

# **The Rise of the Modern Business Enterprise: The Case of Citibank**

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A case study examines the singular in order to illuminate the general. Although the subject of the case may be interesting and important in its own right, the case's purpose is to test broader hypotheses, not statistically, but qualitatively. The rich detail of a case study can suggest nuances to propositions derived from more sweeping surveys. In this article the propositions to be illuminated concern the rise of the modern business enterprise, and the case shedding light is the history of Citibank [4].

## **THE RISE OF THE MODERN BUSINESS ENTERPRISE**

"The modern business enterprise is an economic institution that owns and operates a multi-unit system and relies on a multi-level managerial hierarchy to administer it [5, pp. 203-4]." When, why, and where did this form of business arise, and what were its consequences for the firms themselves, the industries in which these firms operated, and the economy at large? These are the

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questions that business historians, notably Alfred Chandler [3], have posed and answered.

*When* the modern business enterprise emerged is clear. It arose during the years 1870 to 1920. Before the earlier date, firms were simple proprietorships, serving a single market with a single product from a single location. Markets, not managers, coordinated the flow of inputs to the firm and of output to the consumer.

Then came the railroad or, more precisely, the completion of a national railway system in the 1870s. This was important for two reasons. First, it created a potential national market for a far wider range of goods. This broadened the opportunities open to firms from the county to the country. Second, the railroad pointed the way to how the enterprising firm might take advantage of the new opportunities offered by a national market. Partly in order to keep trains from running into one another, railroads developed a managerial hierarchy that delegated responsibility for day-to-day operations to salaried managers. Such organizations permitted railroads to carry a rapidly growing volume of traffic at a lower unit cost.

Lower cost is the reason why the modern business enterprise triumphed. Specifically, managerial hierarchies lowered costs through routinizing transactions among the different stages of production and distribution. The integration of production, purchasing, and marketing permitted firms to reduce the cost of information about markets and suppliers, to push goods through the production process faster, and to use resources more intensively. Further cost reductions came in raising capital. The steadier cash flow achieved by the modern business enterprise reduced the risk of securities issued by the corporation, enabling it to float bonds and equity at lower cost.

The modern business enterprise triumphed in industries where these cost advantages were greatest, namely where technology permitted companies to produce goods in large volumes for distribution to large, geographically dispersed markets. To obtain the

full competitive advantage that the lower unit cost of production afforded, the technologically advanced firm integrated forward into marketing and distribution and backward into the production of intermediate goods or even raw materials. This vertical integration assured that the factory could always run at close to full capacity. But vertical integration also required that the areas of the firm outside the factory be as efficient as the factory itself, and this required an institutional innovation analogous to the technological innovations installed in the factory. That institutional innovation was the managerial hierarchy, or, as Chandler has termed it, the visible hand.

What were the consequences of the visible hand for the firm itself? First, there was a shift from owner to managerial control. Although owners continued to have a critical say in policy decisions until well into the twentieth century, salaried managers soon dominated day-to-day decision-making and ultimately came to make policy decisions as well. In part, the reason was the sheer number of managers that a rapidly growing industrial firm required: no one family could hope to provide them all, even if every child went into the family business. In part, the reason was the greater expertise of the salaried manager; intimate familiarity with the day-to-day operations of the company enabled the salaried manager to make the policy decisions himself, or, at the very least, to phrase the policy options open to the owner.

Whatever the balance between these two reasons, the separation of ownership and control made economic sense. It enabled the firm to tap the markets for capital and executive talent separately and, thus, to secure a greater amount of each than if the firm had continued to seek both capital and executive capability in the same individuals.

Secondly, firms that successfully developed managerial hierarchies achieved what modern consultants call "a sustainable competitive advantage" [12; 13]. Together with the advanced technology employed on the shop floor, the managerial hierarchy made the firms that employed it low cost producers within their own industries. Thus, they tended to gain market share at the

expense of their rivals and to survive downturns in the economy somewhat better. Over time, therefore, firms with managerial hierarchies came to dominate their respective industries.

The success of the managerial firm had consequences for the industry as well. Production tended to become much more concentrated in the hands of a few large firms. Finally, the advent of the managerial hierarchy had consequences for the economy and society at large. It was an important contributor toward the transformation of America into an organizational society [17].

## **THE CASE OF CITIBANK**

In broad outline, the development of Citibank parallels that of other modern business enterprises. In 1870 the firm was an owner-managed entity with few employees. It operated from a single location, had a restricted customer base and a single product. Its share of the total banking industry was by any measure small. By 1920 the picture had changed dramatically. Citibank had become the largest commercial bank in the country and a leading investment banking house. It had put a managerial hierarchy in place and was in the process of separating ownership from management. It was on the verge of becoming the nation's first truly modern bank.

