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Ms. Jennifer J. Johnson
Secretary, Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Docket Nos. OP-1158 and R-1159, Anti-Tying Restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970, Proposed Interpretation/Guidance and Proposed Rule

Dear Ms. Johnson:

Citigroup Inc. appreciates the opportunity to comment on the proposed interpretation and supervisory guidance (the "Interpretation") and the proposed rule (the "Financial Subsidiary Exception") issued by the Board of Governors of the Federal Reserve System (the "Board") on the anti-tying restrictions of Section 106 of the Bank Holding Company Act Amendments of 1970 ("Section 106").

We strongly support both the Interpretation and the Financial Subsidiary Exception. We thank the Board for clarifying the operation of Section 106. We also have the following specific comments and suggestions.

Relationship Banking – Timing. We support the Board's "meaningful option" approach to relationship banking. Relationship banking is an essential part of the business of banking and is not prohibited by Section 106.

We request that the Board expand its discussion of the use of an internal profitability threshold ("hurdle rate") by a bank and its affiliates. In the example provided, it is assumed that, after a periodic review of the customer relationship, a bank informs a customer that it will not renew a credit facility unless the customer commits to buy additional products from the bank and its affiliates.

We believe that the Board's discussion of the legal implications of this example is accurate. The example, however, reflects a relatively uncommon situation. More often, a bank will enter into a new customer relationship on the assumption that the customer will not be profitable (i.e., will not meet the hurdle rate) for the first two or three years. After that initial period, and periodically thereafter, the bank will review the relationship and, if the customer does not meet the hurdle rate, terminate the relationship and therefore refuse to extend additional credit.

Insofar as the customer is not expected to meet any profitability threshold during the initial period, the anti-tying rules do not apply at all during that period.[1] After the initial period, as we understand the Board's discussion, the key issue under the anti-tying rules will be whether the customer is then *capable*, at that time and looking forward, of meeting the hurdle rate solely through the purchase of qualifying products. If not, the bank is permitted to terminate the relationship at that time. On the other hand, if the customer is capable of meeting the hurdle rate solely through the purchase of qualifying products, the bank may either continue the relationship (e.g., if the customer in fact has met the hurdle rate) or terminate it (e.g., if the customer has not met the rate).

Relationship Banking – Diligence and Documentation. The Board is correct to state that the types and amount of information and level of analysis necessary for a bank to establish a good faith belief that a customer has a meaningful choice under a mixed-product arrangement may vary depending on the nature and characteristics of the arrangement and the types of customer to which it is offered. Unfortunately, however, the specific listing of the factors and types of information that a bank may review in forming such a good faith belief suggests an impracticable level of diligence on the part of the bank in ascertaining that a customer meets these criteria. In particular, the list includes "information provided by the customer concerning the types and amounts of traditional bank products needed or desired by the customer and the customer's ability to obtain those products from the bank or its affiliates." Similarly, the Interpretation states that "a less detailed and granular review likely would be required for a bank to establish a good faith belief that a large, complex company has a mean-

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[1] As discussed in the Interpretation, Section 106 does not prohibit a bank from granting credit or providing any other product to a customer based solely on a *desire or hope* (but not a requirement) that the customer will obtain additional products from the bank or its affiliates in the future.

ingful option of satisfying a condition solely through the purchase of traditional bank products than a smaller company with less complex business operations."

While these statements are perhaps intended to be permissive rather than restrictive, they could be read to suggest a duty on the part of the bank to inquire into and evaluate each customer's need, desire, and ability to purchase each of a whole range of qualifying products. Such an individualized inquiry and evaluation would be, at best, unduly burdensome, and at worst impracticable. It would substantially complicate the loan underwriting process and would put U.S. banks at a competitive disadvantage to other lenders.

