Omission? Citibank's SIVs and Subprime Exposure

Citibank is already 'half-pregnant' on subprime mortgage exposure. If I sign off on this language for 3Q 2007, am I guaranteeing myself an SEC lawsuit?

GARY CRITTENDEN, CFO OF CITIBANK, looked again at the draft text sent to him by Investor Relations (IR). It was late September, 2007. Teams inside Citibank (Citi) had been working for weeks to tabulate the losses from subprime mortgage instruments. Reasonable estimates were now available and the news wasn't good. It looked like Citi was going to have to take a \$1 billion 3rd quarter write-down on its subprime assets.[1]

This news was going to shock the market. For months Citi had been issuing reassuring statements about its subprime exposure. Events in the third quarter had, however, undermined that posture. In July, two Bear Stearns hedge funds, both heavily invested in subprime assets, had gone into liquidation. Around the same time, Standard & Poor's (S&P) and Moody's started downgrading outstanding issues of subprime Residential Mortgage Securities Backed (RMBS) and Collateralized Debt Obligations (CDOs). Trading in these instruments immediately dried up. Market prices plummeted. This meant Citi would record large losses on the subprime RMBS/CDOs held on its balance sheet. The wolf was now at the door. There was no getting around reporting this ugly news to investors.

To prepare the market for bad news, IR had persuaded Citi management to issue a pre-announcement. This press release would preview news of the losses some weeks before Citi's 3Q earnings release. As Crittenden held IR's draft script in his hand (see Attachment 1), two sentences caught his eye:

> *"At the beginning of this year we had \$24 billion of secured subprime exposure in our lending and structuring business. That number was \$13 billion at the end of June, and declined slightly this quarter."*[2]

Gary knew this to be a half-truth at best. The \$13 billion figure excluded the so-called "super-senior subprime CDO" tranches. It also excluded a large sum of "liquidity puts." Citi had issued these in favor of several off-balance sheet Structured Investment Vehicles (SIVs).[3] The vehicles were holding large amounts of subprime CDOs, implying indirect exposure for Citi. By including these two exposures a neutral observer could easily conclude that Citibank's subprime position was closer to $53 billion than $13 billion. If, God forbid, the bank ever reconsolidated the SIVs, subprime exposure could exceed $100 billion.

For multiple quarters now Citi had been citing the $13 billion figure in response to questions. Once Citibank admitted that $1 billion in subprime losses, the $13 billion exposure figure would come under heavy scrutiny. Investors would be screaming to know how such a relatively small exposure could produce a loss of that size.

Crittenden felt a personal moment of truth approaching, and he was worried. Under the Sarbanes-Oxley law (SOX), Crittenden, as CFO, had to sign off on Citibank's SEC financial filings. In doing so, he could be held personally and criminally liable for any material errors or omissions. Attachment 2 contains the relevant SOX wording. Gary was now deeply concerned that events were casting a dubious light on prior disclosures. He was even more concerned that the pre-announcement text, as drafted, would lock in a reporting position which Crittenden was finding increasingly difficult to defend.

As if these were not problems enough, Citibank's sponsored SIVs were beginning to unravel. Stresses in the subprime market were causing SIV investors to head for the exits. Citi was getting more involved in picking up the pieces. How much more bank intervention would be needed to stave off collapse? And, if Citi decided it had to rescue its SIVs, what would that imply about the earlier decision not to consolidate the vehicles into the bank's financial statements?

Crittenden re-read the pre-announcement text. Getting this script right could help Citibank navigate an intensifying market demand that it report its subprime exposure. Getting it wrong could unleash a hornet's nest of questions with the potential to threaten Citibank's funding and drop Crittenden into a morass of legal trouble. Gary cast his mind back over the events that led Citi to channel subprime mortgage securities into the SIVs. Perhaps if he reexamined how the bank had gotten to this point, Gary could fashion a final text that might fairly represent that history and accurately present Citi's financial condition.

Citibank's Subprime Product Flow and its SIVs

By 2006 Citibank had constructed a formidable mortgage security machine. Citi had developed an integrated mortgage business model. Consumer Lending (CL) employed an extensive U.S. branch network to originate mortgage loans.

