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2008

### FRBNY Summary of Supervisory Activity and Findings on Citi

John J. Ruocco

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## FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

AREA CODE 212-720-5000

January 14, 2009

**BY HAND**

Board of Directors  
 Citigroup Inc.  
 c/o Vikram Pandit, CEO  
 399 Park Avenue  
 3<sup>rd</sup> Floor  
 New York, NY 10043

Dear Board Members:

Enclosed is our annual report of inspection for Citigroup Inc., as of December 31, 2008. We assign ratings of 444/4<sup>1</sup> to Citigroup, and consider the firm to be in “marginal” condition<sup>2</sup>. Without prompt action, the organization’s future viability could be impaired.

The financial condition of the firm has deteriorated. We are lowering our assessment of the firm’s financial condition to “marginal” from “fair.” Losses for five consecutive quarters weakened the firm’s capital base. Earnings and liquidity are “unsatisfactory” and asset quality is “fair.” The capital subcomponent remains unchanged at “fair” balancing various considerations.

Serious deficiencies in Board & Senior Management oversight relating to the strategic direction of the firm, serious weaknesses in liquidity risk management, and material weaknesses in the firm’s ability and its systems to monitor key vulnerabilities lead us to lower our assessment of Risk Management to “marginal.”

We are also lowering the “Impact” rating of the firm from “limited” to “considerable” to reflect the weakened financial condition of the parent and non-bank subsidiaries, which significantly increases the likelihood that the firm may be unable to serve as a source of strength to its subsidiary banks.

Details of these findings are contained in the enclosed report and will be discussed with you during our scheduled meeting of January 21, 2009. Because of the nature and seriousness of the overall weaknesses, it is our intention to intensify our direct communication with the full board of directors,

<sup>1</sup> The components of the RFI/C rating system are risk management, financial condition, likelihood of a negative impact of the parent and non-bank subsidiaries on the depository institutions, an overall composite, and a depository institution rating. All components use a scale of 1 to 5, ranging from strong to unsatisfactory.

<sup>2</sup> Institutions so rated have significant risk management and financial weaknesses which may pose a heightened risk of significant negative impact on the subsidiary depository institutions. Companies so rated require close supervisory attention and substantially increased financial surveillance.

COPY

January 14, 2009

as well as engage in regular dialogue with the chairs of the Audit and Risk Management, Nomination and Governance, and Personnel and Compensation Committees to insure that remedial action is overseen at the highest levels. We are also requiring that senior management revise its corrective action plan pertaining to the Memorandum of Understanding of June 3, 2008 so that the concerns expressed in this letter are fully addressed to our satisfaction.

After you have had an opportunity to review this report, and within 30 days of the receipt of this letter, we would appreciate receiving management's written response to the matters discussed herein. Please note that this letter and enclosures contain confidential bank examination material and should be treated accordingly by your organization as described in the footnote.<sup>3</sup>

Respectfully,



John J. Ruocco  
Asst. Vice President

Enclosure

COPY

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**RESTRICTED FR**



## **SUMMARY OF SUPERVISORY ACTIVITY AND FINDINGS**

Name: CITIGROUP INC.

Period Covered: January 1, 2008 – December 31, 2008

Location: NEW YORK, NEW YORK

RSSD ID Number: 1951350

### **THIS DOCUMENT IS STRICTLY CONFIDENTIAL**

This summary has been prepared by an examiner selected or appointed by the Board of Governors of the Federal Reserve System. The summary is the property of the Board of Governors and is furnished to directors and management for their confidential use. The summary is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 U.S.C. 1817(a) and 1831m) and in the regulations of the Board of Governors (12 C.F.R. 261.11). Under no circumstances should the

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**FEDERAL RESERVE BANK OF NEW YORK**