We believe that the Interpretation should clearly recognize (i) that a bank has no such duty of inquiry, (ii) that in the vast majority of cases a customer's ability to purchase qualifying products may be evaluated through an examination of the types and amounts of such products that comparable companies are typically able to purchase, and (iii) that an individualized evaluation by the bank of each customer's ability to satisfy the hurdle rates solely through the purchase of qualifying products is required *only* where the types and amounts of such products that comparable companies are typically able to purchase has not been evaluated or where the bank has actual knowledge that the customer cannot meet the hurdle rate solely through the purchase of qualifying products.[2] Where a bank determines that a particular customer falls within a category of comparable companies that typically are able to satisfy hurdle rates solely through the purchase of qualifying products, then the diligence requirements of the Interpretation should be met.

Foreign Exchange and Derivatives. The Interpretation's listing of "traditional bank products" is extremely helpful. The word "traditional,"

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[2] In addition, the reference to qualifying products "desired" by the customer should in any case be deleted. The measure of the customer's meaningful choice is whether the customer is *able* to satisfy the bank's conditions solely through the purchase of qualifying products, not whether the customer desires to do so. While it may be appropriate to calibrate need and ability to reflect the extent to which comparable companies actually purchase comparable products, we do not believe that the test should be based in any way on subjective factors such as the specific products that the customer intends to purchase.

however, is something of a misnomer. Although the word appears in the legislative history, it is not in the statute, and we believe that the purpose of the statutory list was not to grandfather certain "traditional" products but rather to identify those products that constitute the usual or characteristic business of banks. Therefore "standard," "fundamental," "basic," "integral," "characteristic," or some similar word would be more accurate than "traditional."

As the business of banking evolves, so must the list of standard bank products. We believe that the list of standard bank products should include foreign exchange and all derivative products.

Foreign exchange has long been an essential part of the business of banking, and we see no reason why it should not be specifically listed as a standard bank product along with other similar deposit-related services like cash management, payment, and settlement services. The Interpretation should state that foreign exchange products are standard bank products.

Derivative products are now also an integral part of the business of banking. Although recent in historical terms, they have become a standard bank product and should be treated as such for purposes of Section 106. Indeed, derivatives transactions were initially determined to be permissible bank activities precisely because they constitute a form of financial and credit intermediation. To the extent that such products are authorized for banks, therefore, they are within the scope of the standard bank products listed in Section 106. The Interpretation should state that all derivative products are standard bank products.

If the Board is unwilling to conclude by interpretation that foreign exchange or derivatives are standard bank products, the Board should adopt a regulatory exemption determining such products to be standard bank products.

If the Board is not willing to conclude that all derivatives are standard bank products, at a minimum the Interpretation should state that interest rate and foreign currency derivatives – which are fundamental to interest rate and currency risk management – are standard bank products. (In doing so, however, the Board should be careful not to imply a determination that other types of derivatives are not standard bank products.) The Interpretation should also state that all credit derivatives,

not just those in which the bank sells credit protection, are standard bank products. In addition, the Interpretation should state that total return swaps are standard bank products.

Finally, if the Board declines to include foreign exchange or derivatives on the list of standard bank products, it should at least treat such products as being part of "one product" when they are provided in connection with a financing or other standard bank product.[3] In such cases, the foreign exchange or derivative product is only one component of a single overall transaction structured to meet the customer's needs, and it is artificial to separate such products from the overall transaction for purposes of Section 106.[4]

Foreign Transaction Safe Harbor. The Interpretation states that the foreign transaction safe harbor is generally available for a loan entered into by a bank with a foreign company even if the loan is partially guaranteed by a U.S. incorporated affiliate of the foreign company. We believe, however, that the exemption is available even if the loan is *fully* guaranteed by the U.S. affiliate, and that the word "partially" should therefore be dropped from the Interpretation. The key qualification here, which is already clearly stated in the Interpretation, is that the borrower must in substance be the foreign company and not the U.S. affiliate.

The phrase "generally available" also appears to introduce an ambiguous limitation on the scope of the exemption. We therefore suggest that the Interpretation should state that the foreign transaction exemption does not become unavailable for a loan entered into by a bank with a

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[3] Thus, in the example in the third paragraph in section IV.c, a bank should be permitted to condition the availability of floating rate credit on the requirement that the borrower hedge its floating rate exposure by purchasing a fixed-to-floating interest rate swap from the bank or an affiliate.

