The New York Times

October 22, 2000

Along With a Lender, Is Citigroup Buying Trouble?

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WALL STREET rejoiced last month when Sanford I. Weill, the legendary deal-making chairman of Citigroup, announced that it was buying Associates First Capital, one of the nation's largest consumer finance concerns, for $31 billion. Investors bet that the deal would repeat the success of Mr. Weill's other mergers, notably Salomon Brothers and Citicorp, while bolstering Citigroup's presence in Asia, where Mr. Weill is staking a big part of his company's future.

''It's the perfect Sandy Weill transaction,'' said Joan Solotar, an analyst at Credit Suisse First Boston who follows Citigroup. ''It's a business he knows, there are real cost-cutting opportunities, there's a consumer franchise in Asia and it's accretive. What more could you ask for?''

People in North Carolina might say ''plenty.'' Last year, legislators there became the first to pass tough anti-predatory lending laws, taking aim at finance companies that lawmakers and consumer activists say routinely take advantage of unsophisticated homeowners. And, according to people who supported the bill, the most talked-about lender during legislative hearings was Associates.

''The abuses by the Associates were the key catalyst for the North Carolina legislation,'' said Martin Eakes, founder of Self-Help Credit Union, a nonprofit community lender in Durham, N.C. Mr. Eakes, who piloted carts carrying VCR's through the Capitol in Raleigh so lawmakers could watch taped news broadcasts about Associates practices, questions whether Citigroup knows what it is getting into. ''It's simply unacceptable,'' he said, ''to have the largest bank in America take over the icon of predatory lending.''

While the deal will give Mr. Weill the Associates' huge consumer-finance businesses in the United States and Japan -- the company has about 1,000 branches in this country alone -- those gains come with some risk to Citigroup's reputation as it marries a company that has been named in more than 700 private lawsuits, was fined $147,000 by Georgia officials earlier this year for violating state insurance regulations and is being investigated by the Federal Trade Commission, the Justice Department and the North Carolina attorney general. Consumer groups and some former customers have accused Associates of draining the home equity of some borrowers by deceiving or pressuring them into taking out loans and insurance policies that they did not need, might not have understood and could not afford.

Should Democrats retake Congress next month, the ranking party members on the House and Senate banking committees promise to give priority to antipredatory lending legislation that could affect Associates' practices. Those senior legislators, Representative John J. LaFalce of Buffalo and Senator Paul S. Sarbanes of Maryland, sent a letter to federal banking regulators this month urging them to ''closely scrutinize this transaction in light of the disturbing allegations of predatory and discriminatory lending practices by Associates.''

For their part, Citigroup officials do not defend Associates' sales methods, and they say Associates employees who will be absorbed by Citigroup's consumer-finance arm after the merger will be required to adhere to strict lending guidelines.

''We have to do whatever is necessary, because reputation is worth more than any particular quarter or any particular year's profits,'' said Charles O. Prince, Citigroup's chief administrative officer. ''I am absolutely confident we would change any practice in any part of our company to make absolutely sure that our reputation remains intact.''

ON Thursday, at a meeting in Durham, Citigroup executives listened to civil rights and community-lending leaders detail the problems they say Associates has caused for lower-income borrowers. A half-dozen homeowners told their stories personally. The group also gave Citigroup officials a laundry list of changes they wanted to see made at Associates branch offices.

Mr. Prince, the most senior official at the meeting, told the group that he understood reputational risk, noting that he recently told his daughter to go to Goodyear, and not Bridgestone/Firestone, to buy new tires. ''We don't want that same type of reaction to happen to Citigroup,'' he told the group.

Many consumer advocates are skeptical that Citigroup will take any action that hinders Associates' profitability, and they say Citigroup officials have so far promised little in the way of improving business practices. In fact, some critics fear that Associates' lending habits will be masked by the cachet of Citigroup's franchise and its status as the nation's largest financial institution.

But in an interview on Friday, Mr. Prince said Citigroup was considering changing several lending practices at its consumer-loan unit, Citifinancial, which will absorb Associates' consumer lending business if the deal closes, as expected, by year-end. He declined to say what was being considered, however, and added that, ''I'm sure we will not make everybody happy.''

While nothing that Citigroup is contemplating would have a material effect on its financial performance, he said, ''most all of the things we're talking about here would be new for Citifinancial as well as for Associates.'' Associates' way of doing business is ''strikingly'' different than Citigroup's, he added, in part because many of Associates' consumer loans are originated through brokers.

After listening to the Associates' customers tell their stories, Mr. Prince told the group that he would investigate their cases personally. ''These were very sad cases, and there was no way to come away from yesterday's session without being deeply moved,'' he said.

