July 31, 2003

Mr. Jaime Caruana
Chairman of the Basel Committee on Banking Supervision
c/o Bank for International Settlements
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Re: Response to the Consultative Document "The New Basel Capital Accord"

Dear Mr. Caruana:

Citigroup appreciates and welcomes the opportunity to comment on the Third Consultative Paper ("CP3") of The New Basel Capital Accord ("the New Accord"). We continue to support the goal of making regulatory capital more risk sensitive and we appreciate the process the Basel Committee ("Committee") has implemented of actively engaging the industry in an open and interactive dialogue. Citigroup recognizes and values the enhancements that have been added to the New Accord since the issuance of the Second Consultative Paper (CP2) in 2001.

Nonetheless, Citigroup believes several material problems remain in CP3, which must be addressed. As written today, CP3 will not fully achieve the risk-sensitive goal of the Basel Committee. CP3 will in fact create economic distortions and an unlevel playing field between banks and between banks and non-banks in several product lines. Citigroup's concerns with the New Accord fall into six major areas:

1. <u>Capital is mistakenly defined to cover both Expected and Unexpected Losses</u> in contrast to both accounting principles and widely accepted economic capital standards. The Basel Committee has chosen a path of material inconsistency that will force a permanent divergence of regulatory and economic capital. The Expected Loss component of capital should be removed from each model.

2. <u>For Credit Risk,</u> the New Accord is falsely prescriptive in several areas and so cumulatively conservative that it distorts the economics of a number of important banking businesses. This is done in spite of the fact that banks would undoubtedly hold a buffer above minimum Tier 1 & Tier 2 capital ratios beyond the results of the prescribed models:
   - Floors and Ceilings are imposed in the models as opposed to using empirical data (especially in retail)
   - Fixed Parameters are introduced into the models with little regard to empirical evidence (in retail and corporate)

- Mis-categorizations exist, including treating Unused Lines of Credit in retail as if they were contractual commitments
- One-size-fits-all risk functions are prescribed for credit risk, as opposed to allowing the use of validated internal models as the Basel Committee has presciently decided in both market and operational risk

3. Regarding Operational Risk, Citigroup strongly supports its inclusion within Pillar I, as the only way to achieve consistency and transparency in the banking system for a very real risk area. Still, we strongly believe certain elements must be revised, and that the industry is in critical need of much greater clarification as to the AMA qualifying criteria for each of our many lines of business.

4. Diversification is not adequately recognized in the New Accord across products, regions, and risk types in assessing capital requirements—in contrast to modern economic theory and all empirical evidence. We recommend that the Basel Committee at a minimum explicitly state that diversification and scale are essential components of the Operational Risk AMA models, and a critical part of Pillar II supervisor guidance.

5. The Pro-forma Deconsolidation of Insurance is completely inconsistent with the Committee's decision to consolidate banking and securities subsidiaries. Furthermore, this approach effectively abdicates capital standard setting responsibilities to the public rating agencies, not to insurance regulators, as is the Committee's specific intention.

6. Disclosures have begun to be addressed, but certain critical improvements are still necessary to make the New Accord practical and fully workable.

If the Committee will address our concerns, we are hopeful that the New Accord can be modified to provide an acceptable system within the stated timeframe.

Citigroup supports the stated objectives of the Committee and looks forward to working actively with the Committee and with its own national supervisors to develop a truly improved Capital Adequacy framework that would implement the laudable goals. Attached to this document are addendums that address in more detail the topics discussed above. In addition, we are submitting several appendices under separate cover that contain confidential Citigroup data and analysis which we believe may be useful in your deliberations.

