

# The myth of financial supermarket or why Citi's business model has not and will not work

Kosrow Dehnad, Adjunct Professor of Operational Research and Financial Engineering,  
Columbia University, and Head of Quantitative Trading, Samba Financial Group

In 1998, when with much fanfare and press accolades the merger of Citibank and Travelers was announced, pundits declared the dawn of one-stop shopping of financial products: from checking accounts to mergers and acquisitions, from credit cards to cash management, from leveraged finance to life insurance. In those heydays of M&A and tech bubble, any deal that could tag along the title of 'global,' 'universal,' or 'ground breaking,' would sell particularly if its architect was a charismatic leader like Sandy Weill. A legend on Wall Street and a roll up artist who had grown a sleepy consumer lending company into a financial giant that on the way had swallowed up Salomon Brothers – once a Wall Street powerhouse. Sandy's reputation as a 'postman' who regularly delivered value to investors plus market euphoria carried the day, particularly at a time when a book with title of "Dow at 36000" was selling like hotcakes. A few voices that raised questions about the viability of Citigroup's business model were drowned by the initial hoopla and the rally in the stock price. Warning signs, such as the departure of Jamie Dimon, Sandy's trusted lieutenant, could not dampen the market's enthusiasm and raise questions about viability and success of the merger. It was after more than 40 quarters of disappointing earnings and fiascos like Enron and the CDO losses that one heard "it just does not work" or "it is just too big to manage." The main reason for the failure of the merger was a flawed business model that ignored important characteristics of financial markets and the impact of information technology on them.

Sandy Weill's mantra and strategy has been that Citigroup must be the "provider of least cost" because there is not much difference between financial products and that this strategy will lead to increased market share and profit growth. Further, being a financial supermarket diversifies revenue sources and leverages off synergies between different businesses. By becoming a financial supermarket, Citigroup would dominate the market and grab market share from niche players similar to the way that supermarkets drove out mom and pop grocery stores by putting more than 30,000 items under one roof, as compared to a maximum of 7000 items in a large grocery store. Supermarket chains used their purchasing power to drive down prices and increase their profit margins. The same way that supermarkets eliminated the need for going from store to store to buy different grocery items, Citigroup would eliminate the need for a person or a company to go to a bank, to a broker, or to an insurance company to satisfy their financial needs. Though a one-stop shop for financial products has a nice ring to it, it ignores the fact that in a supermarket the physical nature of the products, and hence their transportation, delivery, shelf space, and storage are factors that greatly impact the availability and final price of the product. This,

however, is not true about financial products and services in the age of the Internet. The fact that Citi might be able to offer a checking account, a brokerage service, and a life insurance policy all at one branch and under one roof sounds exciting but a consumer with access to Internet can have all these at his/her fingertips and in the convenience of his/her home. Further, he/she will most probably be able to get better deals by surfing the web and using aggregators that bring together a lot of information filtered according to his/her needs. A consumer might not drive 10 miles to save 5 cents on the price of a can of beans but will gladly opt for a CD rate that is 5 basis points higher if all he/she has to do is go to another website. In the age of Internet and ATM machines the motto of "Citi never sleeps" sounds hollow. Further, even if customers value one-stop shopping for financial services because of its convenience they, at the same time, are acutely aware of their increased exposure to the credit risk of the counterparty. A notion that is absent when someone buys a loaf of bread, a toothpaste, or a bottle of orange juice from a supermarket, since these products are consumed while a universal life insurance policy exposes the insured to the credit risk of the insurer for the life of the policy. Consequently, when a company conducts all its financial transactions through one financial institution, it is putting all its financial eggs in one basket and is taking on the credit risk of that institution.

This brings us to the topic of the 'cheapest provider,' which again ignores the fundamental differences between a can of beans and a checking account and the pricing dynamics of each. The total cost, hence the price and profit of products and services are a function of production, marketing, distribution, and sale expenses. These costs and expenses vary greatly from product to product. In the case of cars, the major expense is production costs, whereas for bottled water it is the distribution cost. On the other hand, for items such as music, it is the marketing cost that makes up the lion's share of expenses. For each product, the proper business model is dictated by the nature of that product and the firm's position in the market. For example, Amazon.com is focusing on marketing and has outsourced its distribution to the postal service and other delivery services such as UPS. For a retail broker of stocks and bonds – Sandy Weill's background – where products are quite homogeneous, fee is the determining factor and the concept of being the cheapest provider makes sense. It is interesting to note that even in this area the game has been won by online brokerages and not by SmithBarney, the full service brokerage arm of Citi, due to the significantly lower costs of transaction. Being the cheapest provider is a catchy phrase and has a good ring to it, but similar to slogans like 'power to the people,' when drilled down to the core it is more a slogan than a

strategy, particularly when applied to the financial industry. The slogan of 'cheapest provider' when applied to risk implies that Citi can charge less for the risk than the competition. The natural question is how can Citi do this? Are other shops mispricing the risk? Or does Citi have better pricing and risk management models? Or does it have a better distribution that can transfer its risk to unsuspecting clients? Or perhaps it is because Citi has a big balance sheet that enables it to take risks that would wipe out any smaller institution, even though the risk might be underpriced. The enormous write-offs as a result of the sub-prime meltdown and the many lawsuits related to Enron and World Com and their huge fines show the fallacy of all the aforementioned arguments.

