

CitiGroup: Too Big to Fail or Too Big to Save?

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PERSPECTIVE	#
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IN THIS PERSPECTIVE **FinSightsAdvisor**

FinSights Advisor is a weekly perspective on the financial services industry. It provides financial institutions with timely guidance about maximizing one's technology investments. This week's issue focuses on the current woes at Citigroup – recently reported fourth quarter losses, deposit run-off, and announced reorganization.

This perspective will provide an overview of possible outcomes for Citigroup, including wider implications for the financial services industry, the next likely move by the Obama administration, and the future of technology investments as supermarket banks such as Citigroup reshape themselves.

Background

On January 16, Citigroup confirmed rumors of a major restructuring of the bank, and announced its fifth consecutive quarterly loss. It may be, though, that Citigroup's announcement is foreshadowing the future for unprofitable U.S. banks. Citigroup is at the leading edge of the U.S. banking crisis for now, and it appears to be maneuvering to position itself for the next wave of government intervention. It has led the way in seeking alternative sources of capital through this stage, and we think it is setting itself up to be first in line for the next capital infusion.

Citigroup was one of the first banks to tap into new sources of capital to ease the market turmoil that started for them in 2007. The capital at that time was coming from sovereign wealth funds, including those from Abu Dhabi, Singapore, Kuwait, and Prince Alweid bin Talal from Saudi Arabia. These funds pumped at least \$22B into Citigroup starting late in 2007 and into early 2008. By March 2008, the sovereign funds had had their fill of bank investment and this source of capital has dried up – suffering losses from these investments in Citigroup and in other financial institutions as the first wave of bank failures started to hit.

Next, in October and November 2008, Citigroup tapped government aid in the form of \$45B in capital and \$249B in loan guarantees as the

federal government swung into action to save the top U.S. banks. Even this infusion has been inadequate to save the Citigroup franchise, and there are not many alternatives left to the firm.

Friday's announcement regarding the reorganization of the firm sets the stage for the next wave of government intervention, and may indicate that Citigroup has been privy to some of the details of the next rescue options and the likely course of action. There are few options available to the Obama administration, and the one that seems most likely, especially given Citi's announcement, is creation of a government-backed institution to house troubled bank assets. This course makes sense of Citi's restructuring and is the most palatable of the options the Obama administration appears to be considering.

Taken at face value, the Citi restructuring is modeled after a failed bank in FDIC possession. After acquiring the assets of a failed institution, the insurer prepares the assets for sale, segregating the valuable assets from the questionable assets. The valuable assets are then sold, with the intention that the sales of those assets will recapitalize the fund sufficiently to cover losses from the questionable assets. According to Citigroup's official statements, the plan with this restructuring is the opposite – retain the valuable assets and sell off the questionable assets. However, this strategy is not workable for a number of reasons, and is probably not the real strategy. First, there is no market for the assets in the Citi Holdings portfolio. Subprime loans, private-label credit card operations, and an insurance operation that has been for sale with no buyers for years are not valued commodities. Even the more valuable Japanese securities businesses, by the bank's admission, are targeted for sale in the long-term – but the bank is in need of capital infusions in the near-term. The retail brokerage joint venture with Morgan Stanley will generate approximately \$9.5B in additional capital, but much more is needed as its international deposit base continues to decline and operating losses mount.

So if sale of the assets in Citi Holdings seems unlikely, there are two options. One is sale of the valuable assets with the new Citicorp – signaling the end of Citigroup. Given that businesses are most concerned with self-preservation, it is unlikely that this is the real strategy. The other option, is a new buyer that will have the capital and the appetite to take on the troubled assets – enter the Obama administration. Sovereign wealth funds no longer have appetite to invest in banks, shareholders are running from bank stocks in fear of nationalization, the only other source of capital is the government, and this looks like the only outcome that can "save" Citigroup, even as a much diminished institution.

We see this direct purchase of assets as the next attempt at stabilizing the banking industry, and Citigroup will be first in line. However, this has great complexity, which is why the original TARP monies were redirected to direct capital infusions to the banks. The outcome,

though, of this initial strategy has not preserved the banking industry or increased liquidity as had been hoped. Certainly opacity and a lack of control in use of the funds has been a problem, but the real issue is that banks are in self-preservation mode. Investing in the banks to implement monetary policy is a blunt weapon – the banks can only increase liquidity when they are financially sound, and they are not there yet. More direct government involvement, short of nationalization, is the next step.

Assessing the Impact

Structural Changes

This is the end of the financial supermarket. The largest institutions have become too complex to manage, and too big to save, and it seems – too big to succeed. Since the dawn of the era of automated transaction processing about 50 years ago, conventional wisdom has held that scale enabled more efficient operations. We believe this presumed scale advantage has been overvalued, and what has been overlooked is what it takes to run such a complex financial institution. But more importantly, when these "too big too fail" institutions do fail, they can and have de-stabilized the entire financial services industry and the global economy. It is certainly in the best interest of nations to have strong, global institutions – but there is a limit to the size and control any individual institution should have when a private firm's actions can have such far-reaching impacts.

