NASHVILLE NOTES

Tables turned on Citigroup and Wells Fargo

Tuesday, June 16, 2020 11:19 AM CT

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This year's DFAST and CCAR capital tests should be less academic than in past years given the slow-moving economic catastrophe that is unfolding due to the COVID-19 shutdown of the economy. At stake this year, I think, are common dividends.

Also, there is an interesting subplot to the tests that relates to Citigroup Inc. and Wells Fargo & Co. Citigroup does not hold the nearly unblemished reputation that Wells Fargo held in the prior financial crisis; however, its position today — at least outwardly — is better than Wells Fargo's, which may be ordered to reduce its dividend assuming its capital plan did not incorporate a cut.

In the fall of 2008 when the financial system was coming apart, Wells Fargo was a stalwart having stuck to its main street commercial banking model that never saw it stray too far into subprime lending or the securities business. On Oct. 3, 2008, Wells Fargo announced a deal to acquire Wachovia Corp. for $15 billion after Wachovia had agreed to sell its banking operations to a deposit and capital challenged Citigroup the prior week.

Less than two weeks later the leaders of the nine largest commercial and investment banks, including Wells Fargo and Citigroup, met with Hank Paulson and Ben Bernanke at a conference room at the Treasury Department. Treasury Secretary Paulson handed a one-page term sheet to the executives that described the terms of the investment that Treasury would make in the banks to restore confidence in the system.

One can imagine that Citigroup CEO Vikram Pandit was relieved. The sale of TARP preferred stock to the U.S. Treasury explicitly signaled government support for Citigroup, which in turn would restore investor confidence in Citigroup's funding efforts for its massive balance sheet that was riddled with lousy assets.

Wells Fargo Chairman Richard Kovacevich was livid, arguing that his company did not need capital. Some accounts have Kovacevich being escorted out of the room to cool down. Of course, none of the bankers could turn Paulson and Bernanke down.

Over a decade later, Citigroup largely has been rehabilitated, albeit with some suspicions that a shoe could still drop given the company's propensity to find itself in a hole whenever a deep economic downturn occurs.

In a small way, an April 3 story Bloomberg ran illustrates how Citigroup's fortunes have changed for the better. The article described how Citigroup reaped a $100 million windfall from an AAA-rated collateralized loan obligation trade by buying the bonds from Prudential Financial Inc. for about 90 cents on the dollar in March and then later selling close to par.

There is a lot of irony here because in 2008 Citigroup was the one scrambling to sell bad and good assets to shrink its balance sheet to deal with funding and capital issues. I am making a generalization, but many assets dumped in 2008 at fire sale prices saw a recovery in 2009 once the panic subsided and investors could focus on fundamentals in an eventual recovery.

Wells Fargo's situation today is not remotely close to Citigroup's in 2008. Nonetheless, the operating environment is getting tougher given the recent revised guidance that calls for an 11% reduction in net interest income this year due to the collapse in rates and the regulatory asset cap.

If I were a Wells Fargo board member, I would have pushed management to submit a capital plan that includes a cut in the common dividend. Investors expect that given a yield that is over 7%.

Wells Fargo's dividend decision is a larger issue for the industry and the Fed.

My opinion will not be popular with the buy-side and perhaps the banks, but I think prudence dictates that the large banks subject to DFAST and CCAR reduce (versus omit) their common dividends now. Many regionals should consider a cut a quarter or two later, too.

As noted in one of my earlier posts this year, internally generated capital is the cheapest capital to raise. The cost of TARP capital was far greater than the 5% coupon with detachable warrants than anyone in the room with Paulson and Bernanke could have imagined in October 2008.

Why cut now? Because banks would be doing so from a position of strength with capital at or near all-time highs. But that could quickly change unless open-ended deferrals preclude loss recognition.

It is inconceivable to me that asset quality will not be waylaid by the shutdown. Deferrals for borrowers and government programs to inject liquidity into the economy mask the damage. Solvency for many businesses will be an issue in 2021 and 2022. Plus, Wells Fargo's guidance for a reduction in net interest income will not be unique. Pretax, pre-provision net revenues are poised to decline sharply for most traditional banks this year.

If the economic rebound is sufficiently strong banks can petition the Fed next year to increase dividends. If not, then capital retained between now and the 2021 DFAST and CCAR tests is less capital that might have to be raised in the future and lessens the likelihood the government would have to invest later in a downside scenario. The risk, like a temporary economic shutdown to flatten the curve to protect the healthcare system, is that a one-year cut becomes an open-ended reduction.

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