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Former Co-Head of Global CDOS, Nestor Dominguez, Testimony Before the FCIC

Nestor Dominguez

Testimony of Nestor Dominguez
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Chairman Angelides, Vice Chairman Thomas and Members of the Commission, thank you for inviting me to appear before you and to contribute to the Commission's work and understanding of the origins of the financial crisis. I hope that my experience at Citigroup can shed light, with the benefit of hindsight, on the important issues before the Commission. I look forward to answering your questions.

I understand that the Commission is interested in Citi's business activities with respect to collateralized debt obligations or CDOs. I was involved in Citi's CDO activities from 1999 until I left Citi on November 1, 2007. From 2006 to 2007, I served as co-head of Citi's global CDO business that focused on cash CDOs. I was responsible for overseeing the structuring, distribution, and trading units of that business. I believed then (and still believe now) that Citi's CDO business was performing an important function in the capital markets in creating securitized products to meet investor demand for exposures to specific asset classes and to specific cash flow profiles. Citi completed many successful and productive transactions in numerous asset classes during a time of dramatic global expansion of the CDO industry as a whole.

It may be helpful to begin by explaining the process for originating CDOs at Citi. Typically, the process began with interactions among our salespeople and institutional investors from around the globe during which we would receive feedback about the types of credit exposures that were desired by those investors. That dialogue centered around discussions concerning the type of collateral to be included in the CDO structure—whether it was RMBS securities, corporate bonds or loans, or any of the other numerous asset classes that were part of the market—as well as the specific cash flow and tranching characteristics investors wanted.

Our structuring team would, in turn, interact with independent third-party collateral managers who were investment managers with proven expertise and track records in managing the types of collateral being considered for the prospective CDO transaction. The collateral manager's role was to conduct diligence concerning the underlying assets, purchase the collateral pool, and manage and trade the collateral pool for the benefit of the debt and equity issued by the CDO. The collateral managers also were required to have the operational capabilities to manage the CDO over time.

Once a collateral manager, collateral pool, and overall transaction structure were broadly agreed on, the collateral manager then would begin selecting appropriate collateral assets. The collateral manager selected assets in accordance with: (1) the transaction specifications (which had been originally designed to satisfy investor demand), (2) the feedback obtained from rating agencies, and (3) the collateral manager's own diligence of the assets available and on offer at that time in the market. The assets for inclusion in the CDO were purchased at arm's length by the collateral manager from all sources and dealers to obtain the best possible value for the price paid by the CDO investors.

After a sufficient proportion of the target collateral was purchased by the collateral manager and warehoused at Citi, the transaction would be priced and closed. Citi would then sell the various classes of CDO securities to the investors who had expressed an interest in the transaction. The investors in Citi's CDO transactions were sophisticated (or accredited) investors under the applicable securities laws.

It became common in the industry to structure CDOs collateralized by both cash and synthetic collateral. Typically, "cash flow" ABS CDOs were comprised of a diversified mix of asset-backed securities, which provided cash flows to meet the obligations of the CDO in the form of coupon payments from the cash bonds. By contrast, "synthetic" ABS CDOs typically were collateralized by asset-backed securities held in derivative form—that is, derivatives that referenced ABS bonds. In this form, the CDO received periodic CDS premium payments from the counterparties to the derivative transactions underlying the transaction, and passed those payments on to investors in the CDO transaction. There were certain technical differences between the structure of Citi's cash and synthetic ABS CDOs. Ultimately, though, the returns to investors and the fees were broadly similar for both cash and synthetic ABS CDOs.

Citi expanded its involvement in the structuring of ABS CDOs from 2001 to 2007. Over a number of years up to the fall of 2007, Citi rose to become one of the leading global originators and traders of all types of CDOs—including those backed by RMBS, corporate credits, and several other categories of collateral. The cash CDO business that I co-headed generated approximately $400 million in total annual revenue in 2005 and 2006. This revenue came from one-time structuring fees of between 50 bps to 200 bps (or 0.5% to 2%) of the assets in each CDO deal we structured, and from secondary trading and warehousing activities.

Our CDO business model called for distributing all the securities that resulted from our CDO structuring activities except the most senior tranches of specific transactions that were structured to be held on Citi's balance sheet. These retained positions were referred to in the market as "super senior" because they were structurally senior in the cash flow waterfall to tranches that themselves had virtually zero expected loss based on analytical modeling. The subordinate tranche underlying the super-senior tranche was also rated AAA by the rating agencies. The view that super-senior tranches carried virtually no risk was pervasive at Citi based on, among other things, the level of structural subordination beneath those retained securities and our modeling and stress analysis. We at Citi believed that the retained super-senior tranches were an efficient use of capital and Citi's balance sheet, with an extremely remote risk of impairment of interest or principal repayment.

Citi retained certain super-senior tranches in two forms: First, in a product referred to as "liquidity puts." For certain cash CDO transactions between 2003 and 2006, the senior-most level of the capital structure was funded by the issuance of short-term asset-backed commercial paper—which at the time, was a large and deep market with a long history of stability during previous times of stress. To facilitate the issuance of this commercial paper, Citi issued renewable 364-day put options to the CDOs as a fall-back source of financing, in case of either a significant widening of credit spreads or a temporary inability to issue commercial paper. Second, Citi also retained portions directly, in both cash and synthetic form, of the super-senior notes of certain CDOs issued in 2006 and 2007 by both the CDO desk based in New York and as a result of synthetic CDO structuring activities in London. In both super-senior programs, the risk of loss on the retained super-senior exposure and the liquidity puts was examined extensively and, based on those stress tests and models, the likelihood of losses was considered extremely remote.

In the Commission's invitation letter, you ask me to comment on how practices in risk management and structuring of RMBS CDOs differed at Citi from that of our competitors. I'm afraid I cannot answer that question with the required degree of certainty about the practices of our competitors in the business. However, I can say with certainty that throughout my involvement with Citi's CDO business, I and those who worked with me had an active, ongoing dialogue with Citi's independent risk division and had a very transparent business model open to multiple layers of management within the fixed income business and external to it.

Ultimately, Citi recognized significant mark-to-market losses on its CDO exposures. These losses occurred as a result of cataclysmic and unprecedented market events, housing price declines and mortgage defaults not seen since the Great Depression and anticipated by virtually no one, including those of us who dedicated ourselves to building a business we believed was good for our clients and for the shareholders of our company. I hope I can be of some help to the Commission in putting into perspective the nature of Citi's CDO business.

I look forward to answering your questions.

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