An Associates official referred all questions about the merger and Associates' business practices to Citigroup. In the past, Associates, based in Irving, Tex., has said it has done nothing unethical and is a source of credit for many people who would otherwise be unable to borrow. While it has acknowledged misconduct by some employees, Associates has denied accusations of widespread problems, and said those accusations have been fanned by opportunistic lawyers.

SOME community-lending advocates say they have been encouraged that Citigroup has been willing to listen to their concerns and has offered to make a few, if minor, changes.

''I'm trying to be an optimist through this whole process, because what's at stake here is changing the modus operandi of how these big banks respond to community protests and demands for better products and services," said John Taylor, president of the National Community Reinvestment Coalition.

Mr. Taylor said he wanted to avoid the pattern of past mergers, in which banks held news conferences announcing big-dollars, but unspecific, commitments to community lending and donated money to a few activist groups. He said Citigroup last month offered a $1 million grant to his group, a Washington-based coalition representing more than 600 local and regional organizations. But he said it chose not to consider the offer until the issues surrounding the Associates merger were resolved.

Mr. Prince said that Citigroup officials did meet with coalition officials to talk about the Associates acquisition, and that there was a discussion of Citigroup paying for a financial literacy program through the organization. But he said no specific monetary offer was made.

According to community-lending activists, Citigroup officials have discussed several steps with them to curb overly aggressive lending practices. These include eliminating loans with large ''balloon'' payments; starting a pilot program to have branch offices ''refer up'' customers with good credit ratings into less-expensive conventional loans; limiting prepayment penalties to the first three years of a loan; and limiting the amount of certain up-front fees to 9 percent of the loan value.

Mr. Prince confirmed that those were among the subjects under discussion, but he declined to say what else was being considered.

Yet the activists also say Citigroup officials have indicated that they are not willing to halt what critics consider to be the most serious abusive practices. Those include aggressively selling single-premium credit life insurance, a highly profitable product that a borrower pays up front for and which pays a benefit only if the borrower dies or is injured, and the repeated refinancing, or ''flipping,'' of loans, which results in new fees and other charges that often deplete homeowners' equity.

Mr. Eakes, for one, calls the proposed 9 percent limit on up-front fees shockingly high and a testament to how little Citigroup appears willing to do. ''Citigroup has stated that they would solve the problems in Associates by bringing Associates up to Citigroup's standards, but it's not totally clear that Citigroup's standards are tighter,'' he said.

Mr. Prince, referring to the assertions of flipping and credit insurance abuses, responded: ''Those two issues are key issues in this debate, and I would not feel comfortable if our business model did not in some way address those two issues.''

Earlier this year, he added, Citifinancial began using ''mystery shoppers'' to drop in on branches to check on compliance and sales practices. That will be continued at the newly acquired Associates branches, he said. In any large sales force, he said, ''you're going to have some people who don't do the right thing.''

Officials at the F.T.C. and Justice Department declined to comment on the status of their investigations into Associates. Mr. Prince said that one of his first orders of business after the acquisition closed would be to meet with both agencies to ''resolve those matters pretty promptly.''

He said he had already blocked off time on his calendar. ''Our practice has been that it is not a smart way to run a business to be cross-wise with the government,'' he said.

According to several analysts, Citigroup pursued Associates for almost a year, starting when Associates' stock slumped as more mobile-home buyers stopped repaying their loans and fewer truck drivers borrowed to update their rigs. ''They were in a number of businesses that basically blew up on them,'' said Moshe Orenbuch, at Credit Suisse First Boston. ''Mobile homes blew up clearly, unequivocally.''

Late last year, Associates decided to pull out of mobile-home lending altogether. But by then, growth in the company's domestic consumer lending business had also stalled, leaving its foreign operations as the main source of growth. Moreover, Associates was falling behind competitors in automating its operations, a long and costly process required to make it more efficient, analysts said.

On Aug. 2, Mr. Hughes of Associates came to Mr. Weill's office to negotiate a takeover. They eventually agreed on a tax-free swap of stock that represented a big premium over Associates' share price but still allowed Mr. Weill to crow that it would immediately bolster Citigroup's per-share earnings.

Talking to analysts during a conference call after the deal was announced, Mr. Weill sounded a wistful note about the origins of the financial empire that he had built over the last 15 years.

In 1986, Mr. Weill was hired as chief executive at the Commercial Credit Corporation, a struggling outfit in Baltimore that lent money to working people of modest means. He took that company public, and through aggressive selling and a series of ever-larger acquisitions, he created the Citigroup conglomerate that now spans consumer lending, insurance, stock brokerage and investment banking.