How did this transformation come about? In 1870 Citibank was essentially a one-man operation. Moses Taylor (President, 1856 to 1882) was the principal owner, the president, and the principal customer of Citibank, or National City Bank, as it was then known. Aside from Taylor the bank had one other manager, the cashier. In 1875 total employees numbered twenty-two, and all fitted comfortably into a single office on Wall Street. Aside from Taylor, the bank had few other customers; it operated pretty much as a treasury unit for a group of railroad, industrial, and financial enterprises owned by Taylor and a small number of

close business associates. In fact, Taylor's personal fortune was more than three times the bank's total assets. Clearly, at this point in Citibank's history, the entrepreneur was greater than the enterprise.

This began to change under James Stillman (President, 1891 to 1909 and Chairman, 1909 to 1918). Taylor had been as much an industrialist as a banker; Stillman was a financier through and through. More important, Stillman saw the bank as a vehicle through which he could build a lasting monument to himself. As the journalist Edwin Lefevre wrote,

**Mr. Stillman dreams of a great national bank, and thinks he can make one of the Citibank. It is what he is trying to do, what occupies his mind and animates his actions. He is running his bank, not toward dividends, but toward an ideal. ... To make it great in domestic and international finance: that is the dream of James Stillman. [9, p. 334].**

Together with Frank A. Vanderlip (Vice President, 1901 to 1909 and President, 1909 to 1919) Stillman radically changed Citibank's orientation. Stillman and Vanderlip took a broad view of the possibilities open to Citibank. They saw within the United States the rise of big business, the emergence of the middle class, and the growth of the securities markets. They recognized that the United States would surpass Great Britain to become the world's dominant economic power and that this would make New York the world's financial center.

Stillman, especially, saw that big business demanded big banking -- in size, in the range of its products, in its view of finance. To Stillman is due a concept of banking that has guided Citibank ever since:

**I firmly believe ... that the most successful banks will be the ones that can do something else than the mere receiving and loaning of money. That does not require a very high order of ability, but devising**

methods of serving people and [of] attracting business without resorting to unconservative or unprofitable methods, that opens limited fields for study, ability and resourcefulness and few only will be found to do it [14].

Citibank's business was to be, not merely "receiving and loaning money," but providing any financial service. Its customers were to be not merely Taylor's firms, but institutions and individuals. And it would operate, not merely from Wall Street, but across the United States and around the world.

To play a major role in the financial world, Stillman and Vanderlip transformed the Bank from the narrow, specialized firm it had been under Taylor and Pyne. After 1891 Citibank expanded its product line, broadened its customer base, and opened new locations. It instituted a decentralized, multidivisional structure and, after a severe crisis, succeeded in separating ownership and management. As a result, Citibank became a fully modern corporation and a leading firm in the financial services industry.

Diversification came step by step and in response to market opportunities. Building on the strong base inherited from Taylor, Stillman led Citibank into related areas, offering new products to existing customers or selling existing products to new customers. The key initial thrust was the entry into investment banking at the turn of the century, and it typified the strategy of dominating the periphery that the bank would employ over the next three decades. At the time J. P. Morgan & Co. and Kuhn, Loeb held a tight grip on financing for the nation's leading corporations. Stillman did not compete with these investment houses head on; instead he sought to ally Citibank with these houses by offering services complementary to theirs. Morgan's and Kuhn, Loeb's strength lay in the origination of securities; Citibank therefore stressed the distribution of securities to institutions and individuals and the finance of syndicates that underwrote securities. Starting with the underwriting of the Union Pacific in 1895,

Citibank became a major participant in syndicates led by Morgan and Kuhn, Loeb. By 1905 the nation's leading corporations were customers of the bank, and by 1911 the bank was probably involved in the distribution of more new issues than any other investment house.

To support the thrust into investment banking, Citibank also expanded its customer base to include commercial banks. Through the acquisition of the Third National Bank in 1897 Citibank obtained a large clientele of correspondent banks, and it soon thereafter became the leading holder of bankers' balances in the country. Correspondents not only furnished significant deposits that could be used to finance underwriting syndicates, but they also facilitated payments for Citibank's customers and purchased securities underwritten by the bank.

Thus, by 1913 Citibank had become a big business bank. It provided the nation's largest corporations, correspondent banks across the country and the brokers of Wall Street with commercial and investment banking services.

Further growth depended on a change in the perception of a bank's proper role and in the way banks were regulated. Until 1913 banks, especially members of the New York Clearing House Association, such as Citibank, were considered quasi-public institutions, responsible for the stability of the money market and, indirectly, of the economy at large. As a result, Citibank operated under severe regulatory restrictions that limited its ability to branch or to provide a broad range of financial services. A reduction in this public role, Stillman and Vanderlip realized, was critical to Citibank's expansion as a private business.