Very truly yours,

Todd S. Thomson
Executive Vice President
Chief Financial Officer

Addendums (Attached Below)

Addendum 1. – Six Major Issues
Addendum 2. – Additional Specifics on Operational Risk
Addendum 2. – Additional Specifics on Disclosures

Appendices (Contains Confidential Information—Under Separate Cover)

Appendix 1 – QIS 3.0 Overview and Issues
Appendix 2a – Retail Issues
Appendix 2b – Retail Unused Lines
Appendix 3 – IIF Presentation
Appendix 4 – Insurance Issues

cc: Federal Reserve Board
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Addendum 1 SIX MAJOR ISSUES

1. Definition of Capital (EL and UL)

- The New Accord sets capital requirements to cover both Expected Losses and Unexpected Losses without differentiating between the two. However, the definition of capital is not changed to reflect the provisioning that supports Expected Losses and the margins that act as additional buffers against losses. In the case of credit risk, Expected Losses are reflected as a reduction of capital through a charge to the income statement to fund reserves at the time the exposure is taken on, as well as subsequent charges based upon performance and local supervisory standards. A further regulatory capital charge would double count this exposure. The result is a systematic overstatement of risk and capital. This imbalance creates punitive capital requirements in higher Expected Loss businesses such as credit cards and some consumer lending without taking into account that such businesses have fairly stable losses and therefore are less volatile. The same fundamental issues apply to a broader set of businesses in the context of Operational Risk where Expected Losses are routinely built into pricing, and it is by no means clear that such treatment will result in Expected Losses being deducted from the minimum capital requirement.

- CP3 includes Expected Loss in the definition of Risk Weighted Assets. It then tries to rectify the Tier1 and Tier2 ratios by arbitrarily expanding the definition of Tier1 and Tier2 capital to partially incorporate reserves. The consequence of a) including Expected Loss in the definition of Risk Weighted Assets in the denominator and b) only partially and arbitrarily recognizing the financial resources available to cover Expected Loss in the numerator is to create a break with an economic capital framework and to distort the measurement of capital adequacy. An example of the arbitrariness in CP3 is the limitation of the reserves that can be included in the numerator to a maximum of 1.5% of RWA.

- We understand that EL was included in the definition of Risk Weighted Assets to give banks an incentive to add reserves. We believe that other means to that end, such as market discipline and Pillar II regulatory supervision, are more efficient and would not distort the measurement of capital adequacy.

- Citigroup strongly urges the Committee to clarify in its proposal that Tier 1 Capital must be sufficient to cover Unexpected Loss only. If the Committee insists that Expected Loss must also be covered, then the definition of Total Capital must change to reflect all of the resources available for coverage. Specifically, Tier 2 Capital should include the full amount of established reserves for each portfolio without limitation and should also recognize the margins in each business, which significantly reduces the risk of loss.

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2a. Credit Risk—Retail

- For Qualifying Revolving Exposures, the Advanced IRB is mis-calibrated relative to the Standardized Approach. Based on an IIF Survey, the Advanced IRB approach generates Risk Weighted Assets that are 25-40% higher than the Standard method. The resulting unlevel playing field will materially disadvantage Citigroup and other global banks when we compete against banks that focus on credit cards but remain on the Standard method (which they will have the incentive to do). We recommend substantial recalibration of the Advanced IRB Approach to better reflect the true economics of the credit card business (- we believe the Standardized Approach for credit card exposures is more closely aligned to economic risk than the A-IRB Approach).

    - One primary driver of this miscalibration is that the Asset Value Correlation is punitive for low-PD, low risk credit card customers. Our empirical evidence and that of industry groups such as the RMA have consistently shown that the AVC is set too high in CP3 and should be set no higher than 6%.

    - An immediate implication is that large amounts of capital are being required against unused lines, which tend to be concentrated in these same low PD bands. CP3 treats a credit card customer's "non-binding, cancelable, reduce-able, reprice-able" unused line of credit exactly like the "legally-binding, fully-enforceable, price-specific" commitments that are typically extended to corporate customers. As such, the unused lines in credit cards are carrying the same weight as actual outstanding balances, which is completely inconsistent with the legal framework under which they are governed, and the sophisticated risk management practices in place.