### **OVERALL COMPOSITE RATING**

In light of significant weaknesses in Citigroup's overall condition, we are downgrading its supervisory composite rating from "fair" to "marginal".<sup>1</sup> Our assessment is heavily influenced by the continued deterioration of Citigroup's financial condition, deficient oversight practices by the board of directors ("board") and senior management, and weaknesses in risk management. The financial and risk management weaknesses identified in this report, particularly those related to funding and liquidity risk management, left the firm seriously vulnerable given the recent stresses and market dislocations. Consequently, the firm needed extraordinary and unprecedented U.S. Government assistance in 2008. Further, those weaknesses have had a considerable negative impact on non-bank affiliates and the parent company's ability to serve as a source of strength to its subsidiary depository banks, as reflected in a downgrade of the "Impact" component rating to "considerable" probability of negative impact.

#### ***Matters Requiring Immediate Attention***

The key concerns listed below warrant immediate attention by the board and senior management:

- The strategic direction and execution exhibited by the board and senior management have not been consistent with the vulnerabilities of the firm. The strategic plan must be reworked by the board and senior management to better reflect the firm's current financial resources and global economic realities, as well as address the span of control needed to continue to operate a large set of businesses across a significant number of countries.
- The firm remains in a much weakened state and is facing substantial headwinds from a weakening economy that could cause further credit deterioration and bring into question the adequacy of the firm's capital base going forward. Management's reformulated strategic plan must include actions to bolster the firm's common equity base. The firm's risk levels, as expressed by its own internal measures of risk such as economic capital and stress tests, substantially exceed common shareholder's equity. We caution that efforts to turn a profit for the firm in the near term must not result in outsized risk taking or diminution of the control infrastructure which could further undermine Citigroup's long-term performance.
- Liquidity vulnerabilities must be addressed. The liquidity contingency planning process was insufficient and hampered by structural impediments management had created through the pursuit of other objectives. Management's ability to identify

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<sup>1</sup> Bank holding companies rated "marginal" have significant risk management and financial weaknesses, which may pose a heightened risk of significant negative impact on the subsidiary depository institution(s). Unless prompt action is taken to correct these conditions, the organization's future viability could be impaired. Firms rated as such require close supervisory attention and substantially increased financial surveillance.

shorter-term funding pressures in a timely manner has been substantially hindered by ineffective management information systems and data management practices. We understand that this is in part a function of the data available through legacy systems, with communication channels relied upon within Treasury to help fill gaps in quantitative information. Given the size and complexity of the firm's liquidity and funding demands, these deficiencies need to be addressed comprehensively and immediately.

These weaknesses require the development of immediate action plans and necessitate a more frequent dialogue between us and the full board and senior management of Citigroup. Additionally, we also plan to meet with the chairs of the Audit and Risk Management Committee, the Nomination and Governance Committee; and the Personnel and Compensation Committee on at least a quarterly basis to discuss their plans, or more frequently if circumstances warrant.

### FINANCIAL CONDITION

***Overall: Marginal***

Citigroup's overall financial condition rating has been downgraded to "marginal" from "fair." The downgrade reflects significant deterioration in asset quality, earnings and liquidity, as well as our continued concern with the adequacy of Citigroup's capital base. Accordingly, heightened supervisory monitoring of the firm's financial condition will occur throughout 2009.

<b>Financial Condition Ratings for Citigroup</b>	<b>12/31/08</b>
Overall Financial Condition Rating	4
<i>Subcomponent Ratings:</i>	
Capital Adequacy	3
Asset Quality	3
Earnings	5
Liquidity	5

***Capital: Fair***

The capital rating remains unchanged at “fair” --- balancing various considerations.

On the positive side, Citigroup’s regulatory capital ratios are currently appreciably above “well-capitalized” levels and appreciably higher than they were last year. The high ratios are of course a result of injections of \$45 billion in preferred equity by the U.S. Government, representing extraordinary and unprecedented action by the U.S. Government to address the weakened state of Citigroup.

