October 20, 2009

TO: Board

FROM: Staff[1]

SUBJECT: Regulatory Relief for Citigroup Inc., New York, New York, in connection with certain recent U.S. government actions.

ACTION REQUESTED: Approval of the attached letter granting Citigroup Inc. ("Citigroup"), New York, New York, (1) relief from the Board's capital adequacy guidelines for bank holding companies ("Capital Rules") that would allow Citigroup to (i) apply a 20 percent risk weight to a designated portfolio of assets ("Portfolio") for which the U.S. government is providing credit support and (ii) include in its tier 1 capital without limit senior perpetual preferred stock issued to the Federal Deposit Insurance Corporation ("FDIC") in connection with the FDIC's guarantee of certain losses in the Portfolio; and (2) an exemption from section 23A of the Federal Reserve Act and the Board's Regulation W in connection with the Federal Reserve's commitment to lend to Citigroup against losses on the Portfolio.

BACKGROUND: On November 23, 2008, the Board made a joint announcement with the Department of the Treasury ("Treasury") and the FDIC on an assistance package for Citigroup consisting of guarantees, liquidity access, and capital infusions (collectively, the "Support Package"). As part of the Support Package, the Treasury and the FDIC agreed to provide Citigroup with credit protection on, and the Federal Reserve agreed to provide backstop liquidity support for, the Portfolio. The Portfolio consists of approximately $301 billion in residential and commercial mortgages, retail automobile loans, asset-backed securities secured by residential and commercial real estate and automobile loans, and certain other assets. The aim of the Treasury, the FDIC, and the Federal Reserve in providing the Support Package was to ensure the financial stability of Citigroup and to strengthen the overall financial system.

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[1] Legal Division (Mr. Alvarez, Ms. O'Day, Mssrs. Van Der Weide and McDonough, and Ms. Snyder) and Division of Banking Supervision and Regulation (Mss. Barger, Bouchard, and Hewko).

Under the terms of the Support Package, Citigroup will absorb all losses on the Portfolio up to $29 billion (in addition to existing Citigroup reserves already set aside for Portfolio assets). Losses on the Portfolio in excess of that amount will be borne 90 percent by the U.S. government and 10 percent by Citigroup. Of the losses to be borne by the U.S government, Treasury would bear the first $5 billion and the FDIC would bear the next $10 billion in losses. After these losses are absorbed by the Treasury and the FDIC, the Federal Reserve Bank of New York ("FRBNY") would fund the remaining assets (subject to Citigroup's 10 percent loss share) through a secured, non-recourse loan ("FR Loan").[2]

The Treasury and FDIC guarantees will remain in place for 10 years on residential-mortgage assets in the Portfolio and five years on all other assets in the Portfolio. As compensation for this credit protection, Citigroup issued to the Treasury preferred stock with an aggregate liquidation value of $4 billion ("Treasury Preferred Stock") and to the FDIC preferred stock with an aggregate liquidation value of $3 billion ("FDIC Preferred Stock").

DISCUSSION:

1. Regulatory Capital Requirements for the Portfolio

The vast majority of the assets in the Portfolio are non-trading assets subject to the general risk-based measure of the Capital Rules ("Credit-risk Rules")[3]; the remaining assets are trading assets subject to the market-risk measure of the Capital Rules ("Market-risk Rules").[4] Citigroup would be required to risk weight the non-trading assets in the Portfolio ("Portfolio non-trading assets") under the Credit-risk Rules. In general, Citigroup would be required to risk weight the non-trading asset-backed securities in the Portfolio at between 20 percent and dollar-for-dollar (depending on their NRSRO rating), the commercial mortgage and automobile loans at 100 percent, and the residential mortgage loans at 50 or 100 percent. Under the Credit-risk Rules, Citigroup

[2] The Federal Reserve will have recourse to Citigroup for the payment of interest on this loan.

[3] 12 CFR part 225, Appendix A.

[4] 12 CFR part 225, Appendix E.

effectively would obtain no regulatory capital relief from the Support Package because of the size of Citigroup's first-loss position.

Under the Market-risk Rules, all of Citigroup's trading assets would be subject to a capital charge calculated using a value-at-risk (VAR) measure plus a specific-risk add-on charge ranging from an effective risk weight of zero (in the case of certain government obligations) to 100 percent.[5] Derivative contracts that are covered positions are subject to an additional counterparty credit risk charge based on risk weights ranging from zero to 50 percent.[6] Under the Market-risk Rules, Citigroup effectively would obtain no regulatory capital relief from the Support Package because of the size of Citigroup's first-loss position.

In connection with the Support Package, Citigroup requested relief from the Capital Rules to enable Citigroup to assign a 20 percent risk weight to assets in the Portfolio. The Board has authority to provide exemptions from the Capital Rules.[7] The Board agreed to provide the requested exemption on November 23, 2008. Staff now seeks Board approval for specifying the precise parameters of the exemption and for issuing a letter to Citigroup conveying these parameters.

