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## Citi's \$41 Billion Issue - Should It Put CDOs On the Balance Sheet?

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By DAVID REILLY November 26, 2007; Page C1

A \$41 billion question mark is hanging over Citigroup Inc.

That is the amount, in a worst-case scenario, of potentially shaky securities the bank would need to bring onto its balance sheet. Citi has already taken billions of dollars of such securities onto its balance sheet and expects to take big write-downs on those holdings.

The fate of the \$41 billion rests on the outcome of a debate going on in accounting circles over what constitutes a "reconsideration event." Those who say Citi needs to put these securities, known as collateralized debt obligations, onto its balance sheet argue that because Citi acted over the summer to backstop some of them, its relationship with them changed, prompting a reconsideration event.

At the moment, it seems unlikely Citigroup will be forced to bring the assets onto its books. The bank doesn't believe such a reconsideration event is in order. A spokeswoman says Citigroup is confident its "financial statements fully comply with all applicable rules and regulations."

But the division of opinion reflects debate within accounting circles over just how to interpret rules that govern off-balance-sheet treatment for some financing vehicles. That, in turn, underscores what many consider to be a failure of these rules to ensure that investors in the companies that create these vehicles are adequately informed of the risks posed by them.

In recent months, investors have been shocked to learn that many banks were exposed to big losses because of their involvement with vehicles that issued commercial paper and purchased risky assets such as mortgage securities. The troubles facing one kind of off-balance-sheet entity, known as structured investment vehicles, have even prompted Citigroup and other major banks to organize a rescue fund.

But CDO vehicles created by Citigroup have proved to be a more immediate threat. The bank's announcement this month that it expects to take \$8 billion to \$11 billion in write-downs in the fourth quarter largely stems from its exposure to CDO assets. Citigroup was one of the biggest arrangers of CDOs -- products that pool debt, often mortgage securities, and then sell slices with varying degrees of risk.

If Citigroup had to include an additional \$41 billion in CDO assets on its books, that could potentially spur a further \$8 billion in write-downs, above and beyond those already signaled, according to a report earlier this month by Howard Mason, an analyst at Sanford C. Bernstein. Such losses could further weaken Citigroup's capital position, threatening its dividend or forcing the bank to raise money.

The issue for Citigroup is when, and if, it has to reconsider consolidation of the CDO vehicles it sponsors.

Like other banks, Citigroup structured these vehicles so they wouldn't be included on its books. The vehicles are created as corporate zombies that ostensibly aren't owned or controlled by anyone. In that case, accounting rules say consolidation of such vehicles is determined by who holds the majority of risks and rewards connected to them.

To deal with that, banks sell off the riskiest pieces of the vehicles. This ensures they don't shoulder a majority of the risk and so don't have to consolidate the vehicles. The assessment of who absorbs the majority of losses is made when the vehicles are created.

Over time, though, rising losses within a vehicle can lead a sponsor to shoulder more risk, or even a majority of it. That can also happen if a sponsor takes on additional interests in the vehicle by buying up the short-term IOUs it issues.

That is what happened to Citigroup. Over the summer, the bank was forced to buy \$25 billion in commercial paper issued by its CDO vehicles because investors were no longer interested in the paper. Citigroup already had an \$18 billion exposure to these vehicles through other funding it had provided.

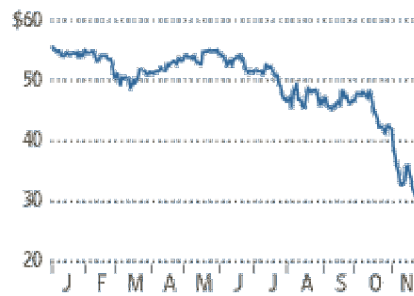
This combined \$43 billion exposure means that if CDO losses climb high enough, the bank could be exposed to more than half the losses, according to Bernstein's Mr. Mason. That would seem to argue for Citigroup's consolidating all \$84 billion of its CDO assets originally held in off-balance-sheet vehicles.

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**Citigroup (C)**

Friday's close: \$31.70

Year-to-date change: down 43%



Source: WSJ Market Data Group

But the accounting rules don't say that sponsors of these vehicles have to reassess on any regular basis the question of who bears the majority of risk of loss. Such "reconsideration events" occur when there is a change in the "governing documents or contractual arrangements" related to these vehicles, the rules say.

Citigroup believes that because it hasn't changed the documents or contracts related to the vehicles, it shouldn't have to reconsider its relationship to them, according to people familiar with the bank's thinking.

But some accounting experts point out that the rule also says a reconsideration event occurs when an institution acquires additional interests in the vehicle. "If a bank is being forced to step in and be a bigger holder of the commercial paper, to me that's pretty black and white that it's a reconsideration event," says Ed Trott, a retired member of the Financial Accounting Standards Board, the body that wrote the accounting rule.

An influential accounting-industry group, the Center for Audit Quality, also seems to lean toward this view. In a paper issued last month, the center said the purchase of commercial paper is an example of a change in the contractual arrangements governing these vehicles. This "may also result in a reconsideration event," the paper said.

But Citigroup believes its purchase of the CDO vehicles' commercial paper is different, because it had taken on the obligation to provide such assistance when the vehicles were created. This means the bank was acting within the contractual arrangements governing the vehicles, not changing them, according to the people familiar with Citigroup's thinking.

Some accounting experts agree. "If all that's happening is one set of [paper holders] is going out and another is coming in, that's not a reconsideration event," says Stephen Ryan, an accounting professor at New York University. "I don't think you reconsider moment by moment; an event is not just bad luck happening."

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## QUESTIONS:

- 1.) What are CDOs? What are the recent problems connected with CDOs? What is the cause of these problems? In general, why are they especially a concern for Citigroup?
- 2.) What is the specific issue facing Citigroup, as detailed in the article?
- 3.) What are the accounting rules regarding consolidation of CDOs? How do banks avoid having to consolidate?
- 4.) Why is there controversy over the how the losses should be booked by the bank? What is the potentially vague part of the rules?
- 5.) What position does Citigroup take? What position are some accounting experts taking? Is either side getting support from other parties? If so, from whom?
- 6.) With what position do you agree? How did you reach this conclusion? Please offer support from your answer.