- Asset Value Correlations (AVCs) are also set too high for residential mortgages, and in particular for non-prime mortgage portfolios (those with a higher PD). The AVC of 15% is set well above common industry practice. In fact, the lack of a lower correlation for non-prime mortgage is inconsistent with the treatment of other retail exposures. Furthermore, a recent US OFHEO (Office of Federal Housing Enterprise Oversight) working paper finds that while default rates are higher for non-prime borrowers, non-prime defaults are less responsive to homeowner equity—which disputes a key assumption of the Basel Committee's model.

- The 10% LGD floor in mortgages is artificial and not justified on economic grounds. This floor ignores the impact of private mortgage insurance (PMI), while CP3 elsewhere gives full recognition to sovereign guarantees. This approach is logically inconsistent. First, PMI (which is usually written by AA and AAA companies) is ignored, while guarantees by sovereigns (who often have lower debt ratings) are fully recognized in the Accord. Second, CP3 would actually discourage the growth of a well-regarded risk-mitigation market and the evolution of advanced risk management practices, both of which are important to the development of an advanced financial system.

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2b. Credit Risk--Corporate

- The substitution approach should be eliminated. There is no recognition in CP3 of the lower risk of the joint default probability ("double default") when credit mitigants are used. The New Accord should allow banks to use internal models to assess the joint default probability arising from credit mitigants, subject to regulatory validation, perhaps with the methodology described in the recent research memo on this topic from the Federal Reserve Board. If this is not allowed, then discounts to the substitution approach should be adopted as per ISDA's proposal.

- The treatment of counterparty credit risk for OTC derivatives has not changed in any fundamental way since the 1988 Accord, other than recognition of master netting agreements for current exposures and a partial recognition of the effect of netting on the add-ons for the potential increase in exposure. However the fundamental approach for calculating the Credit Equivalent Amount (CEA) of counterparty risk has not changed. The CEA continues to be defined in terms of the current market value of each transaction plus an add-on for each transaction's potential increase in exposure. This method is very crude from several perspectives. There are only fifteen add-ons currently defined, for the combination of five very broad categories of underlying market rates (e.g. FX, Interest Rates) and three broad tenor buckets. The add-ons as currently defined are completely insensitive to the volatility of the particular underlying market rates (e.g. exchange rate X vs. exchange rate Y).

  More fundamentally, the add-ons do not capture portfolio effects. In 1990, almost thirteen years ago, Citibank developed a method of employing Monte Carlo simulation to calculate the potential exposure profile of a counterparty over the remaining life of the transactions with the counterparty. Since then, other firms have developed similar methods for measuring a counterparty's potential exposure profile over time. A counterparty's exposure profile can be measured over a wide range of confidence levels, depending on the purpose of the calculation.

  We very strongly support ISDA's recent recommendation that the CEA for each counterparty should be defined in terms of the counterparty's Expected Positive Exposure Profile, scaled by a factor α. For a large bank α will be close to 1.10.

- We disagree with the CP3 proposal that the effective maturity of derivatives or security finance transactions (e.g. repos) under a netting agreement should equal the notional weighted average tenor of the transactions.

  In the first place, sophisticated banks have the ability to directly calculate the exposure profile of a counterparty under a netting agreement. There is almost no relation between the shape of the counterparty's exposure profile over time and the notional weighted average tenor of the transactions under the netting agreement. For example, the shape of the exposure profile will be effected by the volatility of the underlying market rates and by the sensitivities over time of the forward and derivative transactions to changes in the underlying rates. A

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portfolio of five-year interest rate swaps for a low volatility yield curve will have a very different exposure profile over time than a portfolio of five-year forward equity transactions, even if the notional weighted average tenors of the two portfolios were identical.

More generally, we agree with ISDA's proposal that the effective tenor of the CEA for counterparty risk under a netting agreement can be defined as one year.