[4] In this regard, we note that the definition of separate product stated in passing in footnote 23 of the Interpretation is derived from general antitrust law. It is inappropriate to apply this definition in the context of Section 106 to the extent that liability under Section 106 is deemed not to be subject to the market power and competitive effects criteria of general antitrust law. Footnote 23 raises complex theoretical issues that would require far more discussion than is given in the Interpretation and which it is not necessary for the Board to address at this time. We therefore request that footnote 23 be deleted.

foreign company merely because the loan is guaranteed by a U.S. incorporated affiliate of the foreign company, provided that the borrower is in substance the foreign company and not the U.S. affiliate.

In addition, the Interpretation states that the foreign transaction safe harbor is generally available for a loan entered into by a bank with a foreign company even if the foreign company directs the bank to disburse a portion of the loan proceeds to a U.S. incorporated affiliate of the foreign company that is not a party to the loan agreement. We believe, however, that the safe harbor is available even if a U.S. affiliate is a party to the loan agreement, so long as only the non-U.S. company and not the U.S. affiliate is subject to any imposed condition that may cause the loan to be tied. In general, where a foreign borrower directs that the proceeds should be disbursed to an affiliate, it will generally also direct that the affiliate should be included as a party to the loan agreement. Moreover, loan agreements often provide that advances to certain affiliates of the borrower will, for tax or regulatory reasons, be made by certain affiliates of the lender. So long as no tying condition is imposed on a U.S. affiliate of the non-U.S. borrower, the fact that such an affiliate is also a party to the loan agreement should not bring the non-U.S. portion of the transaction outside the scope of the foreign transaction safe harbor.

In other words, where a loan to a non-U.S. borrower is within the foreign transaction safe harbor, while a simultaneous loan to a U.S. affiliate of the borrower is not tied, neither loan by itself is prohibited by Section 106 – and the mere fact that both loans happen to be part of a single overall financing transaction and to be documented in a single loan agreement should not affect this result. The interpretation should therefore be revised to state that the foreign transaction safe harbor does not become unavailable for a transaction entered into by a bank with a foreign company merely because a U.S. affiliate of the foreign company is a party to the loan agreement or otherwise receives a portion of the loan proceeds, provided that the U.S. affiliate is not itself subject to any imposed conditions that would cause the transaction to be prohibited by Section 106.

Similarly, the foreign transaction safe harbor should not become unavailable for tied loans to non-U.S. borrowers under a multiborrower facility merely because the same loan agreement permits tied loans to U.S. borrowers, so long as all advances to U.S. borrowers under the facility are funded by corporate chain and not bank chain vehicles. Once again, the

fact that some portion of the overall financing is not itself within the foreign transaction safe harbor should not prevent the non-U.S. portion of the transaction from qualifying for the safe harbor, so long as the portion that is not within the safe harbor is otherwise permitted under Section 106.

Financial Subsidiaries. We support the Financial Subsidiary Exception. We believe, however, that the scope of this exemption should be defined by cross-reference to the definition of "financial subsidiary" in Regulation W at 12 C.F.R. 223.3(p). Subsidiaries that are not held in accordance with section 9 of the Federal Reserve Act or section 46 of the Federal Deposit Insurance Act may nonetheless meet the Regulation W definition of "financial subsidiary" and are therefore treated as affiliates for purposes of Section 23A. Given that Section 23A substantially restricts such subsidiaries from being funded by the parent bank, we believe that they should also be treated as exempt financial subsidiaries for purposes of Section 106.

Edge Corporation Subsidiaries. The third paragraph of Section V of the Interpretation states that Section 106 applies to all subsidiaries of a bank other than financial subsidiaries. We believe that this statement is overbroad and should be corrected.