On the negative side, this superficially well-capitalized position masks a series of underlying weaknesses. First, Citigroup does not have the prospect of augmenting its capital base over the short-to-intermediate run through earnings retention. The firm generated losses throughout the past four quarters, and is expected to continue to have negative earnings into 2009.

Second, the firm does not have ready access to private equity capital markets at this time. We do note that during the evaluation period senior management did raise capital in response to weaknesses in Citigroup’s balance sheet. The need to enhance significantly the firm’s capital base was a subject of our supervisory dialogue with senior management during the course of 2008. A total of \$32.3 billion was raised through private and public issuance, of which \$4.9 billion was common stock and the balance in non-cumulative perpetual preferred stock, addressing in part the concerns we had expressed. The effect of this capital raise on shareholders’ equity, however, was offset by losses incurred.

Third, the firm is likely to experience substantial credit deterioration, which brings into question the adequacy of the firm’s capital base going forward. The firm’s risk levels are high when comparing risk as expressed by the firm’s economic capital models in relation to regulatory capital. This indicates the firm has a material chance of falling below the well-capitalized threshold, or wiping out the common shareholders.

Finally, Citigroup’s capital base is heavily skewed towards preferred and hybrid equity, reflecting the replacement of lost common equity with U.S. Government preferred. Expressed another way, the firm’s tangible common equity has declined over the last several quarters and is now very low relative to either total tangible assets or risk weighted assets. This shift in the composition of capital is concerning as it limits the discipline common shareholders can exert on the firm’s risk taking.

In light of the above considerations, and notwithstanding the current high regulatory capital ratios, we re-emphasize the need for the board and senior management to outline ways of improving upon the firm’s equity base over time.

***Asset Quality: Fair***

Citigroup's asset quality is downgraded to "fair" from "satisfactory," reflecting weaknesses in the consumer and, to a lesser degree, the wholesale portfolios. Deterioration in the firm's consumer portfolio continues to be driven by worsening trends within the U.S. mortgage portfolio. More recently, deterioration in the domestic credit card, auto and personal installment portfolios has become more pronounced. Similar trends are observed in the performance of the firm's international retail portfolio. We recognize the associated build in the allowance for loan losses in response to the noted deterioration. We also recognize more broadly steps taken to mitigate delinquencies and losses, for example, by moving away from third party origination sources for the home equity and first mortgage portfolios. While the level of non-performing loans and credit losses in the wholesale accrual book remains modest, the upward trend in criticized exposures is a growing concern given the current environment.

***Earnings: Unsatisfactory***

Citigroup's earnings performance has been downgraded to "unsatisfactory" from "marginal." The downgrade is driven by a prolonged period of poor performance, posing a significant threat to the firm's capital base and ultimately, its solvency. Losses for 2008 total more than \$19 billion. Core revenues remain weak across major business lines, such as Global Cards, Consumer Banking, and Securities and Banking. Additionally, those business lines, which had served as a source of positive earnings, such as Global Wealth Management and non-US operations, are under strain. International consumer businesses are expected to deteriorate at a rate closer to that already experienced on comparable U.S. assets. Furthermore, growth in the Global Transaction Services business line, historically a strong performer, is also showing signs of strain and with performance expected to moderate in 2009.

In the coming year, senior management is projecting higher credit costs as demonstrated in its current "2009 Downside" scenario, which forecasts a net loss of \$5.7 billion, including estimated provisions of \$38.5 billion and \$6.4 billion of further write-downs in legacy portfolios. To help offset declining revenues, Citigroup has a significant reengineering initiative underway including a total workforce reduction of up to 35,000 by 2Q09; however, these efforts are insufficient in and of themselves to restore the firm to profitability.



***Liquidity: Unsatisfactory***

Citigroup's liquidity has been downgraded to "unsatisfactory" from "fair" as the funding position of the firm remains at risk and immediate steps are needed to address liquidity vulnerabilities. In our Summary of Supervisory Activity and Findings delivered this past April, we concluded that the funding position of the firm was at risk and steps were needed to improve liquidity. We are not satisfied that enough has been done to address those concerns.

