CITIGROUP

by

Lee Biles, Isaac Julian, Sergio Tristan

A paper submitted in partial fulfillment of the requirements for the course of

Managerial Economics (ECO 351W)

for

Dr. R. Preston McAfee

Department of Economics

The University of Texas at Austin

Fall 2002

OUTLINE OF PAPER

1. Problem Overview
    - History of the merger
    - Citicorp
    - Travelers Group
    - Issues facing the merger
2. Benefits of merger
    - Economies of Scale
    - Diversification
    - Regulatory Advantage
    - Synergies
3. Possible Downfalls
    - Diseconomies of Scale
    - Conflicts of Interest
    - Risk Bounds
    - Loss of current Synergies
    - Product bundling
    - Too many Chiefs
4. Conclusion

Problem Overview

In the last decade we have seen massive consolidation in the financial services industry. In this paper we will discuss the largest mega merger in this industry, the combination of Citicorp and Travelers Group to form Citigroup. We will discuss the importance of its timing and benefits and possible downfalls of the merger.

History of the Merger

The Citicorp-Travelers Group merger occurred in the fall of 1998. It joined the two companies into a $70 billion dollar financial giant[1]. By joining the two company's banking, brokerage, and insurance services, they created the largest financial firm in history. The merger marked a major turning point in the financial industry. Although the Glass-Steagall act still prevented commercial banks from dealing in insurance underwriting, the proposed Citigroup received approval from the European Union and Federal Reserve. Under the proposed talks, Citigroup would be evaluated two years from date of merger to gain final approval. Instead of having to be re-evaluated, Senator Gramm, R-Texas, lead the push to repeal the current regulations on the financial sector.

On November 15, 1999 President Clinton signed the Gramm-Leach-Biley Act. This act became law and repealed the Glass-Steagall Act and Bank Holding Act. The law did not make major changes to the type of practices that financial firms can do, instead it is more of an affiliation act. The Gramm-Leach-Biley act repealed both prior acts by allowing strategic alliances between financial services including banks, securities firm, and insurance companies.

---

[1] "A Closer look at Citigroup", S. Gunawan, E. Joo, J. Young Kim, R. Yang.

Citicorp

Citicorp served consumer, and corporate customers through its Citibank branches. Reaching out to nearly 100 countries, their Global Consumer Business was one of the largest credit and charge card issuers in the world. Citicorp's business included home equity loans, debt consolidation, retirement planning, and other consumer financial services in over one thousand worldwide branches. In the early 1990s, Citicorp was faced with the challenge of dealing with bad real estate and Latin American loans. Citicorp eventually recovered, thanks in part to Alan Greenspan, and became one of the most competitive banks by the mid 1990's. In years leading up to the merger Citicorp focused its efforts on credit cards and savings accounts while decreasing the bank's involvement in domestic wholesale business such as corporate lending.[2]

Travelers Group

Travelers Group had a diversified range of products including investment banking, asset management, life insurance, property casualty insurance, and consumer lending. Major subsidies included the prestigious brokerage house Salomon Smith Barney, Travelers Life and Annuity, Primerica Financial Services, Travelers Property Casualty Corp, and Commercial Credit. In the early nineties Primerica purchased Travelers insurance creating the parent company Travelers Group. Travelers, by its Salomon Brothers addition in 1997, became the third largest stock underwriter in the United States and the fourth in the world.

Issues facing the merger

As non-bank providers increased their pressure on commercial banks, new ways were needed to expand market share. Commercial banks began to operate in certain investment banking business such as underwriting debt and equity because of the higher profits generated. While Citicorp had the financial muscle to expand their services into these markets the cost of internal development was extremely high. As commercial banks began searching for new ways to increase profits, insurance companies were faced with a strong challenge to keep market share. Many

---

[2] Citicorp, Travelers, and Citigroup data from http://www.citigroup.com

Insurance firms began forming strategic alliances with financial service firms. These alliances were made in the hope of gaining economies of scale and becoming more cost-efficient. Revenue growth was the biggest driver of the huge flux of consolidation efforts in the financial sector. By combining the customer base of both firms into one the opportunity to cross-sell products from their bank and insurance services made merging the best option. Citigroup, the new name created out of Citicorp and Travelers Group, was now able to service its customers with a wide variety of products, which is extremely important in a client-focus industry such as the financial sector. The need for product diversification allowed for the creation of Citigroup. Risk reduction was achieved by combing the commercial bank and insurance business of Citicorp and Travelers. With diversifying both Citicorp and Travelers became better prepared to handle fluctuations in the business cycle and increased the likely hood of having the right skills to compete in new activities which will arise in the future.