Because of the substantial credit protection that the Support Package provides to Citigroup with respect to the Portfolio, there is justification for permitting Citigroup to assign a lower risk weight to the assets in the Portfolio. Citigroup's exposure to credit risk in the Portfolio has been significantly reduced by the Support Package. Citigroup is retaining the first approximately 10 percent of losses on the Portfolio and has transferred approximately 90 percent of the residual risk in the Portfolio to U.S. government agencies (whose risk weighting is zero). Because of the Support Package, if the Portfolio were to become completely worthless, Citigroup would be

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[5] See 12 CFR part 225, Appendix E, §3.

[6] See 12 CFR part 225, Appendix A, §§ III.C and III.E. To calculate the counterparty credit risk charge on a derivative contract, a banking organization must first multiply the notional principal amount of the contract by a conversion factor ranging from zero to 15 percent and then risk weight the resulting amount plus the positive market value of the derivative according to the risk-weight category assigned to the counterparty under the Credit-risk Rules, subject to a maximum risk weight of 50 percent.

[7] See 12 CFR part 225, App. A, § III.A.

exposed to approximately 20 percent of the total losses (although mostly on a first-loss basis).

Additionally, requiring Citigroup to hold risk-based capital against the Portfolio in strict accordance with the Capital Rules would undermine the goals of the U.S. government in providing the Support Package. The Treasury, the FDIC, and the Federal Reserve are providing credit protection and liquidity support to the Portfolio in order to stabilize Citigroup's financial position, and to permit Citigroup to operate normally and continue its important role in lending markets. Requiring Citigroup to continue risk weighting all the Portfolio assets as if it had received no credit protection from the U.S. government would undermine the credit protection provided by the Support Package and blunt its impact on financial stability. Staff therefore recommends that the Board grant Citigroup an exemption from the Credit-risk Rules to allow it to risk weight all Portfolio non-trading assets at 20 percent.

With respect to trading assets included in the Portfolio ("Portfolio trading assets"), staff has considered various options for applying capital relief comparable to the 20 risk weight for Portfolio non-trading assets. Unlike capital requirements for non-trading assets under the Credit-Risk Rules, capital requirements for trading assets under the Market-Risk Rules are generally calculated on a portfolio basis. Moreover, Citigroup's trading assets include some assets in the Portfolio and some assets not in the Portfolio. Accordingly, it is difficult to apply a simple 20 percent risk weight to the trading assets included in the Portfolio ("Portfolio trading assets").

Having considered various options for applying relief comparable to the 20 percent risk weight for Portfolio non-trading assets, having discussed these options with Citigroup, and having discussed the proposed relief with members of the Committee on Supervisory and Regulatory Affairs, staff recommends that the Board grant Citigroup an exemption from the Market-Risk Rules to allow it to calculate the capital charge on the Portfolio trading assets using Citigroup's current VAR measure and specific-risk add-ons, and for derivatives that are trading assets, a 20 percent risk weight for the counterparty credit risk charge.

Allowing Citigroup to calculate the capital charge on the Portfolio trading assets in this manner would provide an imprecise but logical approximation of the capital

relief granted to the Portfolio non-trading assets in the context of the Market-Risk Rules. It would also allow for minimal disruption to Citigroup VAR calculations, which include both Portfolio and non-Portfolio trading assets.

In light of the fact that the credit protection from the Treasury and the FDIC under the Support Package partially expires in five years, any capital relief to be received by Citigroup as a result of the Support Package also should expire in five years. After five years, the Board should reassess whether continuing capital relief would be appropriate for the Portfolio.

2. Inclusion of FDIC Preferred Stock in Tier 1 Capital

On May 22, 2009, the Board announced the adoption of a final rule ("TARP Tier 1 Rule") that allows bank holding companies to include in their tier 1 capital without restriction senior perpetual preferred stock issued to the Treasury under TARP authority.[8] The Board adopted the TARP Tier 1 Rule – despite the cumulative nature and dividend rate step-up feature of the TARP preferred – in order to support and facilitate the implementation of the Treasury's Capital Purchase Program and promote the stability of banking organizations and the financial system. The Treasury Preferred Stock is covered by the terms of the TARP Tier 1 Rule and therefore would be eligible for inclusion in Citigroup's tier 1 capital as an unrestricted core capital element.

