CLOSING CASECitigroup: the opportunities and risks of Diversification

In 2015, Citigroup was a $70.1-billion, diversified financial-services firm known around the world. However, its history had not always been smooth. From the late 1990s through 2010, the company’s diversification moves, and its role in the mort-gage crisis, combined to bring the company to its knees, raising fears that the venerable bank—one of the oldest and largest in the United States—would not survive.Citigroup traces its history all the way back to 1812, when it was formed by a group of merchants in response to the abolishment of the First Bank of the United States (the First Bank’s charter had been permitted to lapse due to Thomas Jefferson’s arguments about the dangers of centralized control of the economy). The merchants, led by Alexander Hamilton, created the City Bank of New York in 1812, which they hoped would be large enough to replicate the scale advantages that had been offered by the First Bank. The bank played some key roles in the rise of the United States as a global power, including lending money "to support the purchasing of armaments for the War of 1812, financing the Union war effort in the mid-1800s, and later pioneering foreign-exchange trading, which helped to bring the United States to the world stage in the early 1900s. By 1929, it was the largest commercial bank in the world.The bank’s capital resources and its trusted brand name enabled it to successfully diversify into a range of consumer banking services. The highly innovative company was, for example, the first to introduce sav-ings accounts with compound interest, unsecured per-sonal loans, checking accounts, and 24-hour ATMs, among other things. However, its business remained almost entirely within traditional, retail-banking ser-vices. That would soon change with the rise of a new concept: the “financial supermarket. During the 1990s, there was much buzz in the financial industry about the value of having a wide range of financial services within the same bank. Why have your savings account in New Jersey, your stock broker in California, and your insurance agent in Maryland, when you could have them all under one roof ? Merging such services would enable nu-merous “cross-selling” opportunities: Each com-pany’s customer bases could be more fully leveraged by promoting other financial products to them. Fur-thermore, cost savings might be realized by consoli-dating operations such as information technology, customer service and billing, and so forth. In 1998, Sanford “Sandy” Weill, who had already begun cre-ating his own financial supermarket, which included Travelers insurance, Aetna, Primerica, Salomon Brothers, and Smith Barney Holdings, convinced Citicorp chairman and CEO John Reed that the two companies should merge. Travelers Group purchased all of Citicorp’s shares for $70 billion, and issued 2.5 new Citigroup shares for each Citicorp Share. Ex-isting shareholders of each company thus owned approximately half of the new firm. The merger cre-ated a $140-billion firm with assets of $700 billion. Renamed Citigroup, it was now the largest financial-services organization in the world.Unfortunately, at almost exactly the same time, the Internet rendered the bricks-and-mortar finan-cial supermarket obsolete: The best deals were to be found at the financial supermarket on the Web. To make matters worse, rather than cross-selling, the different divisions of Citi and Travelers began bat-tling each other to protect their turf. Savings in con-solidating back-office operations also turned out to be meager and costly to realize. Harmonizing each company’s information technology systems, for ex-ample, was going to be so expensive that ultimately the legacy systems were left intact. Additionally, though the merged company shed more than 10,000 employees, it was harder to part with executives—indeed, the company kept so many pairs of execu-tives with “co” titles (including co-CEOs Weill and Reed) that some people compared Citi to Noah’s Ark. According to Meredith Whitney, a banking an-alyst who was an early critic of Citi’s megabank mod-el, Citi had become “a gobbledygook of companies that were never integrated... The businesses didn’t communicate with each other. There were dozens of technology systems and dozens of financial ledgers.”To boost earnings Citi began investing in subprime loans, the risk of which was camouflaged by bundling the loans into mortgage-backed securities known as collateralized debt obligations (CDOs). Trouble be-gan brewing before even Citi knew the scale of risk it had undertaken. Loose lending policies had resulted in a large number of poor-quality mortgages, the vast majority of which were adjustable-rate mortgages (i.e., the initial rate was very low, but would increase over time). This combined with a steep decline in housing prices that made it next to impossible for homebuy-ers to refinance their mortgages as their interest rates climbed—their homes were now worth less than what they owed. Delinquencies and foreclosures soared, meaning that banks holding those mortgages had as-sets whose value was rapidly declining. A lawsuit by Citi’s shareholders in 2006 accused the company of using a “CDO-related quasi-Ponzi scheme” to falsely give the appearance that it had a healthy asset base and to conceal the true risks the company was facing, but even Citi’s CEO at the time, Charles O. Prince III, did not know how much the company had invested in mortgage-related assets. Prince found out at a Septem-ber 2007 meeting that the company had $43 billion in mortgage related assets, but was assured by Thomas Maheras (who oversaw trading at the bank) that ev-erything was fine. Soon, the company was posting "billions in losses, and its stock price fell to the lowest it had been in a decade (see the accompanying figures). To Lynn Turner, a former chief accountant with the Securities and Exchange Commission, Citi’s crisis was no surprise. He pointed out that Citi was too large, did not have the right controls, and lacked sufficient ac-countability for individuals undertaking risks on the company’s behalf, making such problems inevitable. The amalgamation of businesses had created conflicts of interest, and Citi’s managers lacked the ability to accurately gauge the risk of the exotic financial instru-ments that were proliferating. As the true scope of the problem was revealed, Citi found itself in very dire circumstances. The losses from writing down its mort-gage assets threatened to destroy the entire company, bringing down even its profitable lines of business.