- For Counterparty Risk of Repos and Security Financing the New Accord appropriately encourages VAR-like calculations of the CEA, but assesses penalties for failing backtests that are excessive and inconsistent with the Market Risk Amendment to the Current Accord. These penalties will discourage use of the more precise VAR-like measurement. We recommend lower penalty factors that are consistent with Market Risk Amendment as per the ISDA/Bond Market Association recommendation.

2c. Securitizations

- The floor capital charge in the SFA is generally too high relative to the actual economic risk. The SFA does not take structural mitigants into account.

- The performance information required by the "top down" approach is inconsistent with a) the kind of information available for many asset types and/or b) the type of information a large number of businesses use to manage portfolios of financial assets. Other data or types of analysis can be utilized to equal effect. The prescribed PD, LGD, etc. are too conservative leading to higher than necessary capital.

- To deal with the above SFA issues, we recommend the use of internal analytical processes. Internal processes would include: information and due diligence requirements, third party and/or validated models for structuring and on-going surveillance requirements, all of which would be subject to supervisory review.

- The proposed requirements for "eligible liquidity facilities" do not reflect historical regulatory analysis or market practice. The proposal penalizes securitization related liquidity positions versus other liquidity positions.

3. Operational Risk

- We recognize that operational risk management is an emerging risk discipline and appreciate the progress that we see in the evolution towards a balanced, risk sensitive framework. We strongly support an approach to calculating operational risk regulatory capital requirements in Pillar I in a way that reflects our internal models for operational risk and recognizes the risk reducing benefits of diversification and efficiencies of scale (non-linearity). We support the Advanced Measurement Approaches (AMA) framework because we anticipate that it will recognize these benefits.

- We oppose several elements of the operational risk rules and believe that a quick resolution of these issues is in the best interest of the international banking system. We also seek clarification of some elements of the rules. Given the judgment that will need to be applied in approving an AMA model, we urge quite strongly that the regulatory community to provide clear guidance about the qualifying criteria and standards.

- We seek clarification regarding how the AMA will be implemented across multiple regulatory jurisdictions and suggest that, in most cases, the regulator of the foreign subsidiary should accept the methodology approved by the home country regulator of the consolidated parent. We realize that this will place an increased burden on the home regulator to interface with all host regulators for internationally active banks and to establish appropriate working conventions. We are particularly concerned that the unique requirements of local regulators will burden Citigroup and other global banks with unnecessary and duplicative incremental costs.

- Diversification will reduce overall risk levels and Citigroup believes that AMA must include the opportunity to capture the risk-reducing benefits of diversification and efficiencies of scale. However, we feel that the CP3 validation requirements are too strict. Although correlation of operational risks is certainly less than perfect, empirical data to demonstrate this will remain scarce. We are concerned that the term "validate" will preclude approval of any correlation assumption other than 1.0 and request clarification of the intended standard, and changes as needed.

- We anticipate the possibility that some parts of our diverse set of businesses may not qualify for AMA initially, or in the future, for example, in the case of a recent acquisition. So we believe that partial use of AMA will be necessary for some of our businesses and that a mechanism to permit some recognition of the benefits of diversification and efficiencies of scale should be available for these non-qualifying businesses. This will be necessary for an institution of our breadth and scale to prevent significant distortions in the degree of risk sensitivity reflected in the capital calculations.

- We strongly oppose the requirement to capture, as operational losses, data that is already being captured and capitalized as credit or market risk, because the cost of the effort to collect this data would be a burden, yet the data would not be used to calculate economic capital or regulatory capital requirements. The implementation of this requirement in our Consumer business, in particular, would require significant resources but not produce a clear benefit where these events are already well managed, e.g., as credit risk. The boundaries between operational risk, credit risk and other risks should be well defined with data being captured on only one side of that boundary. "Legal risk" should be clearly defined.