Over the course of 2008, a priority of the Federal Reserve supervisory team has been engaging Citigroup management regarding our concerns with the firm's funding and liquidity vulnerabilities. Those vulnerabilities became significantly more pronounced in times of stress as exhibited through weaknesses in the firm's contingency funding process in part due to structural impediments to building contingent liquidity sources and the absence of quantitative data that adequately highlighted the firm's short term funding vulnerabilities.

The contingency funding process performed poorly as senior management ran out of options for supplementing the needs of its broker-dealer subsidiaries, and was slow in taking action to build contingent capacity for the lead U.S. bank. For example, it was only in response to an impending downgrade by the rating agencies that a limited amount of assets were moved to Citibank N.A. for pledging to the Discount Window. A substantial lead time was needed to consider repositioning other assets which could not be done given the immediacy of the potential risk event. In our view, proactive steps were not taken to address the contingent funding needs of the banks as this vulnerability was well understood by management.

Addressing the liquidity needs of the consolidated firm and of its major individual subsidiaries has been excessively complicated by legal and structural impediments created through the pursuit of other objectives. For example, in establishing the structure of the firm's legal vehicle entities, management focused on minimizing tax implications without appropriate consideration as to how the resulting structure would hamper access to contingent liquidity.

Senior management has been over-reliant on longer-term liquidity measures and on absolute levels of liquid assets, which do not provide a nuanced view of the firm's shorter-term liquidity vulnerabilities. Management's ability to identify shorter-term liquidity vulnerabilities on a timely basis, particularly during times of stress, has been substantially hindered by ineffective management information systems and data management practices which makes liquidity monitoring and reporting manually-intensive, overly anecdotal and prone to error. For example, management was slow to initiate more-timely and granular deposit monitoring as formal daily deposit monitoring by region only began at the end of September 2008, with daily deposit monitoring by country having been initiated this past December. In addition, the monitoring and reporting of significant funding concentrations is not timely (currently done quarterly) and does not provide sufficient insights into concentrations by country and counterparty.

In addition, secured funding data by counterparty and collateral type are not readily available on a legal entity basis for the firm's U.S., U.K. and Japanese broker-dealers.

Citigroup is more dependent on 'non-core' funding sources (i.e., wholesale funding sources such as securities repurchases, commercial paper, capital markets issuances, and foreign deposits) to fund long-term assets than its peers. Citigroup's net non-core funding dependence ratio (defined as net non-core funding sources to long term assets) is 105% with peer institutions at 56% percent. In addition, domestic deposit funding is significantly below peers as domestic deposits represent only 14% of Citigroup's total assets whereas peers is 41%. This is a significant vulnerability as foreign-based deposits displayed a high level of outflow during the firm's recent stress period and the firm is reliant on foreign deposits to fund a substantial portion of its U.S. dollar-denominated domestic assets. Deposit outflows of approximately \$25 billion in late November and early December 2008 posed a significant risk to the firm.

Under a plausible deposit runoff scenario the lead bank would exhaust its cash resources in only a few days. These trends do not show up in the structural liquidity measures management has relied upon most heavily in describing the firm's funding position with us. Further, the firm does not sufficiently monitor funding vulnerabilities by legal vehicle, relying instead on separate views of the composite banks and composite broker-dealers. This contributed to management's inability to quantify the degree of funding stress the individual broker-dealers would be subject to should access to secured financing markets diminish further. This weakness was exacerbated by the fact that the broker-dealers are heavily dependent on the financing of illiquid securities on an overnight basis.

## **RISK MANAGEMENT**

The Risk Management rating represents an evaluation of the ability of Citigroup's board and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk across the bank holding company and its subsidiaries. The rating is supported by four subcomponents: Board and Senior Management Oversight; Policies, Procedures and Limits; Risk Monitoring and Management Information Systems ("MIS"); and Internal Controls.

