

Citi SIV Critical Decision Defeasance versus Consolidation

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It is likely that within days senior management will have to make a very important decision concerning Citi's SIV business: allow the business to defease in the market or provide some sort of rescue to some or all of the SIVs.

Key Facts

- Citi is market leader with around 25% of market share (7 vehicles)
- Other major bank sponsors are HSBC (12%); Dresdner (8%); Bank of Montreal (7%); Standard Chartered (5%)
- Citi SIVs have around \$5.7 billion of customer capital, principally owned by financial institutions in Europe, Middle East and Asia.
- Citi SIVs have combined senior borrowings of around \$85 billion.

Defeasance

The two principal triggers for defeasance are capital adequacy failure (NAV decline) leading to a rating downgrade and liquidity failure.

Capital Adequacy

NAV has come under severe pressure in recent days and is now in the mid-70s. Our capital models still show some 20 bp or more of spread widening space (depending on vehicle) so while a capital adequacy downgrade remains a risk, it is unlikely to create a problem in the next week or so. Furthermore, we have some control over this trigger because it is possible to improve capital adequacy (but not NAV) by selling assets and reducing leverage. We think it is likely that the rating agencies would give us time to attempt to do so before taking action.

Liquidity

By far the greatest concern is the continuing dislocation in the ABCP market. Access to this traditional source of funding has all but dried up. This means that the only way to repay maturing debt is asset sales and the small amount of Citi support approved by Accounting Policy (whereby Citi purchases CP).

Cash needs for the SIV business over the next few weeks are significant with Sedna projected to run short on 18th September and Five's liquidity support exhausted shortly thereafter. Given the 3-day settlement period, Sedna needs to sell more assets this week.

Although we continue to make asset sales we are simply delaying an inevitable wind-down unless some sort of additional funding, Citi or third party, can be raised within the next week or so. Accounting Policy requires any further Citi support to be provided alongside an unrelated third party. Given current market conditions it will be a challenge to meet this requirement. **Accordingly it is now likely that Citi's SIV business will be forced to wind down and this process could start to happen as early as next week.**

Outcome

- Defeasance involves repayment of senior debt through the sale of assets. Given the current state of the credit market, realised losses during this process will be significant. The SIV structure requires such losses to be borne by capital investors and in today's market they are likely to lose 50% or more of their investment.
- The failure of any one Citi SIV will be a major shock to the market and will destroy any chance of restoring confidence in the sector. This means that one by one each Citi SIV will fail as it exhausts its existing liquidity resources.
- Given the current focus by the press on the ABCP market and SIVs in particular, the defeasance of any Citi SIV will be extremely high profile and is likely to attract negative commentary.

- Other bank sponsors appear to be supporting their SIVs at the moment. We should therefore expect further negative press as it will appear that we refused to do the same. Our competitors may continue to provide support after any Citi SIV failure. If not they may take the opportunity to throw in the towel and blame Citi for the demise of their own products.
- If all of Citi's SIVs are forced to defease, total customer losses are likely to exceed \$3 billion.
- Many of the customers are important bank relationships and in regions where Citi has a growing presence: Middle East; China and Japan. Some customers have large holdings (see attached lists).
- Many customers have holdings in the SIVs of other sponsors. If a Citi SIV was to fail first it is likely that they would blame us for any losses on their holdings in competitor products.
- Multiple SIV failures are likely to lead to significant market disruption. Once again, Citi is likely to be blamed for not managing to prevent such an outcome.
- Although unlikely, defeasance could lead to the insolvency of one or more SIV if markets become sufficiently disrupted. This would require a standstill of senior creditors many of which are the large money market funds. Principal loss is very unlikely due to the high quality of the underlying assets. However, the very high profile associated with any such insolvency would add considerable extra discomfort for the organisation and many of our counterparties.

Consolidation

We have been told that any unilateral support further than that already agreed with Accounting Policy will lead to consolidation risk for Citi.

Clearly consolidation would be extremely costly for the organisation given the size of the SIV business and is therefore unlikely to a viable solution.

The key metrics for all 7 vehicles combined are as follows:

Total cash bonds:	\$77.3 billion (circa \$26 billion of which is bank sub debt)
Cash	<u>\$11.9 billion</u>
Cash assets	\$90.2 billion
CDS:	\$6.7 billion
Senior Debt	\$84.5 billion
Capital	\$5.7 billion

Currently the two weakest vehicles are Sedna and Five. If there were an appetite and a means to "rescue" them in isolation it is possible, but not certain, that we could manage the other vehicles through this liquidity crisis.

The key metrics for Sedna and Five combined are as follows:

Total cash bonds:	\$24 billion (circa \$8 billion of which is bank sub debt)
Cash	<u>\$ 2.4 billion</u>
Cash assets	\$26.4 billion
CDS:	\$2.7 billion
Senior Debt	\$25.5 billion
Capital	\$1.8 billion

Conclusion

Neither defeasance nor consolidation is desirable but since we face the prospect of choosing between the two as early as next week, we need to be certain that there is no further flexibility from Accounting Policy for unilateral liquidity support from Citi to see the business through today's difficult market conditions.