The FDIC Preferred Stock is not covered by the TARP Tier 1 Rule because it was not issued to Treasury under TARP authority. Moreover, the FDIC Preferred Stock would not otherwise be eligible for inclusion in Citigroup's tier 1 capital as an unrestricted core capital element under the Capital Rules because of its cumulative nature. The terms of the FDIC Preferred Stock, however, are substantially identical to those of the Treasury Preferred Stock, and the FDIC Preferred Stock serves the same financial stability purposes as the Treasury Preferred Stock. Accordingly, the FDIC Preferred Stock should receive the same unrestricted core capital element treatment as the Treasury Preferred Stock for the reasons set forth in the preamble to the TARP Tier 1 Rule. Staff therefore recommends that the Board grant an exemption to Citigroup from

[8] 74 Fed. Reg. 26081 (June 1, 2009). On October 16, 2008, the Board announced the adoption of an interim final rule ("TARP Tier 1 Rule") that allows bank holding companies to include in their tier 1 capital without restriction senior perpetual preferred stock issued to the Treasury under TARP authority. 73 Fed. Reg. 62851 (October 22, 2008).

the Capital Rules to allow it to include the FDIC Preferred Stock in tier 1 capital without limit.

3. Exemption from Section 23A and Regulation W

Section 23A of the Federal Reserve Act and Regulation W limit the aggregate amount of "covered transactions" between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus, and limit the aggregate amount of covered transactions between a bank and all its affiliates to 20 percent of the bank's capital stock and surplus.[9] "Covered transactions" include the purchase of assets by a bank from an affiliate, the extension of credit by a bank to an affiliate, the issuance of a guarantee by a bank on behalf of an affiliate, and certain other transactions.[10]

Under the transaction documents giving effect to the Support Package, for various operational reasons, the FR Loan, when drawn upon, would be made to Citigroup directly. Citigroup is expected to lend on the proceeds of the FR Loan to its various bank and non-bank subsidiaries to enable them to finance their holdings of the assets in the Portfolio. To provide the Federal Reserve Bank of New York ("FRBNY") with additional protection on the loan, each Citigroup subsidiary that holds Portfolio assets — including its subsidiary depository institutions ("DIs") — will provide guarantees on behalf of Citigroup for the benefit of FRBNY. Each subsidiary guarantee will also be secured by the Portfolio assets held by the subsidiary.[11] These guarantees by Citigroup's subsidiary ("DIs") on behalf of Citigroup would be "covered transactions" under section 23A and the Board's Regulation W and subject to the limits on covered transactions contained in the statute and rule.

Section 23A and Regulation W specifically authorize the Board to exempt transactions or relationships from the requirements of the statute and rule if the Board finds such an exemption to be in the public interest and consistent with the purposes of

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[9] 12 U.S.C. § 371c(a)(1) and 12 CFR 223.11 and 223.12.

[10] 12 U.S.C. § 371c(b)(7) and 12 CFR 223.3(h).

[11] Under the guarantee, each Citigroup subsidiary's liability is limited to FRBNY's interest in the Portfolio assets held by the Citigroup subsidiary, and no subsidiary is personally liable for any payments on the FR loan.

section 23A.[12] The Board previously has indicated that the purposes of section 23A are (i) to protect against a depository institution suffering losses in transactions with affiliates and (ii) to limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the Federal safety net.[13]

The Support Package is a unique and temporary Federal safety net provided to Citigroup under extraordinary circumstances to prevent significant disruption to the financial system. The Support Package is designed in large part to protect Citigroup's DIs against losses in connection with their holdings of Portfolio assets and, as noted above, Citigroup is expected under the Support Package to allocate funds from the FR Loan to its subsidiary DIs in proportion to their holdings of Portfolio assets. Moreover, the subsidiary DIs' exposure to Citigroup's credit risk in these transactions is minimal because the FR Loan is without recourse to Citigroup. Therefore, although the guarantees by subsidiary DIs of Citigroup's obligation to repay the FR Loan would fall under the definition of "covered transaction," the underlying policy concerns of section 23A are not significantly implicated in the context of the Support Package.

For these reasons, staff believes that exempting these collateralized guarantees from the limits of section 23A and Regulation W would be in the public interest and consistent with the purposes of section 23A. Staff therefore recommends that the Board exempt the collateralized guarantees made by DIs on behalf of Citigroup in connection with the FR Loan and the Support Package from the requirements of section 23A and Regulation W.

CONCLUSION: In light of these considerations, staff recommends that Citigroup be granted (1) exemptions from the Capital Rules that would permit it (i) until the partial expiration of the Treasury and FDIC guarantees in five years, to risk weight all non-trading assets in the Portfolio at 20 percent and to risk weight the Portfolio trading assets using Citigroup's current VAR measure and specific risk add-ons, and for derivatives that are trading assets, a 20 percent risk weight for the counterparty credit risk charge; and (ii) to include the FDIC Preferred Stock in its tier 1 capital as an unrestricted core capital

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[12] 12 U.S.C. § 371c(f)(2) and 12 CFR 223.43.

[13] 67 Fed. Reg. 76560 (Dec. 12, 2002).

element; and (2) an exemption from the limits of section 23A and Regulation W for the collateralized guarantees made by the subsidiary DIs on behalf of Citigroup in connection with the Support Package.

Attachment