<b>Risk Management Ratings for Citigroup</b>	<b>12/31/08</b>
Overall Risk Management Rating	4
<i>Subcomponent Ratings:</i>	
Board and Senior Management Oversight	4
Policies, Procedures, and Limits	3
Risk Monitoring and MIS	4
Internal Controls	3

### **Summary of Risk Management Conclusions**

The assessment of Citigroup's overall risk management is downgraded to "marginal"<sup>2</sup> from "fair," with similar assessments assigned to the "Board and Senior Management Oversight" and "Risk Monitoring and MIS" elements. The remaining sub-components, "Policies, Procedures and Limits" and "Internal Controls" remain rated at "fair." We do acknowledge efforts by the board and senior management in several areas to improve the management of risk, including initiatives undertaken to address our supervisory concerns outlined in the Summary of Supervisory Activity and Findings of April 2008. Most notable have been steps taken to implement uniform approaches across businesses in measuring risk, and to instill greater discipline on balance sheet usage. However, from an overall supervisory perspective, these actions are outweighed by the negative consequences of the deficiencies noted throughout this report.

### **Discussion of Risk Management Subcomponents**

#### ***—Board and Senior Management Oversight: Marginal***

Board and Senior Management Oversight has been downgraded to "marginal" from "fair" based on shortfalls in the design and execution of appropriate strategies that are commensurate with the firm's financial condition, particularly its funding position, and liquidity risk management process. There is a need for the highest level of engagement by the board and senior management to ensure that weaknesses within the firm are addressed immediately. The board must set a strategic direction for the firm that reflects current realities and prepares the firm for weathering further deterioration. The strategic plan

<sup>2</sup> A risk management rating of "marginal" represents deficient risk-management practices that fail to identify, monitor, and control significant risk exposures in many material respects; one or more of the four elements of sound risk management are deficient and requires immediate and concerted corrective action by the board and senior management.

must be sized appropriately to the firm's available financial resources and consistent with the current global economic realities.

We do recognize the concerted efforts of the board and senior management to attract new talent to bolster the strength of Citigroup's senior leadership committee. We also recognize the extent of recent efforts by the board to engage strongly with senior management and the supervisors on financial and risk management concerns. Management also has employed strategies to offset the firm's financial deterioration, including asset divestitures, cost reductions, and scaling back of certain exposures though they have proven to be insufficient in the current environment.

Deficiencies were also observed in senior management performance, as it did not proactively address significant liquidity risks of the firm. These shortfalls were exacerbated by prior excessive risk taking at the firm that put downward pressure on earnings and capital, coupled with significant funding vulnerabilities.

With respect to funding and liquidity risk, management has over-relied on longer-term and aggregate funding metrics that do not provide a nuanced view of immediate vulnerabilities. Among other concerns is the firm's high degree of reliance on non-core funding sources. The board of directors and senior management must resolve the firm's structural funding vulnerabilities, as they pose significant risk to the safety and soundness of the organization. We require the board of directors and senior management to submit an action plan that identifies corrective actions as well as the time frame in which these actions will be taken.

***—Policies, Procedures, and Limits: Fair***

The rating of Policies, Procedures, and Limits remains "fair," recognizing that some steps have been taken to respond to the risk management deficiencies identified in the Summary of Supervisory Activity and Findings of April 2008. However, greater attention is needed in the liquidity risk management program. We also note that management continues to further refine and rationalize the credit limit structure, and develop and implement supporting policies and procedures. Within liquidity risk management, an urgent need remains to improve communication and coordination across individual country treasury functions, as well as to align treasury reporting and ALCO processes across regional treasuries.

