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Citigroup Third Quarter 2007 Earnings Call Transcript

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Seeking Alpha α

Citigroup Q3 2007 Earnings Call Transcript

Citigroup, Inc. (C)

Q3 2007 Earnings Call

October 15, 2007 8:30 am ET

Executives

Art Tildesley - IR

Charles Prince - Chairman, CEO

Gary Crittenden - CFO

Analysts

Jason Goldberg - Lehman Brothers

Betsy Graseck - Morgan Stanley

Guy Moszkowski - Merrill Lynch

Glenn Schorr - UBS

John McDonald - Banc of America Securities

Ron Mandle - GIC

Mike Mayo - Deutsche Bank

Meredith Whitney - CIBC World Markets

Jeff Harte - Sandler O'Neill

Vivek Juneja - JP Morgan

Diane Merdian - KBW

Operator

Welcome to Citi's third quarter 2007 earnings review featuring Citi Chairman and Chief Executive Officer Charles Prince and Chief Financial Officer Gary Crittenden. Today's call will be hosted by Art Tildesley, Director of Investor Relations. (Operator Instructions) Mr. Tildesley, you may begin.

Art Tildesley

Thank you very much, operator and thank you all for joining us today for our third quarter 2007 earnings presentation. We are going to walk you through a presentation, that presentation is available on our website now, so if you haven't downloaded that, you want to do that now.

The format we will follow will be Chuck will start the call, Gary will take you through our presentation and then we would be happy to answer any questions you may have.

Before we get started, I would like to remind you that today's presentation may contain forward-looking statements. Citigroup's financial results may differ materially from these statements, so please refer to our SEC filings for a description of the factors that could cause our actual results to differ from expectations.

With that said, let me turn it over to Chuck.

Charles Prince

Art, thanks very much and good morning to everybody. Thanks for joining our call this morning. As Art indicated, I'm going to start with a few minutes of discussion on our performance this quarter, both the core performance in certain of our businesses that we pre-announced a couple weeks ago, as well as the very good performance in some of our businesses. Then I'm going to turn it over to Gary to take you through the detailed presentation; then as always, we will be happy to answer questions.

Before I get started, I would like to comment briefly on our Thursday organizational announcement. I hope all of you saw that we are forming a new business segment. We're going to call it the Institutional Clients Group. By combining our Markets & Banking business and our Alternative Investments business under one leadership team. We have asked Vikram Pandit to lead this new group. I believe everybody knows Vikram pretty well and his background, his very significant accomplishments. In this newly formed group, we will continue to have Michael Klein doing his good job as Chairman and Co-CEO of Markets & Banking. We have promoted Jamie Forese, who has done a very good job running Equities the last few years and has a long history in Fixed Income, to be Co-CEO of Markets & Banking with Michael. John Havens will be the President and Chief Executive Officer of Citi Alternative Investments.

I think these changes are going to be very positive for us. There are obvious overlaps between these two businesses and this new structure will enhance our ability to serve institutional clients both across the entire capital market spectrum and around the world. We are looking forward to real progress in moving capital between these two businesses, and in growing and retaining our clients, and attracting good talent on The Street.

With that said, let me turn to the quarter's results. As we pre-announced two weeks ago, the writedowns and losses in our fixed income business and the higher credit costs in our Global Consumer business drove a significant earnings decline. Some of the writedowns and losses in Fixed Income were because we have been one of the largest providers of leveraged financing and mortgage-related structured products to clients around the world. When those markets severely dislocated, we obviously suffered losses.

However, some of our losses in Structured Credit and Credit Trading were greater than would have been expected from that market dislocation and simply reflect poor performance. In the context of our strong track record in these businesses going back over many, many, many years, I would say this quarter's performance was well below our expectations and frankly, surprising. We are focused on improving these areas. We are working very hard on making sure that our return to strong performance is something we can be confident in, in these traditional areas. Gary will discuss some of the actions we are taking.

I do you want to say a word about risk management in this context. We have a very strong risk management infrastructure at Citi, and the losses this quarter in Fixed Income were within the range of potential outcomes, but obviously at the very far end of that range as they relate to our risk limits. We look at these risk practices all the time and we are going to incorporate this summer's experience into that as we go forward.

Let me just switch to consumer credit for a second. As we said on our second quarter earnings call, the consumer credit environment is a challenging one, especially here in the U.S., and we expect meaningful increases in credit costs. This quarter that played out. Credit costs in consumer increased over \$2.8 billion as we built both loan loss reserves and had a meaningful increase in net credit losses. Gary will take you through the drivers of this increase in great detail later in the presentation.

Now at the same time as we had this poor performance in these various businesses, I do want to touch on a couple of areas where we continue to have strong performance, and strong performance that continues the trend we saw beginning in the fourth quarter of '06 and continuing in the first and especially in the second quarter of '07.

In Securities and Banking, we had many businesses perform well. Equity markets, equity underwriting up significantly. Advisory revenues up significantly. Even in the Fixed Income markets we discussed earlier, several product areas performed well. For example, municipals, interest rate trading and currency trading.

Our Global Transaction Services business generated another quarter of strong growth and record results. In our international Markets & Banking businesses in Asia, Latin America, and Mexico, we again generated record revenues and double-digit net income growth. Our Global Wealth Management business also had a very strong quarter, with record revenues, and that is even before adding the benefit from the Nikko Cordial acquisition.

Also in the international space, our international consumer business continues to do very, very, very well with both revenues and business volumes growing at a strong double-digit pace. This reflects our strategy with both organic growth and our recent acquisitions pulling forward very strongly.

In our U.S. consumer business, while the market dislocation that affected our fixed income business affected certain aspects of the revenue generation of this business, which Gary will get into, the underlying business momentum that

we have seen over the last few quarters continues to be very good. Deposits were up 16%. Loans up 8%. So as I have said right along, I'm cautiously optimistic about our U.S. consumer business, and I would say the third quarter reinforces that. I still feel good about that business momentum.

In addition to the operating results, we also announced or closed several important transactions during the quarter. We recently announced our intention to make Nikko Cordial a fully-owned subsidiary in Japan via a stock exchange. The Nikko transaction is a very good one, something I am proud of and something where we can show how we combine with strong, local institutions to grow our international franchise.

In August, we closed the acquisition of The BISYS Group, which increases our footprint in the high growth prime brokerage and securities processing area. We recently completed the acquisition of ATD, making us a top-tier electronic market maker and liquidity provider to institutional and retail clients.

So with that overview, let me just wrap up. This quarter's results were well below our expectations and as Gary will describe, we are working very hard on the areas that need improvement. At the same time, the underlying momentum across many of our businesses continues very strong. Execution on our strategic priorities continues and we are very well positioned to grow these businesses and especially to grow our international franchises.

With that as an overview, Gary, let me turn it over to you.

Gary Crittenden

Thank you, Chuck and good morning to everyone. Thank you for joining us this morning. Let me turn to the slides that are available to you on our website. Slide 1 shows you our consolidated results for the quarter versus the third quarter of 2006. To summarize our third quarter results, net revenues grew 6% on strong underlying volume growth, partially offset by losses in Fixed Income and writedowns in leveraged lending. Expenses were up 22%. The cost of credit was up 139%, driven primarily by a substantial charge to increased loan loss reserves and higher net credit losses in our global consumer businesses. Pre-tax income was down 59%. Net income and EPS were down 57%; and our return on equity was 7.4%.

Turning to slide 2, it shows five items which significantly impact the results for the quarter. First, we took a \$1.352 billion writedown in our highly leveraged finance portfolio. Second, we took writedowns in the value of our mortgage-backed securities and leveraged loans which were warehoused for future CDO or CLO securitizations, as well as on CDO positions of \$1.561 billion, net of any hedges. This number is higher by approximately \$250 million from the time of our October 1 announcement, due to a refinement of our calculations as we went through the quarter-end closing process.

Third, in credit trading we suffered a \$636 million loss as many of the historical relationships which form the basis for trading decisions in this business were disrupted.

Fourth, we had a \$729 million pretax benefit in international card revenues from a partial sale of the shares that we own in Redecard.

Finally, we had a \$2.847 billion higher credit cost in our global consumer business. This number is higher by approximately \$250 million from the figure which we disclosed in our October 1 announcement. The increase is driven by higher charges to loan loss reserves, reflecting accelerating delinquencies in September in our U.S. mortgage portfolio, and a finalization of our estimates during the quarter-end closing process.

Turning now to slide 3, this shows a five-quarter trend of some of the key drivers in our business. Strong momentum continued across these drivers, especially in our international franchises, which drove revenues up by 30%, including the impact of acquisitions and the Redecard gain.