- We object to the requirement that any risk measurement system must include the use of internal data, relevant external data, scenario analysis and factors reflecting the business environment and internal control systems. Certainly,

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each of these elements is well worth considering, but a requirement to include all of them may be excessively burdensome. Consider a business that has an internal data set that is sufficient for modeling the risk using an allowable AMA methodology. Such a business should be permitted to proceed without using external data. Similarly, scenario analysis might be an appropriate way to evaluate the results of an AMA model for some business lines, but should not be a required element in every AMA calculation.

- We oppose specification in the Accord of a loss data collection threshold because we believe that the threshold should be established by line of business at a level that is appropriate for the quantification methodology being use there. The guidelines should be clarified to establish that the use of gross loss threshold does not imply that firms must capture data on “near misses”.

- We welcome quite strongly that operational risk charges need only apply to unexpected losses. We request clarification in the rules that the terms “measure and account for its EL exposure” will include standard business practices, such as pricing, and not be limited to accounting “reserves”. Significant flexibility to demonstrate that expected losses are covered by business practice should be available.

- Direct calculation of specific risk results at a 99.9% confidence level, with a high degree of accuracy, will not be possible for most business lines, given the available data. We request clarification that the regulatory standards will reflect the practical necessity to generate results at lower confidence levels which can then be scaled to a higher target confidence level using an estimated scaling variable.

- We object to floors and caps and welcome their elimination over time, including the 20% limit on insurance-related capital benefits. The recognition of risk mitigation is welcome, but should be expanded beyond insurance. We favor an initial increase in the amount of the cap above 20%, followed by its eventual elimination.

- We oppose the CP3 language denying both the benefits of captive insurance coverage and consolidation of their capital as economically flawed. The approach should be changed so that the capital in the captive is recognized as available to cover firm risks. The current draft denies most of the benefits of using a captive insurer, while on the other hand it restricts the recognition of the capital held in that insurer.

- The language of CP3 might be interpreted to presume that quantification of operational risk will require modeling of individual events. Other models may be more suitable for certain consumer or other businesses. We request clarification that the allowable models will not be limited to those that can be considered to model individual events.

- We request clarification and specification of the eligibility criteria for use of the Alternative Standardized Approach.

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4. Diversification

- Bank supervisors have traditionally, and in Citigroup's opinion properly, viewed diversification of businesses in a well-managed organization as a value, which contributes to the organization's strength. Diversification allows holding companies to rely on earnings from one business line when another business line slows and, similarly, to benefit from diversification of risk. It allows the continued strength in market or credit performance for some areas to offset weakness or problems in others, without necessarily relying on capital. It is well recognized in financial services risk management that concentration risk is the single largest risk an institution can have. Yet, while the New Accord seeks to recognize the strengths of the holding companies, it fails to accomplish this goal by not giving any recognition –in principle or in computation – for diversification in business lines, asset classes and risk types.

- We believe that diversification needs to be explicitly incorporated in the New Accord. One obvious remaining opportunity is in the Operational Risk AMA models. Another obvious opportunity is to explicitly direct supervisors to consider diversification as part of Pillar II.

5. Pro-Forma Deconsolidation of Insurance

- Citigroup continues to believe that a consolidated regulatory capital approach should be the ultimate goal of the New Accord. However, by deconsolidating insurance, the New Accord is essentially ignoring the diversification benefit that comes from multiple subsidiaries—either the use of insurance subsidiary capital for the benefit of the sister subsidiaries or the use of sister subsidiary capital for the benefit of insurance in times of stress. There is little rationale for treating insurance subsidiaries different from other financial subsidiaries, such as broker/dealers, consumer finance, non-bank leasing, etc.

- Deconsolidation encourages dangerous arbitrage across insurance and banking entities. Assets of different qualities are treated differently by bank risk standards and insurance risk standards, a situation that will encourage the movement of assets into the least restrictive supervisory situations. In addition, deconsolidation will encourage the development and use of a variety of parental guarantees that may be used to arbitrage regulatory capital.