A second CL unit purchased mortgages from brokers and other lenders. A third unit purchased pools of mortgages that had already been gathered for the purpose of using them to back new security issuance.

Citi next took all of these mortgages and pools and packaged them into tranches that would collateralize new RMBS. This required some technical skill. The mortgages backing a security would have to generate flows which in aggregate would resemble normal bond payments. The tranches would also have to be composed in such a way that the highest ranking tiers, dubbed "super-senior" and "senior", would be regarded by the rating agencies as virtually immune from losses. Once accomplished, the super-senior tiers were regarded as so remote from losses that Citi did not even submit them to the ratings process.[4] The two senior tranches typically constituted 65–80% of a subprime mortgage pool.

After taking the various tranches through the rating agencies, Citi would sell RMBS to institutional and foreign investors. U.S. interest rates were low during this period. Citi's RMBS offered premiums of 1–2% over comparable US Treasury securities, and the bank had little trouble selling off the higher investment grade securities.

However, the lowest ranking tranches usually remained on Citi's books. In order to make way for new mortgage inflows, Citi reapplied its structuring technique. The bank constructed pools of equity and mezzanine tranches, using them to back new securities. It then tiered these into senior and subordinate securities, known as Collateralized Debt Obligations. The more senior of these CDOs would be rated and sold to investors. Citi expanded this business rapidly; from 2003–05, Citi's annual underwritings of CDOs grew from $3 billion to $20 billion.[5] The RMBS/CDO business model proved hugely profitable, as Citibank's 2001–05 results indicated (Attachment 3).

This left Citi with a variety of subprime exposures on its books. For starters it had subprime mortgages, pools and purchased RMBS that had not yet been packaged into new RMBS or CDOs. These assets were regarded as residing in a "warehouse" awaiting sale. Citi also retained certain equity and mezzanine tranches; these were either awaiting further structuring or represented a Citi decision that it was more economic to retain than to sell them. Finally there were the super-senior CDOs; these were regarded as so remote from loss that typically they were offered at very small premiums over U.S. Treasury securities. Buyers were sometimes scarce and Citi often considered it more economic to retain the super-seniors.

All of this subprime exposure created a problem – it tied up a lot of Citibank's Tier One capital. This was especially the case with the equity and mezzanine tranches, whose risk ratings required high capital allocations. Citi harvested fees at many points along the mortgage pipeline. Keeping this pipeline flowing was regarded as the key to rising profits. However, as Citibank's subprime business grew, the capital demanded to support this business was also growing – and at a rate that was beginning to curtail both the mortgage business and other business lines.

To unblock this pipeline, Citi landed on the idea of developing Structured Investment Vehicles. Starting in 2003, a sizeable portion of Citi's subprime mortgage assets was directed into these SIVs.

Citibank Structures and Launches SubPrime SIVs

Structured Investment Vehicles were introduced by Citibank in 1988, and since used for a variety of purposes. Citi's growing mortgage business suggested another application. The idea was to construct a family of SIVs to act as dedicated buyers of Citi's RMBS/CDOs; this held three attractions. First, it created a ready-made destination for Citi's mortgage securities factory. Second, it promised to expand Citi's investor base for these products. Finally, the SIVs promised to ameliorate the Citi capital constraints. In sum, SIVs as final destinations for subprime securities promised to be hugely value creating.

However, Citibank discovered there were problems to overcome before these benefits could be harvested. The problems involved issues which Citi would have to address for the SIVs to work as intended.

The basic SIV structure was crafted as follows:

1. Citi would set up a separate legal entity
2. the bank would sell a small amount of venture equity to third parties, thus creating independent ownership
3. the SIV would then buy subprime assets, predominately CDOs, from Citi
4. the SIV would sell asset backed commercial paper (CP) to investors, using the proceeds to pay Citi for the subprime assets; and
5. Citi would contract to manage the SIV going forward.

A core problem here was the mismatch between SIV assets and funding. The SIVs would own assets whose maturities stretched out to 30 years while its funding consisted of 30–60 day CP. Given the SIVs minimal equity, any failure to rollover CP would present the vehicles with a funding crisis. Either the SIVs would have to sell long term assets, perhaps at marked-down prices, or fail to honor a commercial paper redemption.