Drivers of net interest revenue showed strong growth. Consumer loans were up 8% in the U.S. and 29% internationally. Internationally, organic consumer loan growth was 16%. Corporate loans were up 22%. Consumer deposits were up 16% in the U.S. and 18% internationally. Internationally, organic deposit growth was 8%.

Drivers of non-interest revenues also grew nicely. Credit card purchase sales were up 6% in the U.S. and 37% internationally. Internationally, organic card purchase sales growth was 22%. Investment assets under management were up 28% in international consumer. Client assets under management in CAI were up 50%. In our Global Wealth Management business, assets under fee-based management grew 38% or 20% organically.

In Investment Banking, we ranked number 1 in global debt underwriting, number 3 in announced and completed M&A and number 2 in global equity underwriting on a year-to-date basis.

Now slide 4 shows third quarter year-over-year revenue growth in each of our major businesses on the top half. The graph at the bottom of the page shows the year-to-date growth. In looking at the top half of the page, in U.S. consumer

revenue growth was flat, primarily driven by the absence of a prior-year gain from the sale of mortgage-backed securities, a writedown in the valuation of the residual interest related to the securitization activities, combined with lower securitization gains on lower-yielding assets in our U.S. Cards business.

Markets & Banking revenues reflected the writedowns and losses that I have mentioned already. Alternative Investments revenues were lower, reflecting lower hedge fund activities; the absence of a prior-year gain from the sale of MetLife shares; and changes in the market value of the Legg Mason shares.

Offsetting these results was organic revenue growth in international consumer and global wealth management, driven by both organic growth and acquisitions. U.S. revenues were down 12% and international revenues were up 30%. Acquisitions accounted for 5% of the year-over-year revenue growth and business as usual activities accounted for 1%.

Year-to-date revenue growth trends are strong, despite these severe market dislocations in the third quarter. We are pleased to see that the relative growth rates of our businesses -- Markets & Banking, International Consumer, and Global Wealth Management -- all grew revenues at double-digit rates. In total, our international revenues grew 27% and our U.S. revenues grew 2%, as we continue to reweight Citi to the higher-growth opportunities. Acquisitions accounted for 3% of the year-to-date revenue growth. Business as usual activities accounted for 11%.

The bar graph on slide 5 shows the nine quarter sequential trend of the change in net interest revenue. The table at the bottom shows you the net interest margin for the entire company for those same nine quarters. As I mentioned earlier, we have had strong volume growth in all of our businesses, which has resulted in a fairly steady improvement in the net interest revenue over the last four quarters. As the table at the bottom of the page shows, net interest margin declined by 3 basis points sequentially. If you exclude the grey zone impact from both periods, net interest margin decreased by 1 basis point sequentially.

Slide 6 shows the trend of our expense growth. We anticipated that this quarter's expense growth comparison would be challenging. If you look at the chart, expenses in the third quarter of 2006 were the lowest in the last seven quarters, primarily reflecting reductions in advertising and marketing spend in U.S. consumer, and lower expenses in Markets & Banking. The best way to track our progress on expense management would be to track headcount growth and expense growth relative to revenues. On both structural expense saves and total headcount reductions, we are ahead of our commitments.

Our reported expense growth is 22% and 14% without acquisitions; Nikko was the main driver. Our business as usual expense growth of 14% is driven by higher business volume throughout the franchise and the opening of more than 600 De Novo branches in the last 12 months. Sequentially, expenses were down, primarily on lower compensation cost in securities and banking.

Slide 7 shows the trend in headcount growth. Although the graph indicates significant year-on-year growth, this was driven predominantly by acquisitions, which contributed 11 percentage points of the 16% year-over-year growth. Excluding acquisitions, from the first quarter of 2006 to the first quarter of 2007 headcount grew by 9%. From the second quarter of 2006 to the second quarter of 2007, headcount grew by 5%. This quarter we had 5% headcount growth, which includes 2 percentage points caused by De Novo branch openings. The sequential headcount growth rate is 3%, with approximately half from acquisitions and half from business as usual activities. We continue to be heavily engaged in ongoing re-engineering efforts and are focused on expense management driving results for the next year.

Turning now to slide 8, we discuss credit. It shows the year-over-year growth components in our total cost of credit and the key drivers within each component. The total cost of credit increased by \$3 billion, with \$780 million -- or approximately one-quarter of the increase -- driven by higher net credit losses, and \$2.2 billion -- or three-quarters -- driven by higher charges to increase loan loss reserves.

Higher net credit losses of \$780 million were driven primarily by our global consumer business. In consumer, NCLs increased by \$736 million, driven primarily by higher balances from organic portfolio growth and acquisitions, continued deterioration in mortgages and in unsecured personal loans in the US, and in international cards and Japan consumer finance. This quarter's increase in loan loss reserves was driven primarily by the increase in global consumer reserves of \$2.1 billion.

The global consumer increase can be split into two categories: the first contributing approximately 40% of the increase and the second contributing approximately 60% of the total. The first category, which accounts for approximately 40% of the build, includes, for example, a credit card customer who is currently in paying status with us but may increase his balance on a card, or for the first time start to use the card to take cash advances. These behavioral patterns can be correlated with future delinquency and future losses. Our reserve build this quarter reflects such observed behavioral patterns in our portfolio as an enhancement to our loss estimation process. The reserves

we built in U.S. cards last quarter and the builds in our remaining consumer businesses this quarter completes this particular review of our global consumer business.

The second category accounts for approximately 60% of the build. Over half of this approximately 60% build is driven by leading indicators which point to a continued deterioration in credit in certain portfolios, such as in U.S. consumer mortgages and certain macroeconomic indicators. Less than half is driven by growth and seasoning in the portfolio and acquisitions.

Looking ahead, our reserve balance will always reflect the types of considerations I have just described. Markets & Banking credit losses increased \$98 million, primarily reflecting higher net credit losses and a \$123 million charge to increase loan loss reserves for specific counterparties. Credit costs reflected a slight weakening in portfolio credit quality.

The top half of slide 9 shows consumer credit net losses and loan loss reserves as a percentage of loans. The bottom two graphs show 90-day delinquency rates for our first and second mortgage portfolios in consumer lending. The top graph demonstrates that loan loss reserves and NCLs as a percentage of the consumer loan portfolio have held steady. Excluding the impact of grey zone, the ratio of NCLs to average loans has been fairly stable excluding last quarter.

As a reminder, last quarter's 13 basis point sequential decline in the NCL ratio was driven by a number of acquisitions that closed during that quarter. When impaired loans are acquired, they are booked on our balance sheet at their estimated net realizable value, which results in lower NCLs in the early months following the close of a transaction.

Loan loss reserves as a percentage of loans are higher sequentially, but in line with levels of two years ago and below the peak in the first quarter of 2004. Since that peak, the ratio has consistently declined until the first quarter of this year, when we started to see it tick up. The declines were a reflection of a particularly favorable credit environment over the last couple of years. The increase now is a reflection of the current environment and the factors I described above, all of which warranted the addition to our reserve levels.

The two graphs at the bottom show the 90-plus-day delinquencies in our first and second mortgage portfolio in the consumer lending group, which have increased substantially, particularly in the month of September. The first mortgage delinquency trend shows that the current delinquency levels are still running below their 2003 peak. In contrast, delinquency rates in our second mortgage portfolio are at historically high levels. In part, our reserve action for our mortgage portfolio reflects this significant deterioration.

Since the beginning of this year, we had added over 1,700 collectors and recovery staff in our U.S. consumer businesses, of which over 560 were for mortgages in U.S. consumer lending. We continue to take deliberate actions to lower the volume of second mortgage originations through channels that have historically demonstrated a higher incidence of delinquencies, such as third-party correspondents. The shift in origination channels, along with tightened underwriting criteria, have resulted in an improvement in the quality of originations whereby loans originated in this quarter had higher FICO scores and lower loan-to-values, on average, than those originated a year ago.

In addition to restricting the channels of originations, we have eliminated a number of product offerings. For example, we no longer offer mortgage loans for investment properties or three to four-family homes.

A word on resets. In our consumer lending first mortgage portfolio, approximately \$1.7 billion, or 2%, of our adjustable-rate mortgages are scheduled to reset in the fourth quarter. Approximately \$10 billion are scheduled to reset through the end of 2008, compared to \$1 trillion of resets in the U.S. consumer mortgage market. Approximately 90% of our resets have been projected to be in the higher FICO, lower loan-to-value categories.