This was accomplished by the passage of the Federal Reserve Act in 1913. This Act created a central bank, diminishing but not eliminating the perception that commercial banks played a special public role. The Federal Reserve Act opened the door to international and, ultimately, domestic branch banking, and to the exercise of broader powers by national banks and their affiliates.

Citibank was among the first to take advantage of this broader franchise. During the years 1914 to 1916 Vanderlip initiated the development of an international bank with branches around the world. He also transformed the domestic wholesale bank into a truly national institution by instituting relationships with firms across the country. Finally, he expanded National City's investment banking activities by creating a retail distribution system. This brought individuals of modest means into National City's customer base for the first time. By 1916 Citibank's long-term strategy was set: it would offer a broad range of financial services to institutions and individuals around the world.

During the 1920s a new chief executive, Charles E. Mitchell, filled out the vision of Vanderlip and Stillman by adding new, but related, businesses to the structure they had left him. Following further revisions in the banking laws, Citibank opened branches in New York City, establishing a local bank to serve small businesses and individuals. This fueled much of the Bank's growth during the 1920s, for larger corporations had begun to trim their cash balances and to turn to the securities market for financing. National City also added trust services to its product line for individuals and corporations while at the same time developing further the corporation's commercial and investment banking activities around the world.

This comprehensive strategy required sweeping structural change within the firm. When the Bank began to open branches in 1914, it had to impose a managerial hierarchy. Authority for day-to-day operations in a branch located thousands of miles from the head office had to be delegated to a manager on the scene. The growth of the business also demanded that top management delegate more authority for day-to-day operations to middle managers, while reserving policy decisions for itself.

Vanderlip recognized this quite early, as did Stillman. The latter wrote:

Organization, organization, with a system, that will give the fullest attention to details and the wisdom of careful and deliberate council in shaping policies, impresses me more and more as of vital importance to avoid making mistakes and insuring permanent and ultimate success [15].

Decentralization was key. Citibank's strategy was to enter many different markets. To pursue these opportunities successfully managers on the scene had to have the authority to make business decisions. Vanderlip's solution (1917) was to create market-oriented business units, and to give their managers the responsibility and resources required to penetrate those markets.

The actual organization was along product and geographic lines. Product dominated; the corporation was divided into commercial and investment banking affiliates. Later (1929) a trust affiliate would be added. Within these units, geography was the dominant organizational scheme. The commercial bank, for example, was divided into domestic and foreign departments. Within these departments further geographic subdivisions were made. Similarly, the sales force of the investment banking affiliate was organized along geographic lines. Only the origination or underwriting side of the investment banking affiliate had an organization based on customers.

At first, this organization nearly destroyed the bank, for decentralization was not balanced by better risk control, and risk control was absent because Vanderlip and Stillman were feuding with each other about which of them would control the firm. In 1917 Stillman was the principal owner of the firm. As chairman, he had ultimate say on bank policy, but he was ill and spent much of the year in Paris. Vanderlip thus ran the firm on a day-to-day basis and set policy subject to Stillman's veto. As Stillman's health deteriorated, Vanderlip proposed that Stillman grant him an option on Stillman's stock so that control of the firm would gradually pass to him. Stillman refused, and Vanderlip's drive was diverted from the bank into personal business ventures and ultimately into public service.

As a result, the bank faltered. Specifically, Vanderlip failed to control the bank's expansion into Russia. A branch was opened in Moscow one week after the Russian Revolution, and it accepted large amounts of deposits before it was nationalized in 1918. At the time it seemed that the bank would be liable to pay out these deposits in New York in dollars, so that the bank would lose an amount equal to the entire deposits of the Russian branches, or 40 percent of its total capital. At this juncture Stillman returned from Paris, took command of the Bank and told Vanderlip to take an indefinite vacation.

Shortly thereafter Stillman died (March 1918) and was succeeded by his son. Vanderlip resigned as president (June 1919) and once again the principal owner controlled the firm. The bank fared no better, for Stillman, the son, was not the banker his father had been. Specifically, the younger Stillman allowed the bank to become overextended in loans to Cuban sugar producers. Perhaps his extramarital affairs took too much of his attention. He resigned in May 1921 at the depth of a severe recession and at the height of a scandalous divorce suit.

Charles E. Mitchell then replaced the younger Stillman as president of the bank. To solve the problem of motivation, Mitchell and the other top executives of the bank received a management contract that accorded them a 20 percent share in profits over and above those necessary to pay dividends to the shareholders. This completed the separation of ownership and control and paved the way for Citibank's rapid expansion during the 1920s.

By 1929 the bank's strategic initiatives had made it the world's leading financial institution. Each of its three affiliates occupied a primary position in its field. The bank was the largest in the world. Its investment banking affiliate was the world's largest distributor of securities and a leading underwriter as well. Its trust affiliate also served institutions and individuals. While

not the largest trust company, it could, through its merger with Farmers' Loan & Trust Company (June 1929), lay claim to being the oldest and most prestigious. Together the three affiliates provided a range of services from a network of offices that no other financial institution could match.