This problem was particularly acute because Citi was planning something ambitious; it was going to target sales of SIV commercial paper to Money Market Funds (MMFs). Accomplishing this would greatly expand the pool of subprime investors. MMFs are the brokerage house equivalent of bank checking accounts, and their depositors expect their funds to be both safe and immediately available. Typically they would never invest in something as illiquid as subprime mortgage instruments. SIV CP appeared more short term and therefore more liquid, but this was true only to the extent that investors remained confident that the subprime assets backing the CP would perform as expected.

Citi's solutions needed to address both SIV solvency and liquidity. The bank felt that by stocking the vehicles with only highly rated CDOs, SIV solvency would be satisfied. As for liquidity, Citi decided to address the CP rollover risk by issuing "liquidity puts." In the face of a financing crunch, the SIVs could "put" their CP to Citi. The bank would then own SIV CP backed by the vehicles' "super-senior" CDO tranches.[6]

The liquidity puts satisfied the MMF's concerns, and they became big buyers of SIV CP. However, the put instruments raised fundamental questions about whether the SIVs were truly independent from Citibank. If they were deemed not to be, Citi would have to incorporate the vehicles into its consolidated financial reports. Doing so would prevent the bank from harvesting the third SIV benefit – that of ameliorating pressures on the bank's capital position.

Whether this goal too could be realized depended on how one regarded Citi's liquidity puts' in light of FASB ASC 810–10, the rules on "Variable Interest Entities (VIE)."

Citibank's SIVs Finesse the VIE Rules

The FASB "VIE" rules were put in place in response to Enron's collapse. Enron had made extensive use of thinly capitalized partnerships that purported to be independent. These entities received the bulk of their financing from Enron, traded only with Enron, and were usually managed by an Enron employee. Despite this, Enron treated the partnerships as independent for accounting purposes, and never consolidated their assets or debts. Trades between Enron and these vehicles were done to manufacture earnings which Enron used to sustain the impression that it was a well-oiled profit machine. Investigations subsequent to Enron's bankruptcy described the vehicles as having no economic purpose other than to help Enron manage its reported earnings.[7]

In response to this accounting fiasco, the FASB first issued VIE rules in 2002. The essence of the rules was to establish when firms would need to consolidate the financials of an entity in which they held neither a majority of the voting stock or of owner's votes. VIE rules sought to determine "effective control". For example, if a company contracted with another entity to absorb losses which that entity might incur, the VIE rules required the

Attachment 1

Excerpts from Citibank IR's Proposed Pre-Announcement Text

"We typically have sold the lowest rated tranches of the CDOs and held onto most of the highest rated tranches, which historically have enjoyed more stable valuations. As the subprime problem spread across various security types, we started to see valuation declines even in the highest rated tranches…

Starting in January of this year, we began to lower our exposure to these subprime assets as we saw the market changing. At the beginning of this year we had $24 billion of secured subprime exposure in our lending and structuring business. That number was $13 billion at the end of June, and declined slightly this quarter. Despite our aggressive efforts this year to work these positions down and to put in place appropriate hedges, we were still holding mortgage assets in our warehouse, or holding undistributed tranches of CDOs, when the market dislocated. And although we had hedged, this only partially offset our losses, which netted to a write-down of approximately $1.0 billion."

Attachment 3

Citibank Financial Results 2001–05

In Millions of the trading currency, except per share items.

Key Financials[1]

For the Fiscal Period Ending	Dec 2001	Dec 2002	Dec 2003	Dec 2004	Dec 2005
Total Revenue	$60,567.00	$62,472.00	$63,548.00	$73,402.00	$75,713.00
Net Income	$14,126.00	$15,276.00	$17,853.00	$17,046.00	$24,589.00
Total Assets	$1,051,450.00	$1,097,590.00	$1,264,032.00	$1,484,101.00	$1,494,037.00
Total Debt	$316,083.00	$341,552.00	$402,287.00	$467,835.00	$479,462.00
Total Equity	$735,367.00	$756,038.00	$861,745.00	$1,016,266.00	$1,014,575.00
Total Debt to Capital	30.1%	31.1%	31.8%	31.5%	32.1%
Stock Price	$50.48	$35.19	$48.54	$48.18	$48.53
EPS Excluding Extra Items	2.55	2.59	3.27	3.07	3.82