Section 106 applies by its terms to Edge and agreement corporations. Section 106 does not, however, by its terms apply to the non-U.S. subsidiaries of Edge and agreement corporations. Such subsidiaries are not themselves operating under the Edge Act. Rather, they are institutions organized under non-U.S. law, are frequently regulated by banking regulators in their home countries, and operate outside of the United States. Accordingly, we believe that the intention of section 4(h) of the BHC Act was to exclude them from the scope of section 106, as part of the exclusion of entities operating outside the United States, rather than to include them solely because their parents are Edge corporations.[5]

An example helps to explain the importance of this distinction. If a U.S. customer engages a financial holding company lender to make a loan, and that financial holding company lawfully ties the provision of the loan to an investment banking transaction, the U.S. customer also may instruct the lender to lend some of the money to a subsidiary outside the United States. Local legal requirements or tax considerations may compel the lender to

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[5] 12 U.S.C. 1843(h); *see* 12 U.S.C. 1841(c)(2)(C), (E).

make this loan to the customer's foreign subsidiary from one of the lender's overseas lending subsidiaries, which would often be an Edge corporation subsidiary. The fact that such a loan must be made from an Edge corporation subsidiary should not cause the otherwise lawful transaction to become subject to the Section 106 prohibitions. Similarly, Section 106 should not apply to a letter of credit issued by an Edge corporation subsidiary in a transaction that is funded by a corporate chain vehicle that has itself lawfully imposed a tie.

We request that the Board make it clear, either in the Interpretation or by adding a separate regulatory exemption, that non-U.S. subsidiaries of Edge and agreement corporations are not subject to Section 106.

CEBA Leases. Footnote 44 of the Interpretation states that "CEBA leases" entered into pursuant to 12 U.S.C. § 24(Tenth) "are *not* considered to be the functional equivalent of an extension of credit." It is true that a CEBA lease need not be the functional equivalent of an extension of credit in order to be authorized under 12 U.S.C. § 24(Tenth). Nonetheless, in some cases a CEBA lease may be the functional equivalent of an extension of credit. We believe that footnote 44 should be revised to make clear that a lease that is the functional equivalent of an extension of credit is not excluded merely because it is authorized under 12 U.S.C. § 24(Tenth).

Individual Customers. The Interpretation is not generally directed at a bank's relations with individual customers. Section VII.C of the Interpretation, however, contains some very broad statements regarding the application of Section 106 to mixed-product arrangements involving individual customers. We believe that such sweeping conclusions regarding individual customers are not needed in the Interpretation and should be saved for an interpretation or rulemaking in which they can be evaluated through a more detailed analysis of the underlying issues. We therefore believe that the Board should replace Section VII.C with the narrower statement that the Interpretation is not intended to affect the interpretation of Section 106 with respect to individual customers.

If the Board does decide to address the application of Section 106 to individual customers at this time, there are at least two issues that we believe should be considered. We would be happy to provide additional details regarding these proposals.

First, the existing combined balance discount exemption permits a bank to offer a customer a lower price on a loan, but does not permit the bank to offer more liberal underwriting criteria. For example, a bank may wish to offer customers who qualify for a combined balance discount the ability to qualify for a mortgage loan at a slightly lower FICO score than customers who do not qualify.[6] To permit such offers, the safe harbor for combined balance discounts should be revised to permit a bank to vary the availability, as well as the consideration, for a product based on the customer's maintenance of a combined minimum balance.

Second, in July 2002 the Department of Housing and Urban Development proposed amending Regulation X, 12 CFR 3500, under the Real Estate Settlement Procedures Act of 1974. The Guaranteed Mortgage Packaging Amendment would allow mortgage lenders to offer consumers a single guaranteed price for a package comprising a mortgage loan and related settlement services. This amendment is expected to increase transparency and price competition and thereby to lower prices for consumers. Because some of the services that may be offered in conjunction with a mortgage are not on the list of standard bank products, however, Section 106 may undercut the ability of banks – which represent a large proportion of lenders – to offer such guaranteed mortgage packages to consumers. We believe that a guaranteed mortgage package should be treated as a single product for purposes of Section 106, or alternatively that the Board should grant an exemption from Section 106, in order to permit bank customers to receive the full benefits of the Guaranteed Mortgage Packaging Amendment.

Thank you for the opportunity to comment on the proposed Interpretation and Financial Subsidiary Exception. Please do not hesitate to contact me with any questions.

Very truly yours,

Carl V. Howard
General Counsel – Bank Regulatory

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[6] Any such loans, of course, would be have to be made consistent with safe and sound underwriting criteria and based on the borrower's ability to repay.