Slide 10 shows a historical trend of a number of key capital ratios and return on common equity for the quarter. As the graph shows, all of our capital ratios have declined since the beginning of the year, driven primarily by acquisitions which we have completed and organic acquisition growth.

As we have said before, we target to keep our Tier 1 capital ratio above 7.5% and the total common equity to risk-weighted managed assets ratio above the 6.5% level. Both the Tier 1 capital ratio and the TCE to risk-weighted managed assets ratio reflect the impact of acquisitions and additional assets, such as certain leveraged loans and commercial paper which came onto our balance sheet during the quarter. Although at this time there is a lot of variability around the factors that impact our capital ratios, we expect that we will return to our targeted capital ratio sometime early in 2008.

We expect to restore our capital ratios in a number of different ways. First, we are using stock as opposed to cash as consideration for the purchase of the remaining 32% of Nikko in a share-for-share exchange. Second, we are focused on pursuing a disciplined approach to growing our balance sheet and deploying capital to the highest growth and return opportunities. You may have seen our announcement a few weeks ago to centralize our treasury operations.

Finally, organic earnings growth and earnings from our acquisitions will continue to generate capital for the company. We anticipate, however, no further buybacks until we have reached our targeted capital ratios.

Now I will briefly take you through the results of each of our major business lines. Slide 11 shows results in our U.S. consumer business. Revenues were flat versus last year's third quarter. Good volume growth from our strategic actions was offset by three factors: first, the absence of a \$133 million gain from the sale of mortgage-backed securities in the third quarter of 2006.

Second, we had a downward adjustment in the valuation of the residual interest that we hold on our credit card securitizations which gets marked to market. This was driven primarily by an expectation of continued deterioration in consumer credit, combined with an increase in short-term funding costs as commercial paper spreads widened significantly during the quarter, partially offset by the decrease in Fed funds in mid-September.

Third, the receivables securitized this quarter were of higher credit quality and had lower yields than those securitized in last year's third quarter, resulting in lower securitization revenues in the current quarter.

Expenses in U.S. consumer grew by 8%, driven by a significant reduction in marketing and advertising expenses in our cards business in last year's third quarter, as well as the impact of integrating the ABN AMRO acquisition this quarter into our consumer lending group. Credit costs increased by \$1.7 billion, driven by the factors that I discussed earlier. A significant reduction in net income is reflective of the challenging market conditions and year-over-year comparisons, combined with the additions to our loan loss reserve.

Slide 12 shows the results of our international consumer business, which have been affected significantly by the results in Japan consumer finance. Let me start with the impact of the grey zone this quarter. We had a loss in Japan consumer finance this quarter of \$288 million, driven by three primary factors:

First, revenues were lower by 52%, driven by lower receivable balances and increased charges to reserves as estimates for losses for refund claims increased.

Second, expenses increased 67%, driven by writedowns of \$152 million pre-tax on customer intangibles and fixed assets. This charge is being taken because we have concluded that the carrying value of these specific assets is not recoverable. Excluding these write-downs, expenses in Japan consumer finance are down approximately one-third from last year's levels as we continue to reposition the business.

Third, credit costs increased 25% on higher NCLs and a reserve build of \$161 million to reflect our expectation of higher losses inherent in the portfolio.

In this business, the situation remains difficult; and given our recent experience with the level of grey zone related refund claims, our best estimate now is that the business will have net losses in 2007. We continue to analyze the profitability prospects for this business thereafter.

Now let's put Japan consumer finance aside and look at the results. As you can see from the middle section of the slide, excluding Japan consumer finance, international consumer revenues were up 47%; pre-tax income is up 30%; net income is up 17% as the absence of prior-year tax benefits caused a 13 percentage point negative impact on net income growth.

Revenues for this quarter included a \$729 million benefit from the sale of Redecard shares. Excluding the Redecard gain and Japan consumer finance, international consumer revenues were up 31%.

A quick word on Redecard. Redecard is the only merchant acquiring company for MasterCard in Brazil. Prior to the July 2007 Redecard IPO, Citigroup was a 31.9% shareholder. We sold a portion of our Redecard shares for a pre-tax gain of \$729 million and an after-tax gain of \$469 million which is recorded in our international card results. Citi continues to hold a 23.95% investment interest in Redecard.

International cards averaged net receivables grew 52%, reflecting strong organic growth and the impact of acquisitions. We launched five new partnerships in the quarter, including AirAsia in Malaysia and Shell in the UK. We now have 189 partnerships in 44 countries and continue to expand the partnership program.

Retail banking revenues were up 26% driven by strong loan, deposit and investment product sales growth. However, continued investment spending, higher credit costs reflecting the impact of portfolio sales, and a reserve release in last year's third quarter and reserve builds this quarter and lower tax benefits this quarter drove net income down 21%.

Outside of Japan, consumer finance receivables were up 20% and revenues were up 22%. International consumer expense growth excluding Japan consumer finance reflected the acquisitions that closed during the year and continued investment in our distribution network. We opened or acquired 392 retail bank branches and 212 consumer finance branches in the last 12 months.

In Japan consumer finance, credit conditions continue to deteriorate. Outside Japan, credit costs were up \$1 billion reflecting increased estimates of losses inherent in the portfolio, results from acquisitions, organic portfolio growth, and seasoning and the absence of prior year's net releases of \$93 million in international retail banking. For the total business, the net impact of grey zone and higher credit costs were the primary drivers of a 15% decline in net income.

Slide 13 shows the results in our Markets & Banking business. The impact of the severe market dislocations resulted in a revenue decline of 24% and a net income decline of 74%. There were three major drivers of the revenue decline:

First, \$1.4 billion came from highly-leveraged loan writedowns, of which \$901 million was taken against our debt underwriting revenues and \$451 million against lending revenues.

Second, \$1.6 billion from writedowns in mortgage-backed securities which were warehoused for future CDO or CLO securitizations as well as on CDO positions. Our sub-prime exposure related to these positions was \$24 billion at the beginning of the year, \$13 billion at the end of the second quarter, and declined slightly during the third quarter.

Third, \$636 million from losses in credit trading. A major factor driving the magnitude of our losses and writedowns is that we are a major player in the markets that were hardest hit by the dislocation. We have historically been a top underwriter of leveraged finance and a leader in the structured credit and credit trading businesses. That said, as Chuck mentioned, there is no question that we underperformed certain competitors even considering turbulent market conditions. We must examine the situation, learn lessons from it, and make changes.

To give you a sense of some of the things we are working on:

First, we have reorganized credit trading and have changed the leadership of this business.

Second, in our structured credit business, CLO and CDO structuring volumes have dropped significant and we are diversifying our business more towards trading, where we have traditionally had a strong market position.

Third, in leveraged finance we continue to actively renegotiate and restructure the transactions to ensure they are executed at optimal terms.

Fourth, we are examining our risk management organization to enhance particular areas such as convergence risk management and the management of aggregate exposures by asset class.

Fifth, we have changed pricing and terms on many products across the consumer and corporate businesses to reflect the renewed interest in bank funding as a source of capital.

Sixth, in spite of the market dislocation in the third quarter which affected our efforts, we are working on pursuing a disciplined approach to growing our balance sheet and deploying capital to the highest growth and return opportunities.

Finally, as we invest in businesses where we have competitive gaps, such as commodities and prime brokerage, we continue to diversify away from our dependence on the fixed income business in Markets & Banking.

While we are diligently working on many issues across the firm, the underlying business momentum remains very strong across the franchise. The issues we are dealing with are specific to the market dislocations in the quarter and we have taken lessons from it to enhance the way we manage the business.

Offsetting the declines I referenced earlier, several businesses showed strong results in the quarter. In fixed income markets, currency and interest rate trading results were strong and revenues were up double-digits. Equity market revenues were up 19% from a year ago, but down 35% from record second quarter results. Cash, derivatives, and equity finance showed good growth versus last year, partially offset by weaker results in convertibles due to lower customer flows.

In our investment banking businesses, we remain number 1 in combined global equity and debt underwriting for the 24th consecutive quarter. We had record revenue results in advisory, and advised on eight out of the top ten deals year-to-date. Revenues in fixed income underwriting were affected by the leveraged loan writedowns; and equity underwriting revenues almost doubled versus last year, but were lower than the record second quarter.

In global transaction services, revenues increased 38% to a record \$2.1 billion, driven by higher customer volumes, stable net interest margins, and the acquisition of The BISYS Group which closed in August of 2007. Key revenue drivers continued to grow at strong double-digit rates.

