Citigroup deal highlights US banking crisis

By Joe Kay
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On Monday, US banking giant Citigroup announced a deal with Abu Dhabi to secure a $7.5 billion cash infusion. The arrangement is intended to shore up the bank's financing amidst an ongoing credit crisis, but the desperate character of the deal is an indication of the deep crisis facing American capitalism.

Citigroup—the largest US bank and the largest corporation in the world measured by assets—has been particularly hard hit by the deflation of the US housing market, which has called into question the value of hundreds of billions of dollars in mortgages and securities.

Certain basic measurements of the bank's financial health have fallen sharply in recent months—in particular its capital ratio, representing the amount of assets the bank has relative to its liabilities. To provide a temporary bandage for this problem, the bank arranged the deal with the Abu Dhabi Investment Authority (ADIA), a state institution of Abu Dhabi, the capital of the United Arab Emirates.

The structure of the deal is unfavorable for Citigroup. The $7.5 billion will be exchanged for equity units convertible into shares in the company within the next four years. Until the conversion time, Citigroup has agreed to pay out an interest rate of 11 percent annually—which exceeds the average rate for junk bonds in the United States. At the end of the period, ADIA will be the largest single shareholder of Citigroup, with up to 4.9 percent ownership.

In effect, the arrangement amounts to a $7.5 billion loan at an interest rate of 11 percent. The principle will be converted into Citigroup stock at a price only slightly above its recent record-low. If the stock price rises, ADIA can make money on the difference between its purchase price and the market price.

ADIA's share of Citigroup will exceed that of the current largest shareholder, Prince Al Waleed bin Talal of Saudi Arabia, who purchased 3.6 percent of the company at the time of its last major financial crisis, in 1991.

At the same time, the funding is not enough to cover the bank's enormous obligations. CIBC World Markets analyst Meredith Whitney, who has raised questions about Citigroup's financial health, told the British newspaper, *The Telegraph*, "They're desperate. This $7.5 billion is just not enough money by a long shot."

The deal was carefully structured so that it would be accounted neither as a bond—which would not have solved the problem of the bank's capital ratio—or a stock sale—which would have led to a dilution of the company's share value.

Citigroup's search for cash has been made necessary by the loss of tens of billions of dollars by affiliated but off-balance-sheet investment entities. These entities include structured investment vehicles (SIVs), collateralized debt obligations (CDOs) and conduits. Each of these is important in different ways, but they are all invested heavily in subprime and other home mortgage securities, which have lost much of their value in recent months.

Among US banks, Citigroup has most heavily employed SIVs, CDOs, and conduits to gamble on the housing market. The collapse of the housing market has begun to unravel the highly speculative arrangements that were designed to disguise the amount of risk that the bank had taken on. Citigroup has already been forced to write-down $6.8 billion in housing-related losses and is expected to write-down $8 billion to $11 billion in the fourth quarter.

This is likely only a small part of Citigroup's problems. The bank has tens of billions more on off-balance-sheet entities that are nominally independent but are in fact closely tied to the bank. This includes $83 billion in seven SIVs, $41 billion in CDOs, and $73 billion in conduits. Citi is also expected to announce tens of thousands of job losses as a result of its financial woes.

The continued existence of Citigroup as an independent entity is in some question. There have been some rumors of a possible merger offer from Bank of America, which is facing its own severe credit problems. Some investors have called for the bank to be dismantled.

Since the credit crisis began several months ago, several banks have moved to absorb their off-balance-sheet entities. Citigroup has so far resisted, however, due to its increasingly precarious financial position.

In October, Citigroup, along with JP Morgan Chase and Bank of America, worked out an arrangement under the direction of the US Treasury Department, to create a special fund that would buy up assets owned by SIVs to prevent them from becoming insolvent. The establishment of the "super-SIV" was intended to allow the banks to avoid any immediate reckoning with the losses involved.

However, the success of this venture is doubtful, since many investors and banks have balked at supporting it. The deal with Abu Dhabi is another attempt to avoid acknowledging the extent of Citigroup's losses.

ADIA is the world's largest "sovereign wealth fund"—investment funds run by states, particularly the oil-rich states of the Middle East. The fund has begun investing more actively in US businesses, while it had previously concentrated on "emerging" markets. An ADIA-related fund recently purchased a significant portion of the private equity firm, Carlyle Group, which is closely connected with the US political establishment. The funds used to invest are largely recycled petrodollars—surpluses from the export of oil, the price of which has risen sharply.

Fortune magazine writer Peter Eavis, in an article published November 7 ("Does Citi have a capital crisis?") pointed to some of the underlying problems confronting the bank. In particular, Citigroup's capital levels have fallen sharply. Citi's "tier 1" ratio, a standard measure of a company's cushion to absorb losses, was at 7.3 percent of assets at the end of the third quarter of this year, down from 8.6 percent at the beginning of 2006. It is likely that it has continued to fall over the past two months.

Citigroup's "tangible capital to tangible equity"—considered by many analysts to be a more reliable measure of financial health—has fallen to 2.8 percent, from 4.3 percent at start of 2006.

In addition to the immediate problem associated with its off-balance-sheet entities, Citigroup also faces future losses from sharp increases in defaults on credit cards and other forms of debt, as the American worker and consumer faces increasingly hard times.

The troubles faced by Citigroup are linked to the enormous expansion of speculation by US banks. This speculation has been encouraged by the deregulation of the financial sector, including the repeal of the Depression-era Glass-Steagall Act in 1999. The repeal, carried out under the Clinton administration, broke down the wall between investment and commercial banking. This made conglomerates such as Citigroup possible, and encouraged the closer integration of the banking system with Wall Street.

The problems facing Citigroup are a more concentrated expression of problems facing the entire American banking system. In an article published in the *Financial Times* on Tuesday ("Why banking is an accident waiting to happen"), columnist Martin Wolf notes that banks have devised many ways to get around government regulations on capitalization ratios. "The result of this ingenuity [on the part of banks] includes 'special purpose vehicles,' [including SIVs and the like] hedge funds and even, in some respects, private equity funds. These are all, in varying ways, off-balance-sheet banks: ways to exploit the exceptionally profitable opportunities (and corresponding risks) created by high leverage and maturity transformation."

These mechanisms were the vehicles for making a great deal of money for a small layer of executives and investors, profiting off the parasitic extraction of wealth from the working population as a whole, including its poorest sections. The process worked fine as long as the housing market continued to go up, but as the market deflates, they are all beginning to unwind.