Citigroup gained huge economies of scale upon completion of the merger, propelling them into the top financial service provider in the country. Customers will become more likely to want to use Citigroup's extensive network of products rather then separating their accounts between competing firms. Economies of scale also allow Citigroup to benefit from reduce costs in offering a variety of products as one firm rather then several firms offering the same service. Some of the problems revolved around moral hazards. As a consolidated financial firm Citigroup now has access to wider financial safety net from the federal government. Many analysts now saw Citigroup as "to big to fail". By being important to the national economic health of the country, the government had no choice but to subsidize it when problems occurred. This increase in protection creates the incentive for Citigroup to engage in risky investments. These risky investments are sought after during times of weak balance sheets for higher profits. Another type of moral hazard arises from the relationship between investment banking and commercial banking. The underwriting subsidiary of Citigroup, Salomon Smith Barney, now has a larger pool of customers. With the addition of Salomon's investing products Citigroup bankers are now better able to

negotiate deals with top executives. This broaden relationship allows for the possibility of "unspoken" arrangements between Citigroup bankers, Salomon underwriters and top executives.

Benefits of a Merger

Public expectation of the Citicorp-Travelers merger was high. At the close of business on April 6, 1998, the day the merger was announced, Citicorp's stock price had jumped 26% to close at $180.50 and Travelers Group similarly jumped 18% to close at $73.00.[3] Clearly the public anticipated that the benefits of the $70 billion merger would outweigh the costs. Lower operating costs from economies of scale would be one of the clear benefits of the merger.

Economies of Scale

Benefits from economies of scale can be seen in the management of a company's information flow. The management of information is a costly undertaking. The larger the company's customer base and the less the cost per customer to operate a network of information gives it economies of scale. At the core of the banking business is the need to manage huge databases containing demographic information, transactions histories, and other vital information. Cost savings occur only when the database is large enough to support its cost. Specifically, the cost of database-management software is enormous, while the marginal cost of adding one more record to a database is minimal, almost zero. This suggests that the more customers a company has, the larger a base over which it can distribute its cost.[4]

Diversification

Diversification is another advantage of the Citicorp-Travelers merger. Diversification can take the form of product diversification or geographic diversification. Because Citicorp has such as huge domestic and international presence, the merger will allow Travelers access into markets in

---

[3] Carow, Kenneth A.; Citicorp-Travelers Group merger: Challenging barriers between banking and insurance; Journal of Banking and Finance; August 2001

[4] Broaddus, J. Alfred; The Bank Merger Wave: Cases and Consequences; Federal Reserve Bank of Richmond; Summer 1998

which it would never have otherwise been able to reach. The number of Citicorp branches that Travelers will have access to is tremendous. With 464 branches in Europe, 166 branches in Latin America, and 93 branches in Asia, Travelers will effectively be able to distribute its products at more locations than it previously could have hoped to reach.[5] Combining the two institutions will make them less dependent on volatile earnings streams. Diversification prevents potentially poor results from one area of the business from damaging the profits of the entire company.

Regulatory Advantage

The Citicorp-Travelers merger was announced while both the Glass-Steagall Act of 1933 and The Bank Holding Company Act of 1956 were in full effect. Because these two companies merged on a two-year trial basis, it put pressure on lawmakers to remove the barriers between banking and insurance. The result of this merger was "a positive effect for those institutions most likely to gain from deregulation."[6] While Citigroup initially took the gamble of weather the law would be changed, all companies following in their footsteps would have the luxury of knowing one way or the other.

Synergies

Synergies provided the greatest advantages of the Citicorp-Travelers merger. Citigroup is now able to service an individual consumer with a number of financial services, including retail banking, brokerage services, home and auto loans, home and auto insurance, life insurance, and annuities, all under one umbrella. Citicorp and Travelers are now able to cross-sell to each other's customers. While Citicorp has $800 million in new mortgage orientation each year, consumers are typically sent off to find the homeowners insurance required in the contract. Post-merger, Citicorp is able to provide a package of home loans and insurance. This provides an unparalleled

---

[5] Business Week Online http://www.businessweek.com/1998/16/b3574073.htm

[6] Carow, Kenneth A.; Citicorp-Travelers Group merger: Challenging barriers between banking and insurance; Journal of Banking and Finance; August 2001

convenience to the customer while allowing Citigroup to sell twice the amount of products it otherwise would have been able to sell.