Expenses increased 11% versus last year. Lower compensation costs were offset by significantly higher other operating and administrative expenses. These higher operating and administrative expenses are a reflection of acquisitions, legal costs and other business development costs. Record revenues in Asia, Latin America and

Mexico reflected the strength of the franchise in those regions and the fact that the market dislocations in the U.S., while affecting some markets, did not have widespread impact across the globe.

The overall investment banking pipeline decreased during the quarter, driven by a drop in leveraged finance activity. However, the M&A pipeline remained at record levels and the equity underwriting pipeline remains strong.

Slide 14 shows results in our global wealth management business. Revenues were up 41% driven by strong customer activity, the impact of Nikko, and the inclusion of the Quilter acquisition. Excluding Nikko, revenues were up 19% and were a record. Assets under fee-based management were up 38% -- 20% excluding Nikko -- on strong market actions. Net interest margin increased over the last year in Smith Barney, benefiting from the bank deposit tiering program.

Expenses were up 38%, driven by an increase in compensation costs on higher revenues and the impact of acquisitions; excluding Nikko, expenses were up 18%. One point to note. Last quarter we completed the integration of Citigroup Investment Services, which was previously managed and reported in the retail distribution segment into Smith Barney. This resulted in a transfer of 686 FAs and \$47 billion in client assets this quarter into Smith Barney. Strong revenue results, good expense control, and the impact of acquisitions drove an increase in net income of 23%.

Slide 15 shows results in alternative investments and corporate other. In alternative investments, revenue and net income declined, primarily driven by lower results in our hedge fund activities, the absence of gains from the sale of MetLife shares in the third quarter of 2006, and lower market value in Legg Mason shares. Client revenues were up 75%, reflecting the integration of Old Lane and organic growth.

Corporate and other income declined, primarily reflecting higher Nikko-related charges and the absence of a prior-year benefit related to retirement benefits plans, which were partially offset by improved treasury results.

Now to wrap up on slide 16, let me give you a few thoughts on the fourth quarter earnings environment. Starting with what we saw in September, there were some promising signs such as better quality leveraged finance and asset-backed transactions being successfully executed. However, many parts of the fixed income market and many types of investment vehicles such as CDOs have shrunk dramatically; and we are not optimistic that they will regain a foothold in the market.

Our underlying business momentum is strong, and we're well positioned in many of the fastest-growing countries. We expect our broad presence and the depth of our client relationships to generate results. We expect to continue to rapidly expand our international franchise. As the structural expense initiatives we announced in early 2007 are on track, they're delivering the cost savings that we projected. As we embed a discipline of continual re-engineering at the company, we expect to become more and more efficient, driving stronger bottom line results.

We continue to watch credit very closely. Our expectation, based on the acceleration in our mortgage delinquencies in September that I discussed, is that consumer credit in the U.S. will continue to deteriorate in the fourth quarter. Our overall cost of credit, including NCLs and any incremental reserve builds, will reflect the economic environment, the credit performance in our portfolio and the portfolio growth.

The situation in Japan consumer finance remains difficult. Given our experience with the level of greyzone related refunds claims, our best estimates continue to be that the business will have net losses in 2007. We continue to evaluate the profitability prospects of the business thereafter.

Finally, as you may know, we announced that we would centralize our treasury functions which will facilitate the allocation of capital to our highest growth and return opportunities.

Let me now open it up for questions and answers.

Question-and-Answer Session

Operator

Your first question comes from Jason Goldberg - Lehman Brothers.

Jason Goldberg - Lehman Brothers

With respect to earnings, income came in a bit higher than expected, despite some write-downs, a bit more than expected. Relative to your expectations, what came in better? It seemed like a pretty big difference given the quarter was already over.

Gary Crittenden

I wouldn't think about it that way. As you might guess, when we were making our estimates at the end of the quarter we hadn't closed our books, hadn't been through the closing process at the time. Obviously, we were trying to be judicious in what we expected the total potential decline in income to be. It was simply, I think, a judicious call at the time to say that we were going to be down by 60%. So I wouldn't think about it any differently than that, Jason.

Jason Goldberg -Lehman Brothers

Secondly, can you just talk about off-balance sheet exposure, particularly related to SIVs in terms of what your exposure is? Obviously, a lot of news coming out over the weekend on that.

Gary Crittenden

Yes, we have different types of off-balance sheet exposures. Those that we have some kind of contractual commitment to, we disclose in our Q. You can see those numbers in our Q. We also manage, as you mentioned, a SIV that we manage in the UK. We don't have any contractual obligation to provide funding for that SIV, nor do we consolidate it.

Jason Goldberg -Lehman Brothers

With respect to actions announced this morning, can you give us any color?

Gary Crittenden

I'm not aware that any actions have been officially announced yet.

Jason Goldberg -Lehman Brothers

Lastly, can you talk about leveraged lending exposures? You gave us the CDO numbers, but the balances in terms of leveraged loans and where we stand on that?

Gary Crittenden

As we concluded the third quarter, our net exposures were \$57 billion.

Operator

Your next question comes from Betsy Graseck - Morgan Stanley.

Betsy Graseck -Morgan Stanley

A question on the reserve methodology; I know you detailed how you changed it, the impact of the change, but maybe you could help us understand how you have worked with the regulators to get them to approve this change? I am wondering if you even needed regulator approval, because I was under the impression that it was difficult to change methodologies.

Gary Crittenden

We didn't need any type of regulatory approval here. There was actually no methodology change. What we did during the quarter was refine our estimate process. We actually started this back in the second quarter, and we have been working across our entire consumer portfolio to try and identify behavioral changes, which at the end of the day, will result in a loss that is embedded in our portfolio today. I gave you an example of that.

Another example might be if you had a mortgage customer, for example, that is now paying their mortgage three or four days later in the month that they had historically. We went back and did the correlations on that kind of thing. We saw that those eventually resulted in losses that were actually embedded in the portfolio today, but hadn't manifested themselves. So we refined our estimate on that, and that accounted, as I said, for a hunk of the addition to the loan loss reserve that we did during the course of this quarter.

But the regulators aren't really involved in that. That doesn't require any kind of regulatory approval. That is just something that we do as the normal effort to improve the quality of estimating what our eventual loss might be.

Betsy Graseck -Morgan Stanley

Because you indicated that this was the close of the global consumer business review with regard to the reserving levels. Is that right?

Gary Crittenden

This particular set of activities, we have really gone around the world. We did \$240 million of this, roughly, in the first quarter in the U.S. card business, we did the remainder in this quarter. That effort to try and identify these relationships that will eventually emerge as losses in the portfolio is now complete.

Betsy Graseck -Morgan Stanley

But if you were to find other indicators that would help you in the reserving methodology, you could tweak again?

Gary Crittenden

We could, yes. We constantly are working to try and improve the quality of what we do from a reserve estimation process. We certainly could do that in the future as well.

Betsy Graseck -Morgan Stanley

It was my read of the chart on page 9, the net charge-off, net credit losses, and the reserve levels. There is still a gap there, right? Of about 20 basis points?

Gary Crittenden

Between what?

Betsy Graseck -Morgan Stanley

The net charge-offs and the loan loss reserves in the global consumer book?

Gary Crittenden

Yes, but that is just purely coincidence. Those numbers, as you can see historically, have been above and below each other. We don't make any particular effort to try and have those numbers align.

Betsy Graseck -Morgan Stanley

I am just wondering, in an environment where the consumer is deteriorating, should we expect that this gap should persist? Or in the past, because it is not showing here on the chart, in deteriorating credit environments, whether or not the reserve ratio had been running above net charge-offs ever?

Gary Crittenden

What I said about my expectations for the fourth quarter is very much what we feel. We are in a deteriorating credit environment. That was particularly pronounced if you look at the bottom of that same page that you are talking about, there really is a deterioration happening in mortgages right now.

We think we are running better than the industry based on the numbers that we can see, but we have a 30-day lag in getting information from the industry. We think we are running better than the industry; but having said that, there clearly was an uptick in the quarter and our expectation is that that is going to continue as we go into the fourth quarter.

Betsy Graseck -Morgan Stanley

Then on capital allocation, you have indicated a couple of times that there are lots of opportunities for improving the efficiency of the capital deployment. Could you just give us a sense as to what you see some of the low-hanging fruit is, and the degree to which you could move the needle on ROA or ROE?

Gary Crittenden

During the course of this quarter, and we have been talking about it for a time, we organized a central treasury group and appointed a new treasurer. One of the objectives of that team is obviously to help us to allocate capital in the most efficient way across the company as we possibly can. We have been through a process of putting together a matrix, more or less, that shows the product categories in which we compete that have low return on regulatory capital and low return on risk capital. Those are the first assets that we are focused on.