What has led to this precipice? As multinational banks such as Citigroup grew over the years they were also assuming geometric increases in risk interactions that they were not able to properly evaluate or mitigate. In a global economy, multinational financial institutions have to plan and execute to minimize financial and operational risk. Added to the mix is market risk and country risk. Market risk takes the form of taking on and understanding risks in adjacent financial industry sectors – in Citigroup's case it was insurance and brokerage. Country risk can negatively impact foreign operations and cost leverages that the bank requires to meet financial expectations. On rare occasions such as we have seen during 2008, rare risk events within one type of risk can correlate with another type of risk causing leveraged financial events for an institution. In Citi's case there were massive correlated losses associated with mortgages and derivatives.

As time moves on we expect that the art and science of risk transfer will be the subjection of new regulatory requirements. Banks have made it the norm to originate loans and then transfer the risk to their balance sheets off to the capital markets in the form of packaging loans to create asset backed securities. Effectively the bond "owners" are the "holders" of the risk. And then, as we have seen, the bond holders sought risk mitigation through the purchase of credit default swaps and

other derivative securities based hedges. In a sense, too big to manage also means too large to quantify and effectively manage the risk across a vast financial enterprise.

As a result of structural changes to the largest institutions, there will be direct impacts on technology investments. Financial Insights believes that once the dust settles, the largest financial institutions will be smaller than today, with fewer lines of business. Using Citigroup as an example of the course banks will take can provide guidance. First, technology infrastructures will need to be re-segregated. In many cases, business-line silos remain present and will ease divestiture of assets and businesses. This is the good news. The difficulty is at the administrative level where technology investments are more often enterprise-wide. Functions such as financial accounting, security, risk management, and reporting may need to be recreated in business units as financial supermarkets are dismantled. Also, software license fees and maintenance contracts will need to be revised, and applications ported to separate hardware platforms. All of this will be done with an eye toward least-cost options. Also necessary will be valuation of financial assets. This is one of the thorny issues that will need to be determined to both protect government monies but also to keep banks afloat. With illiquid markets, many portfolios for purchase, marked to market, are almost worthless. Determining pricing that is workable will require improved analytics and data management tools to see into the underlying assets, determine default probabilities, and set fair pricing.

Regulatory Changes

This is also the beginning of re-regulating the U.S. banking industry. Certainly, banks are taking actions independently to develop a more conservative culture, but regulatory controls will be introduced to prevent this kind of market crash in the future. Some changes that will be considered include:

- Intervention to create a more balanced banking industry with 10-20 similarly-sized large national institutions, supplementing the 10% of deposits concentration limit with similar limitations on dominance in markets such as small business lending.
- Preservation (via merger restrictions) of a large number of smaller institutions serving local markets, but with some consolidation promoted in these tiers as well to reduce the absolute number.
- Restoration of previous rules segregating investment and commercial banking activities.
- More oversight of investment instruments with transparency into underlying assets, as we have seen with the FDIC already requiring

reporting from the banks they regulate that have taken TARP funds.

- More controls over lending practices, leading to less consumer debt.
- More restrictions of the use of "bought funds" to leverage bank balance sheets in ways that mismatch asset and liability maturities, or rather, more tightly defined bank liquidity requirements.
- Nationalization remains a possibility, but we see this as a more remote option, only chosen if the next wave of government action fails to prop up the U.S. banking industry. However, until the threat of nationalization disappears, bank share prices will not recover.

Guidance

Citigroup will do its best to survive, which will only be achieved by shedding the assets now housed in Citi Holdings. It is also in the best interests of the Obama administration to act decisively, and to get it right this time. There will be no economic recovery, and the recession will only deepen, until the U.S. banking industry is stabilized so that liquidity can be returned. Creating a new government-backed institution to purchase troubled assets is the most likely course of action, and institutions should prepare for such an outcome, as Citigroup appears to be doing.

Valuation of the assets will be the critical determinant. Priced too low, the banks will not sell off assets and will continue to try to weather the storm until markets start functioning. Priced too high, and the government and taxpayers take on unnecessary risk and the potential for high losses in the future. However, this is the central issue that must be solved – either through functioning markets or a deep-pocketed investor that can value the assets and remove them from the books of the banks so that they can operate profitably again.

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- [The 2008 U.S. Elections and Impact on the Financial Services Industry: What to Watch \(Document # FIN215124, November 2008\)](#)

- Fannie Mae, Freddie Mac, and the Feds: What's Next for Mortgage Market Players? (Document # FIN213521, July 2008)
- Dynamic or Dull: Do FinTech Vendors Have a Choice? (Document # FIN213111, June 2008)
- New Regulations – The Impact on Institutions, Markets, and the FinTech Community (Document # FIN211746, April 2008)
- The Bear Stearns Collapse and Implications in the U.S. Financial Services Industry (Document # FIN211487, March 2008)
- The Subprime Lending Debacle: The Mistakes Were in Market Risk Analysis Involving CDOs, not the Credit Risk Analysis of Those Applying for Mortgages (Document # FIN206063, March 2007)

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