Source: www.capitaliq.com

Attachment 4

Summary of FASB ASC 810–10: "Variable Interest Entities"

Overview of VIE guidance, as amended by ASU 2009–17 and ASU 2010–10

A reporting entity that holds a direct or indirect (explicit or implicit) variable interest in a legal entity must determine whether the guidance in the "Variable Interest Entities" subsections of ASC 810-10 applies to that legal entity before considering other consolidation guidance, such as ASC 810-20, "Control of Partnerships and Similar Entities." However, if a reporting entity does not have a direct or indirect (explicit or implicit) variable interest in a legal entity, then the reporting entity is not the primary beneficiary of that legal entity and is not required to provide disclosures for that legal entity under ASC 810-10, "Variable Interest Entities" subsections.

Under the amended guidance in ASC 810-10, "Variable Interest Entities" subsections, a legal entity is a variable interest entity (VIE) if any of the following conditions exists:

- The total equity investment at risk in the legal entity is not sufficient to permit the entity to finance its activities without additional subordinated financial support
- The legal entity's total equity investment at risk does not provide its holders, as a group, with all of the following characteristics:
  - The power through voting or similar rights to direct the activities that most significantly impact the legal entity's economic performance
  - The obligation to absorb the expected losses of the legal entity
  - The right to receive expected residual returns of the legal entity
- Both of the following conditions exist:
  - Voting rights of some equity investors are not proportional to their obligation to absorb expected losses and / or right to receive expected residual returns
  - Substantially all the activities of the legal entity involve, or are conducted on behalf of, a single investor with disproportionately few voting rights

A reporting entity that holds a variable interest in a VIE and has both of the following characteristics of a controlling financial interest in a VIE is the primary beneficiary of the VIE:

- *Power:* The power to direct the activities of the VIE that most significantly affect the VIE's economic performance

Citibank 2007 Q1–Q3 Financial Results

Income Statement			
For the Fiscal Period Ending	Reclassified 3 months Q1 Mar-30-2007	Reclassified 3 months Q2 Jun-30-2007	Reclassified 3 months Q3 Sep-30-2007
Total Revenue	**22,495.0**	**23,010.0**	**17,059.0**
Salaries and Other Empl. Benefits	8,671.0	8,682.0	7,595.0
Amort. of Goodwill &Intang. Assets	-	-	-
Selling General & Admin Exp., Total	3,125.0	3,415.0	3,666.0
Total Other Non-Interest Expense	2,461.0	2,214.0	3,142.0
Total Non-Interest Expense	**14,257.0**	**14,311.0**	**14,403.0**
EBT Excl. Unusual Items	**8,238.0**	**8,699.0**	**2,656.0**
Restructuring Charges	(1,377.0)	(63.0)	(35.0)
EBT Incl. Unusual Items	**6,861.0**	**8,636.0**	**2,621.0**
Income Tax Expense	1,846.0	2,570.0	492.0
Earnings from Cont. Ops.	**5,015.0**	**6,066.0**	**2,129.0**
Net Income	**5,012.0**	**6,226.0**	**2,212.0**
Pref. Dividends and Other Adj.	16.0	14.0	6.0
NI to Common Incl Extra Items	**4,996.0**	**6,212.0**	**2,206.0**
NI to Common Excl. Extra Items	**4,952.0**	**5,929.0**	**2,103.0**
Per Share Items			
Basic EPS	$10.24	$12.44	$4.49
Basic EPS Excl. Extra Items	10.15	11.87	4.28
Weighted Avg. Basic Shares Out.	487.7	499.3	491.6
Diluted EPS	$9.98	$12.44	$4.41
Diluted EPS Excl. Extra Items	9.89	11.87	4.2
Weighted Avg. Diluted Shares Out.	496.8	499.3	501.1
Dividends per Share	$5.4	$5.4	$5.4
Payout Ratio %	53.8%	43.2%	NA

Source: www.capitaliq.com

Author's Note

This case focuses on an issue that formed part of Enron's legacy: how should "off-balance sheet" vehicles be used and accounted for? In theory, this issue was addressed by the Financial Accounting Standards Board in their rule FASB ASC 810-10: "Variable Interest Entities. The Citigroup SIV case suggests that the disclosure problems associated with such vehicles persist.

