Citicorp redux

In the third of our profiles of financial institutions after the crisis, we look at Citigroup, a tarnished American icon.

WALTER WRISTON liked to contend that banks needed little capital as long as they were run well. On several occasions since the legendary Citicorp boss retired in 1984, the bank and its successor, Citigroup—created in a merger in 1998—have been caught embarrassingly short of the stuff. The latest blow-up was the nastiest. Enormous mortgage losses confirmed fears that the group, which grew into a gigantic financial supermarket under Sandy Weill, one of Wriston's successors, had become too complex to manage—a "frankenbank", as an insider puts it. Citi almost drowned in the red ink. It ended up needing three bail-outs, the last of which saw the government take a 23% stake.

Citi must now show that it can thrive on its own. Critics argue that Vikram Pandit, who took over as chief executive in December 2007, has been too slow to pare Citi's product offering and tighten its risk culture. To some, his survival owes more to obsequiousness—he rushed do the Obama administration's bidding on mortgage modifications, for instance—than to managerial talent. Mr Pandit counters that he and his team are far along with what could be the largest bank restructuring ever, and that its fruits are already visible.

The bank is back on a solid financial foundation, with a higher Tier-1 common-equity ratio than most peers, at 9.7%, and oodles of liquidity. It has improved its funding profile, too, replacing tens of billions of short-term debt with long-term debt and deposits. Last month Moody's, a rating agency, raised the outlook on Citi's stand-alone "financial strength" rating (excluding government support), from negative to stable. After two years of heavy losses, Citi made a net profit of $7.1 billion in the first six months of 2010.

Citi is narrowing its focus to something resembling the pre-merger Citicorp. Its unwanted assets sit in a unit called Citi Holdings. This is, in large part, a "bad shadow bank", containing wholesale-funded consumer-finance businesses and securitised assets. Some $362 billion of assets have already been sold or wound down, leaving $465 billion (a quarter of group assets). Citi has also offloaded better-off businesses, such as its German branch network and Smith Barney, a brokerage.

This "healthy shrinkage" will continue as quickly as is economically rational, says Mr Pandit. It goes hand in hand with a general efficiency drive. About $13 billion has already been shaved from an annual cost base that in the past often seemed out of control. Citi hopes to make more savings (and strengthen its risk controls) by further rationalising its mind-bogglingly complex technology platforms. It has already cut the number of its data centres from 68 to 25.

Citigroup's future rests on three pillars, housed in the tellingly named Citicorp unit: retail banking, corporate and investment banking, and transaction services. The last of these is the most straightforward. Cash management, custody, trade finance and foreign-exchange hedging are a cash cow for Citi, which has unparalleled links to the world's multinationals. It is focusing on deepening its relationships with the 5,000 or so firms (of the 40,000 it serves) that offer the most promise.

The success of Citi's investment bank, too, rests largely with these corporations. As it dials back on risk—partly of its own accord, partly in response to trading restrictions—it will rely more on "agency" business from clients: capital-raising, merger advisory work and the like. But it has been sliding down the league tables: in the first half of the year it fell from fourth to seventh place in global debt, equity and equity-related underwriting, ranked by proceeds, according to Thomson Reuters.

As for the retail bank, which includes Citi's cards business, this "looks better the further you go from New York," says a board member. Citi is looking to revive its barely profitable domestic network by focusing on the wealthy in a dozen or so big cities. That will bring its American strategy into line with its more successful approach abroad. Citi boasts a formidable network in emerging markets, built over a century. Asia and Latin America are particularly profitable (see chart).

Mr Pandit sees a role for Citi in "connecting east and west" but also as a beneficiary of the growth of intra-Asian commerce and the underdeveloped state of the region's financial industry. Its Asian network is set to grow by 70 branches, or 10%, this year. Returns on invested capital should grow at two to three times the pace in developed countries, reckons Stephen Bird, co-head of Citi's Asian unit.

Overall, Citi's prospects look far better than they did just a year ago. Mr Pandit looks more secure in his job, too. But there are grounds for caution. Its target of a 1.25-1.5% return on assets is higher than many banks enjoyed even before the crisis and the profit-sapping regulatory reforms it spawned. The overhaul of the American retail bank may flop. The investment bank may no longer take positions that could sink the group, but is yet to prove a consistent winner. Competition in emerging markets will grow.

Mr Pandit has made strides in mending Citi's disjointed culture, restructuring operations to break down silos and encouraging businesses to co-operate. But this remains a work in progress. Also weighing on Citi is the government's stake, now down to 18%. While it remains a shareholder, Mr Pandit will face stiff constraints. He has already been forced to sell assets he would rather have kept: Phibro, a commodities-trading firm, was ditched to assuage anger over its boss's pay packet. Regulators exert pressure via the board, whose non-executive members must brief them after every board meeting. The government is expected to have sold the last of its stake by next spring. That will be a milestone in Citi's rehabilitation. But it will take a lot longer for the bank to show that it really has cast off its accident-prone ways.

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