### **SOME HYPOTHESES ABOUT THE RISE OF THE MODERN BUSINESS ENTERPRISE**

What does the case of Citibank say about the rise of the modern business enterprise? First, it suggests that the diffusion of the managerial hierarchy followed a pattern similar to that of other innovations, such as hybrid corn [7]. The innovation was first adopted in areas, such as petroleum refining or other large-volume processing industries, where technological advances created large profit opportunities, provided firms could organize themselves into sufficiently large units. Finance was not characterized by startling technological change. Hence, the profit potential of the managerial hierarchy was lower, and its adoption by financial firms tended to lag behind industry.

On a minor note, the case of Citibank also suggests that the development of the US capital market may have contributed, along with technology, to the advent of managerial capitalism in industry. The availability of a market for industrial securities enabled entrepreneurs to capitalize future income streams and to diversify their holdings. This facilitated the shift from entrepreneurial to managerial capitalism in the United States. In contrast, family or group capitalism lingered much longer in Europe and Japan, where markets for industrial securities were not as well developed.

The second hypothesis suggested by the case of Citibank concerns the degree of dominance achieved by a managerial firm. The introduction of a managerial hierarchy did not necessarily

make a firm dominant within its industry. It did, however, ensure that the firms adopting it would survive the consolidation of the industry brought about by new technology and that these firms would have sufficient cash flow to invest in the modernization of their core businesses as well as to build new businesses through diversification.

Indeed, a strong base may be a precondition for successful diversification. With a steady income from its principal line of business, the firm can enter new businesses without risking the solvency of the entire firm. This permits the firm to be more aggressive on the periphery, to achieve a leading position in emerging markets that later entrants will find difficult to overcome. Examples would be Citibank's entry into international branch banking or Du Pont's diversification into chemicals from gunpowder.

The third hypothesis concerns the importance of regulation. Specifically, regulation sets limits on the degree to which the firm can exploit the cost advantages resulting from the adoption of a managerial hierarchy. In banking the prohibition against interstate and even intrastate branching set a limit on the extent of the market that a bank could serve. Similarly, industrial concerns were braked in their growth by regulation, especially the antitrust statutes, even though the degree of market power enjoyed by the large firm in the national market may have been no greater than the traditional firm had enjoyed in local markets before the coming of the railroad. However, large firms attracted political attention, and the nation's anti-trust law was written in response to the success of technologically advanced and managerially directed firms such as American Sugar, Standard Oil, and American Tobacco [10].

Fourth, the case of Citibank suggests that individuals count heavily in determining which firms made the transition to managerial capitalism. Although market conditions, such as demand, technology, and regulation, determine the pace and extent of an industry's transition to managerial capitalism, which firms make that transition and which firms fall by the wayside largely de-

depends on the individuals directing the firms within an industry. One only has to contrast James Stillman, who dreamed of making City Bank great in domestic and international finance, with George Baker, the president and principal owner of the First National Bank of New York, who "had no ambition at all to broaden the field" of his bank [11; 16]. While Citibank diversified, the First National remained a specialized institution and was ultimately merged into Citibank in 1955. Thus, structure may follow strategy, but strategy follows a concept of the business [2, pp. 15-6], and that concept, at least in the enterprise's formative stages, generally stems from one or two individuals.

As a corollary to this point, the Citibank case suggests that the health of the firm can hinge on the motivation of the individuals who direct it. Hence, the issue of compensation assumes major importance. If the managerial hierarchy is to work, it must include incentives to induce managers to behave like entrepreneurs. In technical terms the firm must overcome the agency problem inherent in the separation of ownership and management [6; 8]. This requires compensation and internal accounting systems that mimic the market, so that the firm can match compensation to performance. The management fund of Citibank during the 1920s was a clear example of this.

Finally, the case of Citibank suggests that history has a role to play in the ongoing development of the modern business enterprise. According to textbook corporate strategy, the environment sets the strategic choices open to the firm. From this range of options the firm selects a strategy and a structure to implement that strategy. Together, environment, strategy, and structure dictate performance -- a firm's profitability and growth relative to its competitors.

History completes the loop from past performance to future strategy. How a company performs influences not only its position vis-a-vis competitors, but also how the firm will view the strategic choices open to it and how the firm will implement its strategic decisions.

Thus, a knowledge of a firm's history is of practical value to the executive. To know the history is to understand a great deal about the kind of things the firm is likely to be able to do well and what it might best avoid trying to do or to be. Thus, history provides perspective. As Lord Acton wrote:

History must be our deliverer not only from the undue influence of other times, but from the undue influence of our own, from the tyranny of the environment and from the pressure of the air we breathe [1, p. 33].

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