The cornerstones of the financial industry are capital, information, and trust. From a checking account to cash management, from equity line of credit to M&A, from securitization to loan syndication, in all these cases the role of a bank or brokerage house is to gather, aggregate, and transfer information. It is to draw conclusions, to give advice, and to commit capital to trades while keeping the trust of its customers and counterparties in the integrity and solvency of the firm. In a nutshell, information and capital. An important characteristic of information technology (IT) in the financial industry is the low barrier to entry and the speed of innovation. For example, a number of companies offer front-to-back turn-key systems for trading and risk management of different asset classes. Advances in financial engineering have created a wave of financial innovations, unfortunately not all good. Citi, while 'rolling up' companies, ignored the important task of fully integrating their information systems. The result has been that the ever larger company was unable to offer its customers the full array of its products and services, which was the main idea behind the merger and the creation of a financial supermarket. In reality, many of the acquisitions resulted in diseconomies of scale, since as the number of employees in the organization increased, the need for communication increased exponentially and by ignoring the important task of fully integrating IT systems, Citi ended up with a clogged up lines of communication. It should not come as a surprise that the bank's CDO risks and exposures were not properly aggregated and reported. When Vikram Pandit, the new CEO, complains about so many different database standards, he is alluding to the negligence of previous management to truly integrate the IT part of their new acquisitions. When some investors complain that Citi is too big to manage and should be broken up, they are alluding to an easy way to solve the IT and communication problems: eliminate the need for integration.

Economies of scale and savings gained by merging or vertically integrating companies that are engaged in manufacturing are different from those gained from mergers of financial firms. One reason is that manufacturing deals with fairly modular entities and earnings can be improved by closing inefficient plants and streamlining operations. On the other hand, in the case of Citi-Travelers,

the driver of growth and higher profits was claimed to be the synergy and the cross-sell which, by the way, calls for a different approach. Integration of information systems is the main challenge because different businesses such as insurance, consumer lending, and loan syndication have their own features and nuances. It is naïve to assume that different IT systems can be seamlessly and quickly integrated. Often, under time pressure, they are wedged together and after two or three acquisitions the IT systems become a mess of spaghetti codes. In the case of Citi, the integration was more complicated because of the acquisitions in different parts of the world. In practice, management mistook a New York-centric organization, where all decisions had to go through New York, with an integrated one. The result was a sluggish company that, unlike what it was heralded to be, turned into a collection of grocery store silos controlled from New York. The hodgepodge of acquisitions did not even have the benefit of local autonomy. It should come as no surprise that Vikram Pandit, the new CEO, is opting for a local control model with some global oversight. This constant reorganization, with each one trumpeted as "This will enable us to better serve our customers" is a manifestation that the system is not working and the management, without paying attention to the root cause, is constantly trying to tweak and adjust the organization with the hope of finally stumbling on the right business model that will enable them to operate on all cylinders.

Another selling point of the merger was diversification of revenue sources of the new financial giant. However, what was not mentioned was that the reputational risk of the company was also diversified and given the nature of this risk, diversification in fact increases it. In the case of financial risks, gains and losses net out and a loss in one position can be offset by gains in another, and if the decisions are sound and there is enough capital, law of large numbers ensures that diversification will lead to reduction of financial risk. Unfortunately, reputational risk is asymmetric and a bad reputation and publicity in one part of the world can not be offset with some community service in another part of the world. In fact, any expansion or acquisition increases the reputational risk of the company. Consequently, Citi with its far-flung operations is constantly running the risk of a blow up somewhere. For example, consider the flipping of a coin where with heads we win \$1 and tails we lose \$1. Suppose we flip this coin 1000 times. Financial diversification is similar to receiving the average of the outcomes while the impact of diversification on reputational risk is similar to receiving the worst of the outcomes. Now, suppose the probability of getting heads is 99%, which means that after flipping the coin 1000 times we will almost surely be financially ahead. However, in the case of reputational risk, the reverse is true and there is more than a 99.99% chance that at least one of the flips will be tails, i.e., a blow up. Negative press and damages to reputation can cost the company money in terms of fines and compensations that it has to pay to various parties, and could have a long lasting impact on the

firm, especially since in most lawsuits the lawyers go after the party with the deepest pockets, which in most cases is the bank.

Embedding and instilling the corporate culture in newly acquired firms can be quite challenging when the firms are in different lines of business and in different countries. Unless the management makes a concerted effort, the company will be saddled with different cultures. Even today, almost a decade after the merger, Citi has not been totally successful in merging the Salomon and old Citibank cultures. Another side effect of diversification is slow growth, because not all businesses grow at the same rate and since employees are generally compensated based on the overall performance of Citi, there is always discontent and whining. Lines of businesses that are thriving resent the slower ones and complain, for instance, the neverending complaints of the credit card business that they are subsidizing trading losses with no upside and investment bankers whining that slow-growing retail banking is limiting their upside.

The concept of financial supermarket in the age of Internet is a flawed one. A lot of services and products that fall under the title of financial services have quite different characteristics and often their only common denominators are risk and capital. However, the mortality and mortgage prepayment risks are quite different, as are the risks of merger arbitrage to having a car accident. No doubt in mergers of financial institutions there are inefficiencies that can be wrung out. However, unless the fundamental risks of the businesses are similar, together with their capital needs, the merger could result in a sluggish company that will not be able to adapt quickly to the ever changing financial landscape.