So if you look on the balance sheet in the supplement, for example, I'm just going to turn there very quickly. This is now on page 7 of the supplement, and you focus on the investment line item of the supplement, you will see that that

line item is down by 12%, reflecting, for example, the sale of a significant portion of the mortgage-backed securities that we had in our consumer lending business in the United States. It is examples like that, Betsy, that we are very focused on to try and take out of the portfolio as soon as it makes economic sense to do so. That is the kind of example that I think serves us well.

Now we have a long-term target for return on equity of somewhere between 18% and 20%. We obviously will underperform that target today, so we have got a lot of work to do to keep the commitments that we have made to you all. It is not helped, obviously, by the fact that we have had some assets come on the balance sheet this quarter that were not part of our original plan. But we are attacking those assets, we are going to be thoughtful about this. We have someone who I believe is an excellent leader for the treasury function to lead that effort.

It's going to take us a while to reverse the impact of these assets that have come onto the balance sheet but we have every expectation of being able to make good progress on this over the next couple of years.

Betsy Graseck -Morgan Stanley

The key capital ratio that you are focused on is TCE to risk-weighted managed assets, is that right?

Gary Crittenden

Yes. I mean, Tier 1 and TCE are both important, but we are obviously very focused on both. Our hope, as I mentioned, is that we will return to a more normal level in the early part of 2008.

Betsy Graseck -Morgan Stanley

More normal level is 6.5% on a TCE?

Gary Crittenden

Yes, 6.5%.

Operator

Your next question comes from Guy Moszkowski - Merrill Lynch.

Guy Moszkowski -Merrill Lynch

First a factual question. Leveraged finance writedown gross of the fees, because you presented it net of fees?

Gary Crittenden

We haven't disclosed it. Fees typically run 1.5% to 2%, so I'm going to just have to let you make an estimate, because we decided not to disclose.

Guy Moszkowski -Merrill Lynch

We will work with that. On the structured product, the sub-prime MBS writedown, the stuff that was going to go into the structured product, do you have a gross number there? Would the hedges that you referred to that would have reduced that include structured finance gains on the structured financial liabilities?

Gary Crittenden

If you take the total gross number there -- again, we haven't disclosed that -- there was significant hedging. So if you look at the way the kind of final position came out, the \$1.6 billion, that was net of our hedges. We didn't disclose the hedge number again. I guess the way I would think about it is we cut the exposure that we had, as I mentioned, from \$24 billion or so at the beginning of the year down to \$13 billion. Coincident with doing that, we also increased the amount of hedging that we did to what I would say is a significant level. So there was a fairly significant gain on hedges that were reported in the quarter that offset that.

I believe that during the quarter that also included the fair valuing of the liabilities against that number; the answer to that is yes.

Guy Moszkowski -Merrill Lynch

Can we get some round number around the fair value of the liabilities mark?

Gary Crittenden

I think the fair value of the liabilities mark in the quarter was \$466 million. Now of course, there were also similar counterparty spread movements on the asset side of the balance sheet that would have roughly offset that amount.

Guy Moszkowski -Merrill Lynch

Can we talk a little bit, in broad strokes, about the continued decline in net interest margin? How much of that was due to mix shift in your deposit base toward deposits that you're actually paying for and how much due to some other things?

Gary Crittenden

The underlying trend there really was heavily influenced by Nikko. So Nikko came on with a lower funding cost but lower yielding assets. So, a couple of those basis points was influenced by Nikko. If you take that out of the picture and just say more aggregate what is happening, what is happening is that we actually had higher yielding assets in the quarter. We had somewhat lower cost of liabilities in aggregate, but the mix shift between assets was adverse. That is, the mix because of the Nikko acquisition and the mix shift towards the trading assets that we have resulted in some deterioration in NIM in the quarter. But the pronounced impact there was Nikko and Japanese grey zone. If you took those two out of the picture, it was essentially flat on a sequential basis quarter over quarter.

Guy Moszkowski -Merrill Lynch

Thanks, that's very helpful. Let me just ask one more question, if I might, about the increase in net credit losses and loan loss reserves on the international side, which to me at least seemed surprising, I think even beyond Japan consumer finance. Can you give us a little bit more color on what you are seeing in the areas beyond the Japan consumer finance problems in international consumer that caused you to put up such a significant increase in reserves?

Gary Crittenden

It is a fair question. Because if you look, for example, on page 18 of the supplement and focus on the 90-day past due in the card business, what you see is that it actually had improved some during the course of the quarter. I think you see that pretty much across International. That said, we did the exact same exercise internationally that we had done in the U.S. Which is, we made a diligent effort to go through each one of the portfolios and make sure that if we could identify behavioral patterns that would eventually end up in a loss of some sort, that we reflected that and embedded that in our reserve today. Obviously, it is not driven by the underlying deterioration in delinquencies for the most part. I think that is really what is there.

Now having said that, we do have some continued deterioration in Mexico as part of an ongoing effort that we are making to grow our business there; a successful effort to grow our business there. We have had some deterioration, but it is not large enough to reflect itself in the overall numbers for the company.

Guy Moszkowski -Merrill Lynch

Right. One bright spot actually seemed to be GTS, transaction services. The dynamic seemed to be pretty positive there. Maybe you can give us a little bit more color on what was going on in that business?

Gary Crittenden

What is going on, frankly, is a continuation of the excellent things that they have done. So if you look at the underlying metrics for the GTS business, on just about every count the underlying metrics look good. The growth in deposits, the strength that we have internationally in that business. As you can see, the expense leverage was good in the quarter. The addition of BISYS has gone, at least to-date, very smoothly. So that appears to be a business that is obviously performing very well.

Guy Moszkowski -Merrill Lynch

So there wasn't anything in it that you thought was an offset to the problems we were seeing elsewhere, just in terms of flight to quality and things like that?

Gary Crittenden

The one thing that did happen during the course of the quarter, as people did not invest in typical kinds of things, so companies that might have done asset-backed CP investing in the quarter tended to hold higher cash balances. There was some benefit of that that was reflected in the quarter.

Operator

Your next question comes from Glenn Schorr - UBS.

Glenn Schorr - UBS

Could we just get a comment on the asset-backed commercial paper market? Just in terms of if it was functioning at full 100% strength six months ago or a year ago, where are we at now? How much has moved on balance sheet and are durations extending at all? Can you just give a little bit of flavor for what is going on in that market right now?

Gary Crittenden

If you don't hold me to a specific percent, I will give you a flavor.

Glenn Schorr - UBS

Just the flavor is great.

Gary Crittenden

If it was 100% awhile ago, it obviously had declined very, very significantly into the August time period and was essentially not functioning. But it had longer terms associated with it so it doesn't stop functioning and then suddenly there is no asset-backed commercial paper. It terms out over time. As that was being wound down, you saw the asset-backed commercial paper, as a percentage of our funding at least, declining. But not declining at a precipitous rate, because it comes off gradually.

Now beginning about a month ago, the asset-backed commercial paper market started to reopen. Now we are seeing, for high-quality issues, the emergence of an asset-backed commercial paper market. But it is not even anything like the levels that we saw some time ago. So some of that is being replaced, at least in our case by term funding; and that is obviously being balanced as we go forward.

But there has been a return over the course of the last month to funding. Of course, we have a lot of high-quality assets, particularly your credit card receivables, things like that, that function very well in that market and we anticipate will be funded just fine as people have become more discriminating in terms of the assets they are willing to buy.

Glenn Schorr - UBS

What happens to the assets that they are not willing to buy? I agree with you, there is plenty of stuff that got lumped into the four-letter word. But there are plenty of assets that people won't want to buy. So some gets out, and what happens to the stuff-- will it sit on balance sheet, most likely?

Gary Crittenden

I think if you are asking about in the world, I think that is generally true. If you look at the composition of our assets, the composition of our assets are actually very strong. I don't think we are in a position where that is a significant issue for us individually. But I think generally, that is probably going to be right.

Glenn Schorr - UBS

I will push the envelope a little on this one. Conceptually a single master liquidity enhancement conduit, just what is the concept of why it would exist? Just to provide confidence? Because it doesn't seem like there is incremental capital being put out. Or would there be capital put out?

Gary Crittenden

Well again, there has been no specific announcement about anything like this, so I don't know if I should make any comment about it. But let me just say that it wouldn't be surprising to people on the phone that it would be helpful to have other liquidity alternatives for SIVs that are managed in the UK. As I understand from what I read in the paper this morning, that is generally the concept here. Alternatives that would provide liquidity there I think could provide reassurance to the market and make the funding there of very high-quality assets a little bit easier.