- In the US, the forced deconsolidation of insurance will effectively abdicate capital standard setting to the public rating agencies. These rating agencies, in insurance, have routinely held subsidiaries to higher standards than that set by the insurance regulators. Thus a pro-forma deconsolidation approach will inadvertently defer to rating agencies' capital standards rather than insurance regulatory minimum capital standards.

- Were the Basel Committee to truly favor a deconsolidation approach to insurance that actually leverages insurance regulatory standards (e.g. those set by NAIC, the National Association of Insurance Commissioners), then it would incumbent upon the Basel Committee to: 1) Ensure that there is an analytically-driven harmonization between the banking 4%, 6%, 8% standards with those insurance standards, and 2) Develop a cross-subsidiary diversification factor that accounts for the cross-subsidiary risk mitigation benefits

6. Disclosure

- We are encouraged by the fact that the Committee has reflected many of the comments provided by Citigroup and other banking organizations in the CP3 round of proposed mandatory disclosures ("the Pillar 3 disclosures"). As a result, the Pillar 3 disclosures are significantly improved, more streamlined, and (compared to the prior versions) more feasible from a cost/benefit perspective (for example, by allowing management's methods for measuring the interest rate risk in the Banking Book). Nevertheless, the remaining disclosures represent a significant reporting burden on banking organizations – even for those organizations that currently provide much of this data -- which the Committee should not underestimate and which we urge the Committee to address by means of the following positive steps.

- In particular, we urge the Committee to withdraw from the final rule the proposals in Table 6, item (g) for quantitative disclosures of estimated versus actual credit risk statistics and, if later deemed necessary, to put them out for public comment as part of a post-implementation, review process. We strongly believe that it is premature and inappropriate at this time to include in final rules these requirements in item (g), even though the Committee has correctly perceived the difficulty of complying with the proposed disclosures and allowed an extended phase-in period until Year End 2008. We believe there is no valid reason to formulate these requirements until banks and supervisors have learned from actual implementation experience whether this data is meaningful in the context and format of public disclosure. (For further discussion of this and other concerns with Pillar 3, see Addendum 2.)

- Separately, we applaud the decision to only require Pillar 3 disclosures at the top consolidated level and we furthermore urge the Committee to prohibit national supervisors from requiring the full set of data at a subsidiary bank level (other than certain key information such as capital ratios). Absent this approach, the conflict of home country / host country supervision will be exacerbated.

- We are disappointed that the Committee continues to require semi-annual reporting of this full set of data. We believe that annual, not semi-annual, disclosure for most of this information is adequate unless there is a material change that makes year-end data misleading. In that case, the bank would have an obligation to provide an update at the next interim period, e.g. calendar quarter-end reporting dates for U.S. banking organizations.

- Citigroup opposes the Pillar 3 disclosure of the operational risk charge before and after any reduction in capital resulting from insurance. The focus on insurance is too narrow, considering the many possible forms of mitigation. The disclosures would be misleading in those cases where the cap on recognition of insurance benefits is in effect. Such disclosure could be harmful to our economic interests when negotiating premiums with our insurance providers. Additionally, we note that similar disclosure requirements for Credit Risk Mitigation and Securitizations were eliminated in CP3.

- Additionally, we are disappointed that the Committee did not significantly rollback its highly specific proposals in favor of internal economic capital disclosures, which could help to dispel the burden and excessive detail of the Pillar 3 disclosures. As stated in our letter of February 14, 2003, we believe that, ultimately, investors and other interested parties should focus on the internal assessment of the banking organization's economic risk (i.e., economic capital), the assumptions and methods underlying the assessment of economic risk, the ways in which assumptions and methods are validated and the overall level of the banking organization's economic capital compared with its total capital. Public disclosure of economic capital methodologies and requirements will provide more value to investors and other interested parties. Therefore, a more meaningful disclosure would be the level of economic capital that a banking organization's own internal assessments require for credit risk, market risk, operational risk, interest rate risk in the banking book and other risks that are relevant to that organization. Such disclosure may include a general description of modeling assumptions for each significant business activity, as well as the amount of economic capital utilization of each significant business.

