NASHVILLE NOTES

Citigroup's Walking-Around Money

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By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

About 10 years ago, a community bank CEO told me that he was glad his board had agreed to move extra cash to his bank's holding company via an upstream dividend. He called it "walking-around money." The parent company needed the excess cash to make debt service payments because the bank later entered into a consent order with the Office of the Comptroller of the Currency (OCC) that restricted upstream dividends.

The CEO's comment illustrates a not-so-subtle issue about banks and parent companies that I think many bank equity investors — but not bank debt investors — overlook. A bank and its parent company are distinctly different legal entities, and most parent companies depend on upstream dividends from the subsidiary bank for cash to fund debt service, dividends and buybacks.

A consolidated balance sheet is just that: a balance sheet created by accountants that does not speak to the ability of a subsidiary to pay upstream dividends or the cash needs of the parent. It is why investors should regularly review a bank's and parent company's financial statements each on a stand-alone basis.

Citigroup Inc. is subject to the same legal framework as any bank and bank holding company, but Citigroup is an incredibly complex company with $2.406 trillion of assets as of June 30. The key subsidiary is Citibank NA, an OCC-regulated bank with $1.699 trillion of assets. Another notable subsidiary is Citigroup Global Markets Holdings Inc. (CGMH), which provides investment banking and brokerage services and reported total assets of $747.92 billion as of year-end 2023.

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While Citigroup management is pushing to improve mediocre profitability and Wall Street's valuation of the company, it also has had to grapple with intense regulatory oversight that creates an additional expense burden. CEO Jane Fraser, who succeeded Michael Corbett as CEO in 2021, inherited an October 2020 consent order between Citibank and the OCC that arose from internal control issues.

In July, Citibank consented to an amendment to the order apparently due to ongoing control issues, while a roughly $135.6 million accompanying fine was reportedly related to flawed loan files.

Article XVII of the amendment, entitled "prioritization of expenditure on remediation" seems geared to get management's and investors' attention. It requires Citibank to obtain a "no objection" written response from the OCC's examiner-in-charge to a "Resource Review Plan" detailing how the bank is spending enough money to comply with the consent order. Assuming no objection exists, the bank then must obtain a no-objection response to proposed dividends or other capital distributions.

In effect, the OCC has upped the pressure on Citibank, and indirectly on Federal Reserve-regulated Citigroup. The OCC did not and obviously would never provoke a liquidity crisis for the parent company because the order does not prevent the bank from paying dividends to cover Citigroup's debt service obligations, preferred stock dividends and other nondiscretionary obligations of the parent company. That said, the order is nebulous for common shareholders.

While the parent company has access to multiple liquidity sources, including the capital markets, upstream dividends from Citibank provide the majority of its cash flow. The parent company received dividends from its subsidiaries in 2021, 2022 and 2023 of $6.5 billion, $9.0 billion and $16.8 billion, respectively, almost all of which were attributable to Citibank. The upstream dividends ranged from 34% of the bank's net income in 2021 to 146% in 2023.

> ***In an amendment to a consent order, the OCC has upped the pressure on Citibank NA, and indirectly on Federal Reserve-regulated Citigroup Inc.***

CGMH paid less than $500 million of upstream dividends the past three years, as CGMH posted losses in 2022 and 2023 that presumably reflected the weak investment banking market and perhaps corporate decisions about how costs are allocated to various subsidiaries.

The OCC order will not starve the parent company of cash because permissible upstream dividends to fund interest expense and preferred dividends presumably will approach $8 billion in 2024, based upon more than $6 billion of parent interest expense and $1.2 billion of preferred dividends paid in 2023.

It is unclear to me when Citibank management will request to pay dividends to the parent company that would partially or fully fund common dividends that total

roughly $4 billion annually. There does not appear to be an immediate need to push the issue with the OCC because the parent company had about $3 billion in cash as of March 31. Sizable repurchases may be a bridge too far for the time being, however. Repurchases totaled about $2 billion in 2023, down from $3 billion in 2022 and more than $7 billion in 2021.

Fraser released a statement July 10 saying the company would spend whatever is necessary to comply with the order, and has the resources to meet the capital distribution plans, which include a 3-cent hike in the common dividend to 56 cents per share and a resumption of modest share repurchases this quarter. In the parlance of my community banker friend, Citigroup's parent company has sufficient walking-around money to get by.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.