Updates to corporate level policies and procedures also remain a work in progress. For example, we understand that management is on track to roll-out new market risk limits with corresponding policies and procedures by the second quarter of 2009 to provide consolidated monitoring of the more than 2,000 limits currently in place. Refinements are also needed to the firm's economic capital methodology as identified by management. Tools to be used for measuring risk-adjusted returns of businesses are also still in development. Further progress on all of these fronts is needed.

Finally, we note weaknesses in regulatory reporting practices, including data quality and documentation exception issues, stemming from failures to adhere to defined policies and procedures. We have detailed our concerns with regulatory reporting practices to management during the fourth quarter of 2008 and will relay them in a separate examination letter within the next few days.

***—Risk Monitoring and MIS: Marginal***

Risk Monitoring and MIS is downgraded to “marginal,” reflecting serious weaknesses in management’s ability to effectively and proactively monitor key vulnerabilities. From a liquidity standpoint, the firm has been unable to sufficiently monitor funding vulnerabilities on a legal vehicle basis, relying instead on composite views of banks and broker-dealers. As noted above, senior management’s over-reliance on longer-term structural liquidity measures does not provide a nuanced interpretation of shorter-term vulnerabilities, highlighting a critical deficiency for the firm.

Due to systems limitations, the firm relies heavily upon manual intervention to aggregate risk data more broadly, particularly across key legal entities. This reliance has severely constrained management’s ability to identify key funding and liquidity vulnerabilities on a timely basis. The dependence upon manual adjustments is also directly observable in the aggregation of key risk positions, hampering the firm’s ability to generate exposure reports in line with peer.

***—Internal Controls: Fair***

Internal Controls at Citigroup remain “fair,” reflecting a high degree of vulnerability due to a significant level of manual intervention required to capture key risk attributes, verify exposures and ensure data integrity. Reliance on manual processes that put additional pressures on controls is of particular concern given the significant increases in transaction volumes during recent market dislocations. We recognize management’s commitment to ensuring that ongoing cost control initiatives do not postpone or defer needed improvements to systems, processes or controls. We also note that Audit and Risk Review continues to fulfill its mandate in a satisfactory manner, and that controls have been tightened around budget planning, balance sheet management, and counterparty risk management.

**Other Supervisory Matters**

**Status of Enforcement Action: Memorandum of Understanding**

The Memorandum of Understanding (“MOU”) entered into by Citigroup and the Federal Reserve Bank of New York on June 3, 2008 requires senior management to assess, address, and resolve deficiencies in the firm’s risk management processes broadly defined. On August 11, 2008, senior management submitted a corrective action plan in

response to the MOU with most steps slated for completion by end year-end 2008 and the remainder by May 2009. Events since the plan was prepared clearly necessitate the need for management to revisit the actions needed to strengthen the firm.

### **IMPACT RATING**

The likelihood of significant negative impact on subsidiary banks from the parent company and non-bank subsidiaries has increased to “considerable” from an assessment of “limited” at the previous year’s inspection. This revised assessment reflects a weakened financial condition on the part of the parent company, which significantly hinders its ability to act as a source of financial strength to its bank subsidiaries. Operating losses at the non-bank subsidiaries (predominately the broker-dealers and CitiFinancial) have significantly constrained their ability to upstream dividend income to the parent company in support of the bank holding company’s debt service requirements, or the needs of depository institutions. To this point, dividend income has shrunk to approximately \$1.6 billion (September 2008 year-to-date) from more than \$10 billion in 2007.

Furthermore, operating revenue at the parent company is insufficient to cover debt service requirements with cash flows from operations covering only 43% of debt service requirements as of September 30, 2008 (versus 96% a year prior) compared to 116% coverage for peer institutions. This situation is further compounded by a higher double leverage ratio, 123%, relative to peers. This means that the parent has issued a substantial amount of debt with the proceeds having been injected as capital to subsidiary banks allowing them to further lever. It is expected that capacity to upstream dividend income from non-bank subsidiaries in 2009 will continue to be limited in light of weak earnings prospects. This suggests further challenges in generating dividend income to bolster operating cash flow at the parent company.

