, as described in the CIB Price Verification Policy" and, "[a]s requested, assist in the prioritization of Model Validations and the determination of Assumption Review frequency." (*Id.* at 12.) With respect to the models used by the Company to arrive at its third and fourth-quarter marks, Product Control fulfilled its obligations under this policy.

One of Product Control's principal responsibilities is to classify the Company's inventory as Level 1, 2 or 3, pursuant to the mandates of FAS 157, and to perform price verifications with respect to that inventory. Product Control is not charged with verifying prices on Level 3 inventory in the same way that it is with respect to Level 1 and 2 inventory. Level 3 inventory is unverified, and Product Control's role with respect to it is limited to "[r]eview[ing] for reasonableness the methodologies used in marking inventory that is classified as unverified." (*See* exhibit 71 at 15 (Capital Markets and Banking ("CMB") Pricing and Price Verification Standards and Procedures).) There was an unprecedented rise in the Company's unverified inventory during the third quarter: as a result of the tremendous shifts in the market, including the seizing up of credit markets and the resulting sudden lack of liquidity, unverified inventory in Citi's Markets and Banking business increased 97 percent, or by $66.5 billion, between June 30, 2007 and October 15, 2007. As the Letter acknowledges, market events placed tremendous pressure on the business to develop a new valuation methodology on extremely short notice.

Despite these challenges, Product Control appropriately overcame the absence of "direct quotes" in the third and fourth quarters of 2007. The process employed was vigorous and thorough, and ultimately Product Control determined,

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OCC3-00008524

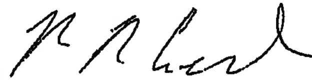
consistent with its mandate, that the marks used in both the third and fourth quarters were reasonable.

* * * * *

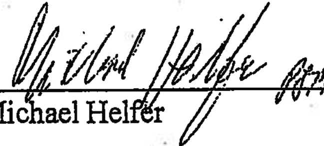
We hope that this response has fully addressed the issues identified in your Letter. We understand and appreciate your recommendations, and will promptly address those matters that we have not already resolved. At the same time, we believe, respectfully, that the Letter's criticisms and conclusions regarding independent risk management, and the roles played by the Board and the Audit Committee, are not justified. We hope that you will receive our observations with an open mind and take them into consideration in determining how most appropriately to proceed.

We look forward to continuing to work closely and collaboratively with you on these issues, as we continue to manage our risks in this challenging market environment.[8]

Respectfully submitted,



Brian Leach



Michael Helfer

cc: Office of the Comptroller of the Currency (w/o exhibits)
Disclosure (FOIA) Office
Washington, D.C. 20219
Attn: Frank Vance

[8] We respectfully request, pursuant to 31 C.F.R. § 1.6, Appendix J thereto, and 5 U.S.C. § 552b, that confidential treatment be accorded this letter, the accompanying exhibits, and the confidential and privileged business, commercial, and financial information they contain, as well as any transcripts, notes, memoranda, or other records created by, or at the direction of, the OCC, its officers or staff that reflect or relate to this confidential information. We also respectfully request that you promptly inform us of any request under the Freedom of Information Act seeking access to any of the information enclosed herewith, to permit us to substantiate the grounds for confidential treatment.

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