The merger also allows for an effective doubling of the companies sales force. While Citibank has private bankers catering to the very wealthy, "Travelers has 10,300 Salomon Smith Barney brokers, 80,000 part-time Primerica Financial Services insurance agents, and 100,000 agents that sell Travelers insurance"[7] that could all be trained to push Citibank credit cards and services. Insurance agents could set up shop in the already established bank branches, creating an even greater benefit to consumers. Consumers would be able to log into one website to access bank account information, pay bills from their checking account, check credit card balances, purchase mutual funds, and check on the status of their insurance. Citicorp, which caters to the very wealthy and currently offers clients such services as trust and estate planning, could extend those services to the customers of Travelers. Since Salomon Smith Barney does not offer these products, a pre-merger broker lost a "$20 million account because the company didn't have the expertise to value and set up an art trust for the client."[8] With cross selling between brands, the possibilities are plentiful, while the implementation may be difficult.

Possible Downfalls

The possible downfalls are arguments against "bigger is better" though the above pros are convincing, it does not negate the importance of the possible downfalls of a merger of this magnitude.

Diseconomies of Scale

Some parts of this industry feature diseconomies of scale. For instance, the same database that contains customers' history and all product holding creates an ethical dilemma for the management of the company and a perceived risk of unethical practices from the customer. The

---

[7] Business Week Online http://www.businessweek.com/1998/16/b3574073.htm

[8] Business Week Online http://www.businessweek.com/1998/16/b3574073.htm

company must be sure that pricing strategies for product sold to customers is not misusing existing customer profile and assets information. Maintaining barriers between information channels are costs the two separate companies did not have to pay. Though managing the barriers is a marginal cost, it does not increase significantly with an additional customer.

Conflicts of Interest

Though this diversification of products helps increase their customer base and allows cross selling, it has its downfall too. With a wide array of customers it increases the odds that the company may have a conflict of interest with the client. Citigroup as well as its sister giant in the financial services arena JP Morgan Chase experienced the case where developed relations of subsidiaries were lost because of conflicts of interest with the parent company[9]. These simple conflicts of interest may cause losses on big money making deals because of conflicts with less profitable customers.

Risk Bounds

The reason the government created the Glass-Steagall act was to protect the public from irresponsible banking. These financial safety nets in place by the government may lead to Citigroup acting irrationally, investing in high-risk environments to improve Citigroup's financial picture. This may also cause the personal risk preference of the customer's not to be matched because of this behavior without the knowledge of the customer.

Loss of current Synergies

Those internal relationships will now replace previous synergies may have been created out of partnership agreements with companies in different financial services. The new structure would destroy any partnerships Citicorp had with firms that compete directly with Travelers and Travels those that competed directly with Citicorp. There is no guarantee that these new relationships will be more efficient than the previous partners.

---

[9] CFO Online. Sleeping with a mega bank, Roger Hogan http://www.cfoweb.com.au/stories/20010823/4718.asp

Product bundling

These relationships and possible customer sharing may be better for the customer. The bundling of services may make it easier to manage, but it does so at the risk of the customer "putting all her eggs in the one basket." This exposure to the customer may decrease the profits that separate companies would have been able to capture. If the consumer were to à la carte despite these incentives, they would pay more the same product just to reduce this risk. Citigroup will likely offer the à la carte pricing but at a higher than pre-merger price. In addition, the ever-present possibility that bundles created pre-merger better fit the desires of the customers than post merger bundles. This loss in potential loss in efficiency must also be taken into consideration. In addition pre-merger switching cost would have been product by product, and now switching cost would be much higher, for they would now include either the switching cost to take the whole bundle else where or the cost of breaking up a bundle plus the switching cost of switching the individual service.

Too many Chiefs

One challenge that Citigroup will face is also one of its biggest assets, people. Between the two merging parties are some of the greatest performers in their industry. Each of these chief

executives running these branches of the company has very different goals and opinions of what it takes to be successful. Many of the current chiefs executives have expressed distaste for the plans of the two new co-CEOs of Citigroup and will likely leave to work for competitors[10]. With true leadership and clarity of vision passed down to the branches of Citigroup this may be an obstacle that can be overcome, but losing a few executives may be necessary. (Photo[11])

---

[10] Business Week Online http://www.businessweek.com/1998/16/b3574073.htm

[11] Business Week Online http://www.businessweek.com/1998/16/b3574071.htm

Conclusion

The new merger made possible partly by new legislation overturning the Glass-Steagall Act will be a very significant for the financial services industry, creating the largest financial services company in the world. The key to success here is cross selling. This merger combines Citicorp with the capital, customers and products, which failed in cross selling and Travelers group which has more products to offer and succeeded in cross selling. The new company, Citigroup, will prove to be an excellent competitor in the world market where the US companies had been loosing ground. Its main competitive advantage is its size of its customer base. Despite the challenges ahead for the merger and difficulties to follow, it should prove to be success. These changes in bundling and cross selling created by the merger will be significant advantages that others in the industry will soon copy.