### **DEPOSITORY INSTITUTIONS’ RATING**

A discussion of the depository institutions’ rating will be forthcoming.

### **CAMEO: Rating of the Edge Act Corporation**

The overall condition of Citibank Overseas Investment Corporation (“COIC”) has been downgraded to “fair” from “satisfactory,” reflecting similar assessments of capital, asset quality, and earnings. Management remains rated “fair.” The rating for Operational Controls has been downgraded to “fair” from “satisfactory” to reflect the firm-wide weaknesses that have been identified in Internal Controls, Risk Monitoring and MIS, and Policies, Procedures and Limits.

CAMEO RATING	12/31/2008
Overall CAMEO Ratings	3
<i>Subcomponent Ratings:</i>	
Capital	2
Asset Quality	2
Management	3
Earnings	2
Operational Controls	3

**Capital** remains “satisfactory” in spite of capital ratios normally associated with stronger capital positions and due to the parent’s constrained capital position and the likely effects of COIC’s declining profitability and asset quality on capital going forward.

**Asset Quality** remains “satisfactory,” outperforming the parent’s thus far. On a risk weighted basis, classified assets represent only 1.9% of Tier 1 capital and unimpaired surplus, much less than the bank and the consolidated holding company. Loans account for 40% of assets with the remainder in lower risk and inter-company transfers, cash, and securities. Nevertheless, the rising delinquencies continue to spread to new geographies. In 2008, total past due and nonaccruals rose and now constitute 3.4% of outstanding loans. Criticized assets grew 60% and total classified assets nearly tripled as the allowance for loan and lease losses (“ALLL”) slightly outpaced charge-offs.

**Management** remains “fair,” with COIC relying on the same leadership, risk management infrastructure and personnel as the parent bank and bank holding company.

**Earnings** remain “satisfactory,” outperforming the parent’s thus far. Although COIC’s return-on-assets still slightly exceeds 1.0%, the firm’s return-on-equity continues to fall below 11%, reflecting a less than strong earnings performance. Moreover, the effects of the current global economy have begun to impact the firm and can be seen in declining profit margins, high overhead costs, declining asset quality, rising ALLL provisions, and emerging earnings shortfalls in new geographies.

**Operational Controls** has been downgraded to “fair” as policies, procedures, risk monitoring, and MIS are the same as those employed at a firm-wide level and at the parent bank. Moreover, enhancements to information technology and to compliance practices specific to COIC appear to be warranted based on reviews performed by Internal Audit and foreign supervisors.

### **SUPERVISORY ACTIVITIES IN 2008**

The Federal Reserve's supervisory program is accomplished through a combination of continuous monitoring by a core team of resident examiners and a series of more formal targeted examinations. In addition to periodic meetings with management, the core team has access to a significant amount of internal financial and risk management information. Analysis of that information enables the team to keep abreast of changes in the firm's business strategy, management structure, and risk profile.

The review of internal risk management reports is a critical element of our supervisory process. Reliance is also placed on the supervisory work of the primary bank regulator, functional supervisors, and foreign regulators. Supervisory information received from those sources is factored into our annual assessment of Citigroup. During the 2008 supervisory cycle, given the stressed financial markets and economic environment, a more significant emphasis was placed on heightened continuous monitoring activities.

#### **Scope of Reviews**

##### **Liquidity Risk**

- **Liquidity Risk Heightened Continuous Monitoring** The key focus was on the firm's funding position, metrics, MIS reporting and risk management. Particularly, monitoring included reviews of Citigroup's liquidity portfolio levels, stress testing, debt maturity profile, investor and counterparty concentrations, deposit flows and business and geographic composition. Additionally, intensive monitoring was undertaken of the firm's secured financing profile, including dependence on overnight financing of illiquid collateral, contingent borrowing/collateral capacity (FHLB and central bank) and the liquidity impact of potential rating agency downgrades and of off balance sheet exposures.