Glenn Schorr - UBS

Shifting gears to transaction services, are there any numbers you can throw out on what BISYS would have added on either side of the equation? Like revenue and expense, or just to the bottom line? Because I think all the trends still look good. I just want to be able to piece that out.

Gary Crittenden

Glenn, we haven't disclosed it. It is not in the supplementary where; and so, no.

Operator

Your next question comes from John McDonald - Banc of America Securities.

John McDonald - Banc of America Securities

A question on the non-performing assets. There was a big jump in the commercial side on the back page, total corporate cash basis. Can you give some color on that?

Gary Crittenden

That is primarily driven by one single name. There are actually two there in total; but one is the larger of the two. IKB AG, a standby commercial paper arrangement that we had. So they were the funder of a CP. They were a funder of a SIV in the UK. We had a standby arrangement to support that SIV. When they became unable to provide that funding, we had a requirement to step in and provide that funding. You see that as an increase in the cash loans that are there on the balance sheet.

Now, you also see that we took a corresponding increase in our credit reserves in the corporate side of the loan loss reserve. We did that specifically in response to this. But that is the largest of the two pieces that are in that increase that you identify.

John McDonald - Banc of America Securities

So most of the increase from 600 to 1,200 is two things, and you gave us one of them?

Gary Crittenden

And that is by far and away the largest of the two pieces.

John McDonald - Banc of America Securities

The charge-offs for international card jumped a lot. Is that Mexico?

Gary Crittenden

Mexico was probably the single largest increase in the quarter. We have had some increase in Brazil and some increase in India as well, but nothing that would have driven the numbers other than those three items.

John McDonald - Banc of America Securities

The international card delinquency is pretty stable, then? What was your outlook there just in the international card?

Gary Crittenden

If you look at it, it is very stable, and we feel pretty good about each of the markets that we have internationally. That said, we did go through a pretty thorough process to ensure that if we could identify losses that were embedded in the portfolio and refine our estimates based on the identification of those embedded losses that we took them in this quarter. But it's hard to find that in the delinquency numbers. It is really much more based on the refinement of the modeling that we have done.

John McDonald - Banc of America Securities

A question on the net interest margin. You look like you are more wholesale funding reliant than the other U.S. banks. There is some thought that this would make you more a beneficiary of the Fed cuts. Theoretically you should have some benefit as the short rates come down in your net interest margin, everything else equal?

Gary Crittenden

It depends entirely on the shape of the yield curve. So the Fed funds rate has come down, but the yield curve shape has really not helped us materially at this point. The general point that you make is absolutely correct, John. That if the curve shifted in the right way, because of our wholesale fund exposure, it should be beneficial for us. But it would require the curve to have some steepness associated with it and for the low end to shift down.

John McDonald - Bancof America Securities

Which part of the curve would be most relevant when you talk about that shape, Gary?

Gary Crittenden

If it goes down at the short end, that is the most advantageous thing to happen for us.

John McDonald - Bancof America Securities

Which it has. I mean, it has gone down on the short end. Something is happening on the long end that is not helping?

Gary Crittenden

You have got to have both the short come down and the long end stay up.

John McDonald - Bancof America Securities

Like the ten-year?

Gary Crittenden

Right, like the ten-year.

John McDonald - Bancof America Securities

Just on expenses, you were supposed to get roughly \$2.1 billion in expenses this year under the plan previously outlined. Did you say where you are on that \$2.1 billion expected for '07, how much have you've gotten so far?

Gary Crittenden

We are going to hit that number. We haven't disclosed the number that we have hit so far, but we are right on track. In fact, we are probably running just slightly ahead of the plan at the end of the third quarter and we will hit the \$2.1 billion that we committed.

John McDonald - Bancof America Securities

With the restructuring and management changes, any expected severance or anything like that or any restructuring charges from the new business line announced?

Gary Crittenden

No, nothing that is coming out of the activities that we just announced last week. Now, one of the things I should point out is that we have ongoing re-engineering activities and from time to time from in those ongoing re-engineering activities there will be severance costs, restructuring charges that we will take. Those may or may not happen in quarters when we have gains that happen at the same time. But there is certainly nothing coming out of what we have just done that would generate a restructuring charge.

Operator

Your next question comes from Ron Mandle - GIC.

Ron Mandle - GIC

I was just wondering how much foreign exchange might have added to revenue growth in the quarter?

Gary Crittenden

FX added 2% to revenue growth in the quarter.

Ron Mandle - GIC

Second on the loan loss reserve, you mentioned that you saw credit deterioration in September. I am wondering why you didn't build the reserve more than you did, given that you basically said you were going to build it more in the fourth quarter?

Gary Crittenden

Well, first of all we did. So if you look at what we announced the reserve to be for credit costs at the time we did the October 1 announcement, it was a couple hundred million dollars lower than what we actually ended up doing. That came because as we finished the quarter, we obviously saw this uptick that took place during the last two weeks of September.

The credit losses that you recognize have to be credit losses that are embedded in the portfolio as it exists today. So you can do your best to forecast behavioral changes like we have, you can look at macroeconomic factors and talk about how those macroeconomic factors influence what you believe the embedded losses to be in the portfolio today. All of those things you can do. What you can't do is look forward and anticipate losses that are not yet in your portfolio. But you might have a view which you can embed in these macroeconomic judgments that you make that your current portfolio is going to recognize those losses. But you can't pull future losses obviously into this quarter.

Ron Mandle - GIC

So in other words then, you built the reserve in anticipation of higher fourth quarter losses, so you will not have to build the reserve in the fourth quarter.

Gary Crittenden

Let me just tell you the way I would think about it. The way I would say it is that there are a series of macro economic factors. Let me just give you an example. If you look at the number of days homes are sitting on the market, if homes are sitting on the market for a longer period of time that probably means that we have embedded in our portfolio today losses that have not yet emerged but will eventually have to be recognized. We have tried to take into account those types of macro economic factors in assessing the reserve.

However, beyond that kind of thing, you can't anticipate a loss that is not embedded in your portfolio today. If there is significant deterioration in the credit environment that goes beyond where things are today, we simply can't embed that because we have that expectation.

Ron Mandle - GIC

In terms of asset-backed commercial paper and other disruptions in the quarter, I was wondering how much your balance sheet might have gone up in the quarter because those disruptions of that sort?

Gary Crittenden

Well, we didn't split it out specifically during the quarter. You can get a little bit of a flavor for it, obviously, by going through the piece parts of what happened. But we haven't specifically identified the balance sheet increase associated with dislocations.

Ron Mandle - GIC

Would you give us some guidance in that regard?

Gary Crittenden

I don't think so.

Ron Mandle - GIC

Finally, I'm just wondering, you have made the management changes. I am wondering what criteria the board uses to decide how high up the management changes should be, given a quarter like this.

Charles Prince

I think the board's criteria for that is to see whether or not we have a good, sustainable strategic plan, one that can see us through along-term set of performance, especially with the kind of headwinds that come like this quarter's aberrational impact of the fixed income. I think with that kind of criteria, the board feels comfortable at the levels that we have made the changes.

Ron Mandle - GIC

So that kind of assumes that markets and business trends will normalize in the fourth quarter and beyond, and that you will be back on the track that you thought you were on at the end of the second quarter?

Gary Crittenden

I think the best way to think about that, Ron, is to go through the comments that I made on slide 16. I stepped through each one of the major business lines and talked about the factors that we think are the current update of where our performance is in the fourth quarter.

Operator

Your next question comes from Mike Mayo - Deutsche Bank.

Mike Mayo - Deutsche Bank

Chuck said this was the year of no excuses. You guys say the results are disappointing. So what are the repercussions at the level of the Office of the Chairman? When I look at results, and feel free to educate me, but the business line mishaps are not just investment banking. There are some other areas. There are some risk management issues. Expense management, no matter how you look at it, year-over-year, year-to-date, linked-quarter, you add back the charges, reducing some for comp, you still have negative operating leverage.

Then management. It was a year ago when Tom Maheras, Michael Klein were moved to head the Investment Bank and now that has kind of changed a little bit. Also, Dave Bushnell, Head of Risk Management, was promoted three weeks before the preannouncement. I was not sure what was going on with that.

But the bottom line here is almost all the investors that I talk with feel like there needs to be more significant changes in terms of management. So that is the data I am looking at. What are you looking at, or what is the board looking at that they feel more comfortable?

