

Yale University

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents

[Browse by Media Type](#)

11-21-2006

Memo Re: OCC Letter from Scott N Waterhouse to Bruce W Johnson Re Recommendation for Removal of Formal Agreement

Bruce W. Johnson

Follow this and additional works at: <https://elischolar.library.yale.edu/ypfs-documents>

Recommended Citation

Johnson, Bruce W., "Memo Re: OCC Letter from Scott N Waterhouse to Bruce W Johnson Re Recommendation for Removal of Formal Agreement" (2006). *YPFS Documents*. 5708.
<https://elischolar.library.yale.edu/ypfs-documents/5708>

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.



MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Scott N. Waterhouse

From: Bruce W. Johnson

Date: November 21, 2006

Subject: Recommendation for Removal of Formal Agreement

Summary

I recommend we begin proceedings to remove Citibank N.A.'s Formal Agreement (FA), dated July 28, 2003, regarding Complex Structured Financial Transactions (CSFTs). The bank is now in full compliance with all articles of the FA, and internal controls are in place to satisfactorily monitor and restrict this type of activity. Key oversight processes such as the Capital Markets Approval Committee (CMAC) and the Business Practices Committees (BPC) have evolved into a more altruistic view. Today they focus more on "should we do the deal", as opposed to "can we do the deal" based on legal, accounting and tax guidance. Moreover, the bank's risk appetite for CSFTs has greatly decreased. The volume of CSFTs is significantly down and the nature of the deals that are executed is more restrained. The company has embraced the benefits derived from the key oversight processes developed, or strengthened, as a result of the FA, and will retain these functions after removal. Therefore, continuation of the FA would serve no further purpose since it is unlikely that the bank would return to transacting inappropriate CSFTs.

Background

Citibank N.A. signed a FA with the OCC on July 28, 2003 as a result of its role in constructing and dealing in CSFTs with Enron, which had contributed to that company's collapse. Citigroup signed a similar agreement with the Federal Reserve near the same time. The bank moved quickly to implement stronger oversight of CSFTs and to adopt policies to eliminate engaging in transactions similar to the Enron transactions unless the client agreed to fully disclose the nature of the transaction in its financial statements. The bank also enacted a collage of other policies and processes to provide stronger oversight over a broader range of CSFTs and transactions which might expose the bank to undue reputation risk.

In mid-2004 we conducted an examination of the business units in Structured Capital Finance which had constructed the Enron transactions. We found that controls had been significantly strengthened and the units' risk appetite had decreased. However, a series of highly publicized problems occurred in other areas of the bank further damaging reputation risk. While none of the problems involved CSFTs similar to the Enron transactions, most did involve either

structured products or complex transactions. Therefore, the bank increased its efforts to control reputation risk and expanded the depth and breadth of oversight processes.

We had originally planned to conduct a comprehensive examination in February 2005 to evaluate compliance with the FA. Given the events of 2004 we did not feel that it was appropriate to lift the FA at that time and decided to delay the examination while continuing extensive review of the bank's policies, practices and systems through on-going supervision.

We eventually performed a comprehensive examination in February 2006 covering all high risk business units and a sample of other business units across the company. We performed transaction testing as well as evaluated in-business controls adopted to insure compliance with the policies relating to the formal agreement. Our 2006 target examination and extensive on-going supervision throughout 2004, 2005 and 2006 concluded:

- Policies and processes are now reasonably effective in controlling reputation risk,
- Adequate testing is performed by the businesses and Compliance staff to assure reasonable compliance with policies and processes, and,
- The bank's risk appetite for CSFTs has greatly decreased as evidenced by the decreased volume of CSFTs being executed and the more restrained nature of those transactions that are executed. Although the number of new products submitted to oversight committees such as CMAC had increased sharply, many were not CSFTs. The increased volume and expanded scope demonstrated the bank's increased attention to a wider array of issues potentially impacting reputation risk.
- The bank was in compliance with most articles of the FA, except that additional work was needed to achieve compliance with the requirements of Article VI.

As a result of the February 2006 examinations, we issued Supervisory Letter 2006-09 which contained no MRAs and noted our favorable findings.

At that time, we concluded that the accomplishments of the business units, and most of the control functions, warranted removal of the FA. However, a concurrent exam of Audit and Risk Review's (ARR) actions regarding the auditing requirements of Article VI concluded that audit practices intended to test many of the policies related to the FA were deficient. PCAG, a special unit within ARR, had provided satisfactory coverage of the Structured Finance and Tax Policies, but responsibility for many other key policies such as CMAC, Legal Vehicle, Off-Market, Derivative Sales Practices and Retail Distribution belonged to the general auditors in ARR, and were intended to be covered during their regularly scheduled audits. We found that ARR's coverage of these policies was deficient. As a result, we issued Supervisory Letter 2006-08, dated, April 3, 2006, noting non-compliance with the FA and listing four Matters Requiring Attention.