##### **Credit Risk**

- **Commercial Real Estate (CRE)** The review assessed direct and indirect risk exposures and vulnerabilities in CRE portfolios firm-wide. This included a review of the accrual book, with a focus on the degree of credit deterioration in the various sub-portfolios, as well as reserving and other risk management practices and processes. Examiners reviewed valuation practices and the application of "shadow" accrual book internal ratings assigned to the warehoused assets in the mark-to-market portfolios.
- **Counterparty Credit Risk Exposure Measurement and Management** This interagency horizontal review focused on the ability of firms' counterparty credit risk measurement and management processes needed to support trading of complex products with hedge funds that could result in large exposures. The review concentrated on areas of potential slippage between the underlying inherent risks of positions and the processes that support the measurement and reporting of these exposures.



- *Credit Risk Heightened Continuous Monitoring* There were several highly focused credit risk monitoring efforts to determine exposures and risks associated with certain groups of counterparties and obligors, leveraged finance, CDOs, retail credit (including loss mitigation strategies and allowance for loan and lease losses) and wholesale credit risk (including the top single name counterparty credit risk concentrations). Additionally, credit valuation adjustments, unfunded credits lines and corporate refinancing requirements were also evaluated.

### **Market Risk**

- *Market Risk Heightened Continuous Monitoring* Continuous market risk monitoring efforts focused on structured finance, commodities, auction rate securities, structured investment vehicles, stress testing, and covered bonds.

### **Operational Risk**

- *Internal Audit Effectiveness* In a target examination, examiners evaluated the independence of internal audit, the role of the board level Audit and Risk Management Committee (ARMC), the adequacy of the audit methodology, plan and risk assessment, the quality of audit work and other audit ancillary processes.
- *Basel II AMA Implementation* Guided by the Final Rule and the inter-agency Operational Risk Work Program for Basel II AMA, examiners evaluated Citigroup's quantification models, operational risk data and assessment systems, risk management processes such as control, oversight and validation mechanisms, and the progress towards resolution of the issues identified during the 2007 examination.

### **Legal and Compliance Risk**

- *Compliance Metrics Horizontal* The objectives of this review were to develop a better understanding of, and make assessments about, the state of compliance metrics more broadly, and to better understand the development and governance processes for compliance metrics and how they are used to aid in the monitoring of compliance risk.
- *CitiFinancial Puerto Rico (Phase I and II)* Examiners conducted multi phased reviews to assess risk management oversight and compliance controls for specific fair lending U.S. consumer protection laws applicable to the Puerto Rico operations of CitiFinancial.
- *Regulation K Discovery* The purpose of this review was to better understand the corporate arrangements and structures, expectations, and approval mechanisms that pertain to compliance with the Federal Reserve's Regulation K (International Banking Act). The focus of the review included internal reporting mechanisms,

information-sharing channels and the degree of communication and coordination among stakeholders responsible for governance.

**Other**

- *Regulatory Reporting* Examiners assessed the quality of banking regulatory reports and related control processes, tested the accuracy of a sampling of 2008 reports, and evaluated Citigroup's progress in addressing weaknesses from the prior review.
- *Banamex* Examiners assessed corporate governance and the internal control environment for credit risk management, information technology, payments and settlement systems, and anti-money laundering operations.
- *Basel II Draft Implementation Plan (DIP) Review* Examiners from the FRBNY and OCC, with participation from the FDIC, reviewed areas of Citigroup's Basel II DIP (version 3.0); the primary objective was to provide informal feedback on the completeness and comprehensiveness of the documentation supporting the DIP. While examiners did not provide a formal assessment at that time, as the plans were in draft form, the intention was to determine if management had identified all of the significant gaps between processes utilized by Citigroup and those that need to be in place in order to comply with the requirements of Basel II.