Charles Prince

I think I would repeat a large part of what I said to Ron. It sounds to me like a very similar question. If you look at our results this quarter, no one can be happy with the results in our fixed income business or with the results that relate to that. But I think if you are able to look at the other parts of our business, if you look at the strategic plan that we are executing on, I think any fair-minded person would say that strategic plan is working. The benefits that we saw in the fourth quarter and then more in the first quarter and then more in the second quarter are showing through in the third quarter in the businesses that haven't been impacted severely by the fixed income dislocations.

So if you look at parts of securities and banking, and we called those out; if you look at our international business; if you look at our GTS business; if you look at our wealth management business; if you look at our various businesses, the trend line of growth that we have sustained now for several orders is continuing. It is clear that the fixed income dislocation hurt us, and hurt us in a very significant way in those businesses. But I think I certainly have confidence in our strategic plan. I think that it is showing through. I personally expect that it will continue to show through in the future. I think those are the factors that people are looking at.

Mike Mayo - Deutsche Bank

Well, one of your main targets for this year was to grow revenues faster than expenses and that is not going to pan out. This could be the third year in a row where that doesn't pan out. That was clearly a very important factor. Also at the corporate level, the risk management you said it was on the extreme areas of where you thought it should be. How do you think about that?

Charles Prince

Well, you ask two questions there. Obviously, we want revenues to grow faster than expenses. It is true in many of our businesses. As I said, we had a very severe dislocation in revenues in our Markets & Banking business, one that I am not sure any fair-minded person would see a way to lower expenses rapidly enough to offset that in a five-week period. In the rest of our business, I think we are actually making very considerable progress in that.

In terms of risk management, obviously, we wish that our risk management models had predicted what had happened here. In fairness, they included it, but only at the wide margins of what we thought was possible. I am not sure we were alone in that difficulty. But the facts are the facts. Our job is to sustain our strategic plan is we go forward, and that is what we're going to do.

Mike Mayo - Deutsche Bank

As it relates to risk management, the promotion, or maybe it's not a promotion. I am not sure what it was. The addition of responsibilities of the risk management head three weeks before the preannouncement?

Charles Prince

I am not sure of your question, Mike, but it was a promotion for David. David has taken on a broader set of responsibilities. Again, I don't see risk management as a guarantor of results in the kind of market dislocations that we have had this quarter, so I don't see that as a connection at all.

Mike Mayo - DeutscheBank

I mean, reasonable people can disagree. If you don't like the Office of the Chairman or the way it is being run, you just sell your stock. But my question is, I saw Robert Rubin quoted in the press saying that your job should be safe for four years from now. Did the board kind of reaffirm your CEO status for the next several years? To what degree was your job title reinforced?

Charles Prince

I don't think it would be appropriate for me to comment on what Bob said or about what the board might be thinking in that regard.

Mike Mayo - DeutscheBank

But you did say the board feels comfortable with the levels of changes that have been made. So should we assume that the changes are done?

Charles Prince

Again, Mike, I think it just wouldn't be appropriate for me to comment further on that subject.

Operator

Your next question comes from Meredith Whitney - CIBC World Markets.

Meredith Whitney - CIBC World Markets

I have some operational questions regarding cards, mainly internationally, but also domestically, and then Japan's grey zones.

With respect to cards domestically, you haven't seen receivable growth in some time on a year-on-year basis. You have seen pretty rapid growth specific to Latin America in international. What is your strategic effort, strategic aspiration to grow the domestic cards, the U.S. business? What tenets do you have in place to grow that business? What are your aspirations again? What governors do you have in place to manage credit losses on the Latin American or international side given the fact that the growth is so outsized?

My last question related to the grey zones is, you have given guidance to 2007. But can you extend that out to 2008 in terms of what you expect in terms of the earnings impact from the grey zone change in law to be? Thanks.

Gary Crittenden

That was a long list. I hope I get them all, Meredith. On the first one, we have a pretty concerted effort around re-engineering in our U.S. cards business that I think is going to generate investment dollars for us next year that will be larger than what we have had in that business over the last few years.

Essential for that business is having the right level of marketing support. This will provide additional marketing support for that business going forward that hopefully will allow it to do reasonably well. That is a relatively mature market in the U.S. from a receivables perspective and the result of that is compared to the investment options that we have outside the United States, we really do look to them to fund their growth.

Now having said all that I have just said, the group has done a really good job of bringing down promotional balances in that business. That has had a negative impact on our overall receivables growth, but it has had a positive impact on the margin in the business. So you have to look at those going in both directions.

We are obviously very focused on the credit performance outside the U.S. I think that is underlined by the fact that we took a \$1 billion increase in loan loss reserve to make sure that we have gone through each of those portfolios and identified what within the portfolio might indicate the possibility of a loss that is embedded in the portfolio today, but is not yet evident to us. That has been a very comprehensive process. It went on for the last couple of quarters and concluded, as I said, with the results that are embedded in our results this quarter.

But having said that, we are still very much on top of looking at each of these individual countries that are growing very rapidly, and trying to govern the growth rates appropriately to ensure that the loan losses that we have foreseen there are appropriate for what the growth and eventual maturation of the portfolio will be.

Meredith Whitney -CIBC World Markets

Can I just follow up real quick before you do Japan? Most of the growth in the domestic portfolio has been through acquisitions of private label portfolios. What does the core portfolio look like, exclusive of the private label growth? What does growth specifically look like there? Can you give some tangible examples about how you're marketing to grow that portfolio?

Gary Crittenden

The additional portfolios that have been acquired are relatively immaterial; that is, for right now. So you have got the Federated portfolio that has come in during the course of the last year. So the larger portfolios that you have in mind are really a little bit further back. So there is a modest impact from Home Depot, modest impact from Federated, but really relatively small.

You know, the most recent example of something that they have done is a relaunch of the AT&T universal card. That happened about a month ago. There is a brand new value proposition that has been launched with AT&T with a whole set of new reward options associated with it, and I think is a good example of an effort to revitalize a product that is a significant part of our portfolio, but has not grown very much over the last little while.

I think there is a three-sided effort here. One is to take those parts of our portfolio that have not been growing well and go through some effort to revitalize them; AT&T is like that. There is a focus on the faster-growing segments of the portfolio, like travel and entertainment and small business. That is a second effort that that team is working on. Then the third, as you quite correctly point out, are partnership efforts that are underway. All of those, hopefully, are underpinned by a more effective re-engineering strategy next year that will provide them some capacity to expand their marketing efforts.

From a grey zone perspective, I would be the last person, frankly, to make a forecast for 2008 financial results. That is a fluid situation, I think is the best way to describe it. It is important to take away that we did write down to zero the remaining specific intangibles that were associated with this business in this quarter. So, there won't be any charges associated with that in future quarters.

As you know in the fourth quarter of last year, we took a charge of north of \$600 million to reflect what we think the refund claims will be. But it is obviously difficult to say, given the environment around that business, exactly how it will evolve in 2008.

Meredith Whitney -CIBC World Markets

Just to clarify, when you talk about the grey zone loss extending throughout the fourth quarter of 2007, is that new information? Or is that just a reiteration of what you had said all along?

Gary Crittenden

I think at the end of the second quarter, I said that we expected a loss on a full-year basis.

Meredith Whitney -CIBC World Markets

Right, but I thought you had said that at the end of the year, or Chuck had said at the end of last year as well.

Gary Crittenden

No, we had expected that we would breakeven this year at the end of last year. But we have now said for a couple of quarters that we expect it to lose money.

Operator

Your next question comes from Jeff Harte - Sandler.

Jeff Harte - Sandler

Good morning. Most of my questions have been hit on. But a couple, and this is going to be a tough one to answer, but somewhat forward-looking in the investment bank. We are sitting here after a difficult quarter for mortgages and CDOs; and I believe you made a comment earlier about some of those structured finance products really not getting a

foothold again. As we look back over the last couple of years, how important were those businesses for driving revenues in the investment bank? As you start looking to 2008, what kind of budgeting thoughts do you have for what kind of strength we could see in the wake of the troubles this summer?

Gary Crittenden

Well, they have been important for us and obviously have represented a hunk of the growth that we have had in the investment bank over the course of the last couple of years, but they aren't the only area where we have had significant activities underway to try and grow our investment banking business. Those elements of our plan are clearly in place.

So if you look at the success, for example, that we have had with equity derivatives from 2006 into 2007 that change there has been actually pretty good. The growth in interest rate structuring, 2006 to 2007, looks very good. So, I think in these areas where we are making strategic investments, which also include commodities and FX options, we are going to continue to reinforce and invest behind these categories as particularly they overlap with emerging markets where we have strong, fundamental positions.