More specifically, the case discusses the dilemma of "creativity" associated with pushing the limits on accounting rules. Citi was an innovator in the use of SIVs. By 2007 it had been deploying them for 20 years. Using SIVs allowed Citi to relieve capital constraints, make more loans, book more fees and report a higher Return on Equity. For many years this must have seemed a smart practice. Rules, such as ASC 810-10, were successfully wired around, and the architects of such "financial engineering" were duly rewarded. However, the case depicts what happens when markets turn. It is at that point that accounting judgments rendered in calm markets start to look problematic. Just when credit is most precious, the requirements for revised disclosures bite hardest, and the weight of past disclosure decisions hangs heavy on the responsible management.

Gary Crittenden is one of those managers. As Citigroup's CFO, he is responsible for the firm's SEC filings. He's also legally liable for material misstatements and omissions under securities law, including SOX.

Crittenden's challenges are threefold. He must decide if Investor Relations draft statement is factually accurate and complete. If not, he must consider revisions. Second, any revisions must be reconciled with Citi's past disclosures, or else past errors must be admitted. Third, the firm must consider how to present its adverse news in a manner that doesn't exacerbate its financing problems. For Crittenden, this may require action plans that go beyond rewording IR's disclosure statement.

This case is based largely on the SEC's "Cease and Desist" order directed at Crittenden and IR's Arthur Tidesley. Supplemental information comes from contemporaneous reports in the financial press, especially Bloomberg's coverage, and from investor litigation against Citigroup filed in the U.S. Southern District. The draft IR statement is based upon the actual press release issued by Citigroup on October 1, 2007. There is no public record of Crittenden questioning or revising an earlier IR draft. The case imagines him doing so in order to provide students with an opportunity reconsider his dilemmas and devise alternate solutions. Crittenden resigned along with CEO Prince one month later.

The case raises important questions about Citi's longtime auditor, KPMG. That firm is conspicuous by its absence in accounts of these disclosure issues. Missing too is Citi's outside counsel, who must have been advising Prince and Crittenden on securities law requirements. Their failures here are noteworthy examples that the Enron "gate-keeper" problem has not been fixed.

Finally, this case should be considered in the light of the two other Citigroup cases presented in this volume. Collectively these present a disheartening portrait of serial violations and weak governance. Citigroup seems to tarnish the reputations of even the most formidable of financial leaders, from John Reed to Sandy Weill to Robert Rubin. The firm's enduring inability to reform itself raises serious questions of whether Citi is not only too big to fail, but too big to manage.

Notes

1. Citigroup Expects Substantial Decline in Third Quarter Net Income; www.citi.com/citi/press/2007/071001a.htm, *October 1, 2007*
2. Ibid.
3. Securities and Exchange Commission, *Order Instituting Cease and Desist Proceedings in the Matter of Gary L. Crittenden and Arthur H. Tildesley, Jr.;* July 29, 2010, pg. 4
4. Ibid., pg. 4
5. Ibid., pg. 3
6. Ibid., pg. 4
7. *Report of the Special Investigation Committee of the Board of Directors of Enron Corporation* (the Powers Committee Report), February 1, 2002, pp. 52-53
8. Financial Accounting Standards Board, *FASB* ASC 810-10: "Variable Interest Entities, pp.
9. *Citigroup SIVs draw $7.6 billion of Emergency funds;* www.bloomberg.com/apps/news?pid=newsarchive&sid, *November 6, 2007*
10. *Reckless Endangerment*, pp. 274-276
11. *All the Devils are Here*, 2010, pg. 257
12. Citigroup, Inc. (C) Q2 2007 Earnings Call July 20, 2007 10:00 AM ET
13. Ibid.
14. Ibid.
15. *All the Devils are Here*, pg. 300
16. Securities and Exchange Commission, op. cit., pp. 8-10
17. Ibid., pg. 9
18. Ibid., pp. 9-10