We met with ARR approximately every three weeks since issuing SL 2006-08 to receive updates on ARR's corrective actions, and the results of those actions. ARR implemented training, written guidance and oversight to improve the quality of their coverage. PCAG implemented a QA process for CSFT audits as a result of one of the MRAs in 2006-08 ("Implement more effective

pre-review and post-review supervisory processes.”) PCAG’s initial QA results mirrored those of our findings and continued to find deficiencies in the audits of CSFT entities until recently. When PCAG’s results indicated that ARR’s performance was improving we began our own tests of audit work papers. We completed reviews of a series of audit work papers and concluded that ARR’s performance is now sufficient to meet the requirements of Article VI. However, we will continue to review a sample of audit work papers, especially of those business units heavily engaged in CSFTs.

Compliance with Article VI was the only remaining factor delaying removal of the FA. Since the bank is now in full compliance with Article VI, I recommend that we initiate the process to remove the FA.

Summary of Key Policies and Processes

Policies

Structured Finance Policies – Separate policies were created at the corporate level and for each business sector. These policies narrowly define CSFTs as “covered transactions” which are limited to those types of transactions similar to those executed for Enron. The policies prescribe required vetting and approvals, and ban the bank’s execution of “covered transactions” for which the client does not agree to disclose in financial statements.

Tax Policy – The corporate-wide tax policy broadly defines tax products. It requires “should” or “will” external tax opinions for all tax products and requires concurrence by the internal tax department. The internal tax department has the final approval authority on all tax products.

CIB Policy on New Products (CMAC Policy) – The CMAC Policy outlines the requirements and restrictions for approving new products, including CSFTs, in the Corporate and Investment Bank. The definition of CSFTs in the CMAC policy covers a much broader range of transactions than those narrowly defined in the Structured Finance Policy. CMAC’s broader definition is more useful in controlling reputation risk arising from CSFTs. The CMAC policy also establishes the Capital Markets Approval Committee which is the most important screening and approval process for CSFTs at this bank. The other business units also have policies and committees for new products. Their definitions of CSFTs are not as robust as that of CMACs, but their involvement in CSFTs is much more limited than the CIB’s. The definitions and processes established by these units are adequate for the nature of their operations.

Legal Vehicle Policy – The policy establishes approval requirements and oversight for the creation of any new legal vehicle, including SPEs. Since most CSFTs involve the creation of one or more SPEs, this policy provides additional controls over CSFTs.

Off-Market Policy – This policy restricts conducting transactions with terms significantly different than current market prices. Some CSFTs are designed to achieve a result by constructing a transaction with terms significantly off-market, e.g., effecting a sale without transfer of title by issuing a deep in the money option.

Derivatives Sales Practices Policy – This policy provides guidelines for the sale of derivatives, including structured products.

Retail Distribution Policy – This policy provides guidance for the sale of structured products manufactured by the CIB to retail customers. It also establishes the Retail Distribution Committee to provide oversight of retail structured products and distribution channels.

Processes

CMAC – CMAC is the primary screening process for CSFTs. The committees include senior management from Compliance, Legal, Accounting, Tax, several branches of Independent Risk and other areas. The committees approve new products and insure all requirements are obtained, such as tax, legal and accounting sign-off. They also frequently impose restrictions or conditions on the product and insure that the conditions are met prior to granting approval. New products with the highest potential for reputation, compliance or legal risk are referred to the Business Practices Committees (BPC). The CMAC process pre-dates the formal agreement, but the membership and focus of the committees have changed significantly and are now much more attuned to reputation risk.

Business Practices Committees – BPCs were created at the corporate level and in each business sector. They review a wide array of policies, practices, potential conflicts and new products which have the highest potential impact to reputation risk. They also review certain CSFTs referred by CMAC and other committees.

Retail Distribution Committee (RDC) – The RDC oversees the distribution of structured products manufactured by the CIB and distributed to retail customers through Citi's or third parties' distribution channels. They insure that sales practices, marketing and disclosures are appropriate.

Commitment Committees – Commitment Committees operate similarly to CMAC, but are only involved when Citi is investing its own funds. In some CSFTs the bank may also be an investor.

Underwriting, Distribution, Conflicts and Structured Products – UDCS is a function created within Independent Risk Management to oversee the CMAC process, the Commitment Committees, and the Retail Distribution function. It also maintains a conflict of interest data base and manages potential conflicts, particularly in underwriting activities.

In-Business Controls – Business units are required to create compliance functions within their units to insure compliance with key policies, including those related to the FA. The compliance functions are required to perform transaction testing to determine compliance.

Monitoring, Testing and Reporting (MTR) – MTR is a function within Compliance which works with the business units' in-business control functions to improve compliance testing, and, also, performs its own independent testing.