Long ago, in fact, Commercial Credit's original business of lending small amounts at high rates was eclipsed by other lines of business at Citigroup. In the first nine months of this year, Citifinancial, the Citigroup unit that absorbed Commercial Credit, contributed less than 3 percent of Citigroup's $50 billion in revenue and less than 4 percent of its $9.72 billion in profit. Citifinancial has $18.5 billion in loans outstanding, or about one-tenth of Citigroup's total portfolio of loans around the world.

The business is neither the riskiest nor the most profitable within Citigroup. Citifinancial's borrowers default at a higher rate than do typical Citibank customers, but at a lower rate than holders of the bank's credit cards.

Compared with Associates' strategy, Citifinancial's actually implies considerably more risk. Roughly one-half of the money lent at a typical Citifinancial branch is to borrowers who pledge no collateral, for example, while a significantly higher share of Associates' loans are secured by equity in the borrower's home or some other asset.

But because borrowers are more likely to default on unsecured loans, Citifinancial, by and large, can charge higher interest rates than Associates, and collect more profit: Citifinancial's annual return on its assets, or the money it lends, is about 2.5 percent, compared with about 1.8 percent at Associates. Citigroup officials have told Wall Street to expect the mix of lending at Associates branches to shift toward unsecured, higher-interest-rate loans.

THE most contentious point between community-lending activists and Citigroup officials appears to be the sale of single-premium credit insurance to borrowers. The premium is paid to Associates by the borrower in one lump sum that is usually added to the loan balance.

Several government agencies and consumer groups have called for legislation banning single-premium credit insurance, including the Treasury Department, whose former secretary, Robert E. Rubin, is now chairman of the Citigroup executive committee. The Treasury, in a joint report on predatory lending released in June with the Department of Housing and Urban Development, called lump-sum credit life insurance ''unfair, abusive and deceptive.''

Critics say lenders often pack the insurance into loans without telling borrowers what it does, or even that it is optional, and that it is rarely of any benefit to them. The Treasury report said these products also ''unnecessarily increase consumers' total borrowing costs, and disguise the true cost of the insurance on a monthly basis.''

Yet this insurance reaps huge profits: During the last five years, Associates' principal subsidiary, Associates Corporation of North America, has collected $1.8 billion in insurance premium revenue -- half of it from credit insurance -- and earned $397.5 million in investment income on those premiums. But it has paid out just $713.1 million in insurance benefits over that period.

Internal Associates documents produced in court during previous lawsuits suggest that the pressure on Associates employees to sell credit insurance has been intense at times. One interoffice memo, written to group managers in 1988, instructed Associates employees to ''insist that the insurance offer is written on every application, NO EXCEPTIONS.''

Another internal memo, titled ''The Roadmap to Continued Record Profits in 1995,'' stated that Associates agents sold credit insurance on 57 percent of real estate loans and 61 percent of consumer loans, and it implored them to raise those levels. In the past, lawyers for Associates have said the memo circulated only in one region of the country.

CITIGROUP officials say the problem is not with the product, but in the way that it is sold. Unlike Associates, Citifinancial discloses how much the insurance raises a customer's monthly payments and makes clear that the customer is not required to buy the insurance as a condition of getting the loan, said Robert Willumstad, Citigroup's head of consumer lending. Disclosure practices at Associates branches will be improved, he said.

At Associates, ''the consumer has not always understood what he or she is buying,'' he said.

''We feel we have operated at a much higher standard,'' he added.

As with credit insurance, internal documents from Associates suggest that employees have been pressured to encourage homeowners and other borrowers to refinance loans; the emphasis was usually on how this would benefit the company, not on how it might help the customer. In the ''Roadmap'' memo, for example, a chart showed how the profitability of a consumer loan decreases as it ages. ''You can see how the earnings decline over time,'' the memo said. ''Your controller can provide lists to you of aged personal loans to target for renewal.''

Another memo, sent in 1991 to ''all branch managers,'' concerned Associates' practice of acquiring consumer loans made by other lenders or retailers. ''The principal reason we purchase an acquisition is to convert it to a more profitable loan,'' the memo stated. ''If we cannot convert acquisitions, we cannot continue to purchase them.''

The memo then stipulated that employees who renewed such loans, if secured by real estate, would receive a

$100 bonus for each loan.

Last month, in an investor conference call, Keith W. Hughes, the chief executive of Associates, who will join Citigroup as a vice chairman after the merger, cited the strong cultural similarities between the companies. But in an interview last week, Marge Magner, a Citigroup executive who previously oversaw Citigroup's consumer finance business, stressed what she said were big differences, particularly in how the sales staff is paid.

Associates bases pay on the volume of loans that employees generate, a ''count your transactions'' approach, Ms. Magner said. At Citifinancial, she said, ''we deal with the business as a whole, the whole branch and how it's growing.''