So, this is a business which you know changes very rapidly over the course of years. If you look at any business configuration among any of our competitors and go back five years and compare it to today, this is a business that evolves and follows the market opportunity. We intend to do exactly the same thing.

Charles Prince

Jeff, I might add that one of the things that we are taking into consideration is that over the last four or five years providers of liquidity have not generally been rewarded for that. I think at least in the intermediate period in front of us, providers of liquidity will have a greater reward for that effort than they have had in the past.

Jeff Harte - Sandler

Finally on the trading side, a difficult quarter, but it was a difficult quarter for most. You talked a little bit about working on systems to improve the aggregation of risk exposure over positions, geography. Can you talk a little bit about that? Because you guys really span the globe more than most, and products more than most. How able are you to aggregate things like credit risk and even interest rate risk across the franchise?

Gary Crittenden

It is actually more a question of how we think about things, I think. Let me just give you a quick example. We have had a process over the last couple of years that has kept our growth in sub-prime mortgages on the consumer side in check, basically. That has not expanded very much. If you look at our mortgage trading results in the second quarter, although we didn't split that out as a separate category, they were actually okay during the course of the quarter.

In part that was because the credit risk team was very focused on the exposures in both of those categories. The CDOs in large measure were managed by our market risk teams and they were very concerned about the change in interest rates as it would affect the valuation on the CDO warehouse. The cross-pollination between the credit risk team and the market risk team was not as strong as it needed to be.

One of the things that we have learned from this whole experience is that we have to have more integration between the way those teams operate so that risks that are apparent and coming up in one area, that historically have not been relevant for another area, are available to us so we can see them and make sure that we anticipate them in the future. That is specifically the kind of thing that I was referring to in my comments.

With regards to interest rate risk, we obviously know what our position is at any moment in time. What we have talked about on these calls in the past is we need a better capability to forecast under various scenarios on a companywide basis how that interest rate is going to change. We still need to make progress in that regard. It is going to take us into next year before we actually have good dynamic capability under multiple scenarios to forecast out what our net interest margin is going to be. That is one of the initiatives that our central treasury group is working on.

Operator

Your next question comes from Vivek Juneja – JP Morgan.

Vivek Juneja – JPMorgan

Can you comment on the U.S. consumer as well as the international consumer business? If you look at them ex the reserve build, there has really been no net income growth. When should we expect that? What is it that will help drive that, given that you are starting to see a pickup in losses now? Just stepping aside from the reserve build.

Secondly, if you can comment a little bit on the alternative investments business, given that you have added a lot of international stuff with Old Lane, it was still a difficult quarter. How should we expect results in that business to start to show up?

Gary Crittenden

If I think about the U.S. consumer business, I think this was a little bit of an unusual quarter. So U.S. consumer has done a nice job rebounding off of the lows of a couple of years ago, in terms of their revenue performance. You all have seen the chart that we have used in many different circumstances that showed the turnaround in revenue performance in that business being roughly in the 4% to 6% range over the last few quarters.

This quarter, there were actually market-related events that had to do with a couple of specific items, securitization and the way we marked the I/O strip to market, that resulted in a negative impact on the results in this quarter. Also, we had a gain on the sale of some securities in the third quarter of last year that made this quarter's momentum look weaker.

The fundamental trend, the fundamental revenue growth rate is basically the same in that business this quarter as it was last quarter. Last quarter we were impacted by a pretty significant reserve build, particularly when compared to the prior year. So we had reserve releases in the prior year. We took, again, some of the refinement to estimate addition to our reserve in the second quarter.

I think the elements are largely in place. That business has had operating leverage on a year-to-date basis with the exception of what has just happened in this quarter and we have had now significant charges from a credit perspective. We are certainly hoping that on a normalized basis this business will perform as one would expect it to perform.

Internationally, we have made very significant investments in operating expenses. We have grown the branches there very significantly. You can see the number of branches that we have grown. The revenue growth rate there is strong. If you again take out the Japanese grey zone and you look at the business without Japanese grey zone, the underlying performance of that business is actually very attractive and it is obviously a key area for investment for us in the future, and anticipate that to be a business that will return very attractive results for us.

In alternatives, that is a very difficult business quarter to quarter to manage the underlying results. If you look at the results the first two quarters of this year, they did better than what we had anticipated, better than the guidance that we had provided. That was also true of the fourth quarter of last year. They did less well this quarter than what we had anticipated and less well than what our typical average guidance might be for that business as well. But I think it's very difficult to say quarter to quarter that that business is going to have a consistent financial result.

Vivek Juneja – JPMorgan

Going back to the U.S. consumer, given that yes the operating leverage, if you look at just your average expenses are improving, but you have to factor in the credit costs. It is not just the reserve build. Your credit losses are starting to climb. If you factor that in, you are not growing your bottom line; and ultimately that is what matters. What are your plans to try to improve that? Because obviously with the interest rate environment moving away from being as negative as it was previously, it is easier to make the operating leverage look better. But net-net is what matters.

Gary Crittenden

Well, I certainly agree with you that net-net is what matters. We have done what we believed was necessary to do from a reserving standpoint to capture the losses that are embedded in the portfolio today. I gave you my sense of what I anticipated credit to do as we move into the fourth quarter. I believe we have good metric performance in that business. If you look at deposit growth and loan growth on the chart on the page, we have got good operating expense constraints that have been operating in that business as we have gone through this year. Obviously, we are at a point in the credit cycle that has been difficult for us. There is no doubt about it. That may very well impact us as we go into the fourth quarter.

Vivek Juneja – JPMorgan

Is it partly also because you have just stretched, just like you did in the fixed income business, certain areas that are coming back that have grown a little too rapidly, so you are pulling back in areas such as home equity?

Gary Crittenden

I am not sure that I understand exactly the point that you are making.

Vivek Juneja – JPMorgan

The point being that certain areas such as home equity have grown really fast, are you cutting back on that in any way?

Gary Crittenden

As I said in the comments that I made in the script, we have cut back on third-party originations in the home equity business and are primarily using our own sources of origination. But if you look at the parameters of our portfolio, we neither grew as rapidly in the sub-prime portions of that business as others did, and we have very attractive FICO scores in that business. If you look at the growth in delinquencies in the first and second mortgage portfolio, although they are large, as I mentioned in my talking points, at least as we have industry numbers here, we are performing substantially better than the industry. We don't have the industry numbers for September, but up through August we were doing better than the industry.

Vivek Juneja – JPMorgan

Lastly just a little detail. Tax rate, how should we think about it going forward since and you had another quarter where it was a nice benefit? What is a way to think about that from a normalized standpoint?

Gary Crittenden

Obviously, I wouldn't assume that this quarter's tax rate is a typical kind of a number. There were a number of advantages in this quarter that we had. You can go back historically and see what this has averaged. I would go back and use historical numbers rather than provide you some kind of a forecast.

Operator

Your final question comes from Diane Merdian - KBW.

Diane Merdian - KBW

I was also going to ask on the tax rate. I guess the only thing I would add, based on your comment, is should we make some adjustment to the normalized tax rate that we have observed over time, based on the mix between international and U.S., which is shifting over time? Separately, I was hoping to maybe get some insights on the size of the I/O writedown and securitization gains. Finally, I was curious if you would give us any sense about the portion of expenses in securities and banking that is non-comp.

Gary Crittenden

Portion of expenses that is non-comp? In terms of the tax rate, obviously the growth rate in international has been helpful for us. If you go through the actual rates for the first part of this year, it was about 27% in the first quarter; 29.9% in the second quarter; 27.4% in the quarter we have just come through. Those are all related, for the most part, to discrete planning activities that we have engaged in that are beneficial for us from an international perspective. The more we grow our business internationally, the more those kinds of opportunities are available for us.

Again, I wouldn't want to forecast out at these relatively low levels of tax rates. I would look towards the last couple years and do some averaging based on the last couple of years rather than forecast off of these levels, Diane.

In terms of the I/O writedown, the I/O writedown was about \$107 million in the quarter. The securitization gains in this quarter were less than they were last year. They were less than last year by over \$100 million.

Then, the portion of our expenses that is non-operating I'm not going to give you specifically; but if you look in the Markets & Banking supplement, I think the total amount of non-comp expenses is \$2.2 billion. How that relates to comp, you can obviously see back on page 23 of our supplement.

Thanks, everyone for joining with us today.

Art Tildesley

Please call us in investor relations with any other questions you have during the day. That completes the call.

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