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Addendum 2 OPERATIONAL RISK

This response contains detailed comments, which are cross-referenced to the paragraphs of the Consultative Document that they address.

- **Paragraph 610**
  By definition, "peers" should be limited to firms operating in the same lines of business and having similar levels of risk as measured by an appropriate risk sensitive system under the AMA.

- **Paragraph 617**
  Simple summation of the capital by business line assumes that the operational risks of the individual businesses are 100% correlated. Although this is clearly conservative, it is perhaps not inappropriate for such a simple approach.

  The target calibration of the Standardized Approach (SA) appears to be based on the fact that banks will have a range of activities, which on average will give a similar result to that of the Basic Indicator method. Therefore, those institutions with a narrow range of products may be unduly penalized or unduly rewarded for moving to the SA.

  Since the SA has significantly more stringent qualifying criteria than the BIA, there should be some incentive to reward qualifying banks, not just the retail banks, for their more sophisticated approaches to operational risk measurement and management. This could be in the calibration of the beta factors, for example, there would definitely be an incentive if no beta were higher than alpha. Alternatively, it could be in the treatment of diversification - for example, allowing less than 100% correlation between the various business lines.

- **Paragraph 626 (e) (f)**
  Auditors should indeed "perform reviews" of the risk measurement systems, as stated in point (e). However, in point (f), the term "validation" is used rather than the term "review". In our opinion, the term "validation" implies a rigorous exact mathematical proof, which will not always be possible because there may well be insufficient data to perform such a proof. In addition, some AMAs will not be based on precise statistical analysis, and therefore will not be capable of being "validated" according to this strict use of the term.

- **Paragraph 629 (d)**
  Clearly, well-managed diversification is an important method of reducing the total level of operational risk, but in order to take account of this, we need to determine correlation. Citigroup welcomes the introduction of internally determined correlation assumptions into the operational risk models. However, we note that this will be subject to certain conditions that we believe will be extremely difficult to achieve. In particular, the term "validate" implies that the resultant correlations have been estimated with a fairly high degree of precision.

There are many operational risks that must be close to being completely independent. To validate the low correlations that should be estimated between these events would be extremely difficult, if not impossible. A less rigorous standard should be applied to such estimates, for example that the bank should demonstrate the credibility of its correlation assumptions. It would be possible to take some account of the fact that there is a high degree of independence between the events described above, if we were to assume a low, but non-zero, correlation. This would still produce a sufficiently conservative capital requirement. In this context, it is not particularly important whether the correlation is assumed to be 0%, 10% or 20%, as long as it is not 80%, 90% or 100%.

- **Paragraph 633 Bullet 2**

  The requirement for a comprehensive set of internal data covering all geographic locations raises an important question for subsidiaries. We presume that if an AMA method is developed for a consolidated financial institution using global data, then it can be applied to a subsidiary. However, the rules are not clear on this point. It will not be possible to obtain enough internal data for every subsidiary to support unique AMA models, which raises the question as to whether the full global set of data would be accepted as being relevant external data. If not, then there would be a tremendous burden to develop a separate AMA model for each legal vehicle, which would be a barrier to adopting AMA broadly.

- **Paragraph 635**

  Although scenario analysis can be used to check that the AMA model gives realistic numbers, it certainly cannot be validated over any reasonable period of time.

- **Paragraph 636**

  The standards for verification and validation in this section are too high. The choice of each separate business environment and internal control factor has to be justified as a meaningful driver of risk. This choice will have a large judgmental element. It cannot be based on a statistical analysis because we are not aware of empirical studies that have demonstrated valid correlations between operational risk losses and qualitative measures of risk. Therefore, it is highly unlikely that the outcomes will be able to be validated through comparison to actual internal loss experience. Validation implies a degree of proof that we doubt will be possible. The primary use of business environment and internal control factors in many cases may be for management rather than for measurement purposes. Where these factors do play a role in quantification, it likely will be indirect, i.e., via a qualitative adjustment factor.