She also emphasized that the Citifinancial computer system used by the sales staff automatically rejected products and interest rate levels that did not seem suitable for a specific customer, giving Citifinancial a measure of centralized control over lending practices. ''A lot of the compliance issues are built into the system,'' she said.

Bill Brennan, a lawyer with the Atlanta Legal Aid Society who has testified before Congress and represented many Associates borrowers, said the changes proposed by Citigroup were not enough. ''It's crazy to say you will stop balloon abuse and maybe one or two other abuses but keep the credit life abuses and the flipping abuses and the other abuses,'' he said. ''That means the whole process is just as polluted as before. You can't just clean up part of the river.''

In North Carolina, some Associates practices are being investigated by Michael Easley, the attorney general, for possible violations of lending laws. Officials in Mr. Easley's office said they had become more determined after learning that some homeowners' zero-interest loans from Habitat for Humanity, the nonprofit housing group, had been refinanced with high-interest loans from Associates.

And Mr. Easley's office has received complaints from borrowers, including Benny and Linda Mackey of Chocowinity, about 100 miles east of Raleigh. The couple were paying $519 a month on their mortgage but had fallen behind in their payments, according to their complaint last year to Mr. Easley's office. Associates ''said the only way they could help us was to refinance it again,'' they wrote in their complaint.

Their monthly payment rose to $592 after Associates refinanced the $37,117.76 they already owed -- in part because a $4,231 ''loan discount'' fee and $4,910.08 in credit life insurance were added to their balance, according to documents from Mr. Easley's office. The note carried a 14.99 percent interest rate on the new principal balance of $46,541.08.

THE Mackeys complained of receiving harassing phone calls from the Associates after they missed some payments on the refinanced loan. They said that callers would even curse at their sons, and that they were eventually told that foreclosure proceedings had begun. But last year, three months after Mr. Easley's office received the complaint, Associates agreed to lower their interest rate to 9 percent, reducing the Mackey's monthly payment to $370, according to a letter sent by an Associates lawyer to the attorney general's office. Mr. Mackey, in an interview, said he filed for bankruptcy protection from creditors last year after he received the foreclosure notice and had not made any payments to Associates since then.

Alan Hirsch, a deputy attorney general in North Carolina, declined to comment on the state's investigation of Associates, although he said it was not the only lender under scrutiny.

Speaking generally, Mr. Hirsch called single-premium credit insurance ''perhaps the most egregious practice'' by lenders. ''Many borrowers don't understand it's been included in the loan,'' he said.

His office has found numerous cases of borrowers whose loans were flipped, resulting in costly refinancing fees and insurance charges. In one example, he said, a borrower received $6,000 in cash through a refinancing but was charged more than $20,000 in additional financing fees and credit insurance by the lender.

''It's legalized robbery,'' Mr. Hirsch said.

Photos: Sanford I. Weill, chairman of Citigroup, faces risks in its merger with Associates First Capital. (Ozier Muhammad); Benny Mackey of Chocowinity, N.C., studies the Bible in his kitchen, where the sagging floor is patched with duct tape. He says he cannot afford repairs because of high loan payments he owes to Associates First Capital. (Grant Taylor Roberson for The New York Times)(pg. 1); Protesting Citigroup's planned purchase of Associates First Capital, whose lending practices are being investigated, community activists held a courthouse rally in Durham, N.C. They carried red umbrellas, the symbol of Citigroup, with holes cut in them. (Jennifer Warburg for The New York Times)(pg. 15) Chart: ''Lenders Compared'' By buying Associates First Capital and combining it with its existing Citifinancial unit, Citigroup is vaulting to first place in consumer finance in the United States. Revenue Per Branch Office Associates: $0.44 (millions) Citifinancial: 1.10 Lending Mix Associates Personal loans and retail sales finance: 37% Home equity: 63 Citifinancial Personal loans and retail sales finance: 41 Home equity: 59 Market Position Consumer finance companies ranked by dollar value of receivables under management on June 30. Citifinancial and Associates combined: $48.7 (billions) Household International: 38.1 Associates: 32.3 Citifinancial: 16.4 American General: 11.6 Norwest: 6.0 (Source: Citigroup)(pg. 15) Chart: ''New Debt for Old'' Refinancings for borrowers with low incomes or poor credit are growing fast. Consumer advocates say such loans too often serve only to enrich lenders with fee income while leaving borrowers worse off than before. Chart tracks the number of refinancings since 1990. Figures are for loans reported to the government by subprime lenders. 1998 figures are the latest available. (Source: Department of Housing and Urban Development)(pg. 15)