- **Paragraph 640**

The inclusion of partial use is most welcome. Citigroup, because of its broad range of products and global presence, may be positioned to adopt the AMA sooner in some products, regions, or legal vehicles than in others. This capability seems to be fostered in CP3. In a large internationally active bank there will always be a number of foreign subsidiaries that are required to calculate regulatory capital for operational risk at the local, legal vehicle level. Partial use at many levels of the organization hierarchy may always be necessary if these legal vehicles are unable to use the same Advanced Measurement Approach as the consolidated parent company. This may be the case, for example, if the AMA method for a given country must be calibrated using data specific to that country. In such subsidiaries, the use of a simpler approach may be an on-going requirement, even when the subsidiary is a material legal entity.

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Addendum 3 DISCLOSURE

- **Paragraph 7 - Proprietary and confidential information**

  We re-iterate our long-held concern that the proposed disclosures could result in presentation of proprietary information that is not in the best interests of banking organizations to divulge. Therefore, we support the inclusion of a statement on proprietary and confidential information; however, we are concerned that the proposed standard may be too high insofar as it anticipates "exceptional cases" only. For the sake of international consistency, indicative criteria should be developed.

- **Paragraph 774, Table 4 - Credit risk: general disclosures for all banks**

  Item (b): The requirement for "gross" credit risk exposures, which footnote 118 states may be after "accounting offsets" but without taking into account the effects of credit risk mitigation techniques (e.g., collateral and netting), should be clarified to allow for accounting offsets under the particular national jurisdiction's accounting regime. For example, in the U.S. the "gross" amount would reflect offsets in accordance with FASB Interpretation Nos. 39 and 41 and such other rules as issued from time to time.

  Items (f) and (g): The requirements for breakouts of specific and general allowances by major industry or counterparty type, and for the amounts of impaired loans and past due loans broken down by significant geographic areas including the related specific and general allowances (if practical) are not clear and could prove to be more complex than the Committee anticipates, as well as non-comparable among banking organizations given the differences in methods used across national jurisdictions. Additionally, we are concerned that a detailed breakdown of allowances by industry type could result in the disclosure of sensitive and/or confidential information that could impact banking organization's negotiations with debtors or others. For all of these reasons, the Committee should consider eliminating this requirement. Failing that, the Committee should provide clarifying guidance and/or examples.

- **Paragraph 775, Table 6, item (g) - Banks' estimates against actual outcomes of credit risk**

  This proposal should be eliminated from the final rule, as discussed in our cover letter. An independent assessment of the validity of inputs to the Pillar 1 calculations should be part of Pillar 2 (Supervisory Review) and not placed upon investors. Investors do not demand this data. Yet, this would cause an immense reporting burden, including the related explanations to non-expert readers of financial reports. As explained in detail in our letter of February 14, 2003, there are fundamental technical problems imbedded in these disclosures (e.g., the fact that annual rates may reasonably differ from long term rates and there is likely to be significant non-comparability among banks).

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Furthermore, if the Committee decides not to follow our recommendation to prohibit national supervisors from requiring Pillar 3 disclosures at the subsidiary bank level, there would be a significant reporting burden associated with this disclosure, particularly if the basis required by the host supervisor of the subsidiary bank were different from the basis required by the home country supervisor at the top consolidated level.

Finally, banking organizations are rightly concerned about the pro-cyclical impact on their own organizations if such data were misinterpreted, leading to the wrong conclusion about the bank by users of the financial reports, depositors and investors.

- **Paragraph 775, Footnote 138 – Risk assessment of retail portfolios**

  The bias stated in footnote 138 that banks would normally be expected to follow the disclosures provided for the non-retail portfolios should be withdrawn from the final rule. It is customary to use other methods for retail portfolios and the Committee should not inhibit experimentation or evolution by promoting the PD/LGD approach through disclosure rules.