Morgan Stanley 2017 Financials Conference
Tuesday, June 13, 2017

Host
Betsy Graseck, Morgan Stanley Analyst

Speakers
John Gerspach, Citi Chief Financial Officer

QUESTION AND ANSWER

BETSY GRASECK: We're very pleased to have with us John Gerspach. Thanks very much. CFO of Citi as you all know. Appointed CFO in 2009. Been with Citi since 1990?

JOHN GERSPACH: 1990. Yeah.

BETSY GRASECK: Yeah. Good. Good for you. That's awesome. We're going to use the fireside chat format, but I have to rev the audience up with a few questions to get them in the mindset of Citi. All right. Other than capital return, there's a big other than, right?

JOHN GERSPACH: Yeah.

BETSY GRASECK: Other than capital return, what do you think will be the biggest driver for Citigroup shares over the next two years? You can use your polling devices. A, expense management; B, Consumer revenue inflection; C, institutional corporate revenue growth; D, emerging markets growth; or, E, higher rates. So pick your choice here. What will drive Citi shares the most over the next two years outside of capital return? All right. Pretty interesting answers. Higher rates, number one.

JOHN GERSPACH: Wow.

BETSY GRASECK: But expense management right behind. We'll probably talk a little bit about them.

JOHN GERSPACH: Yeah. I'm actually surprised that there isn't more support for Consumer revenue inflection. I would've thought that we would've gotten some on that.

BETSY GRASECK: All right. So let's see if we can convince some people in this session. How about next question?

JOHN GERSPACH: Okay. I'm very happy. I mean, the other ones are fine. Rates, I got nothing to do with, so that's great.

BETSY GRASECK: Well we'll talk about them. How high do you think Citi's payout ratios can go after the 2018 CCAR? This is, A, less than 100%; B, 100% to 109%; C, 110% to 119%; D, 120% to 139%; or E, 140%-plus.

JOHN GERSPACH: So that's next year's CCAR?

BETSY GRASECK: After the 2018 CCAR. This is a long-term question. We got long-term investors so we really want to know what their opinions are.

JOHN GERSPACH: Yeah. That's good. I'm happy to do that.

BETSY GRASECK: How high can it go? All right. 100% to 120%. With that, let's first talk about something a little nearer-term to kick off the...

JOHN GERSPACH: That was it for the polling? Okay.

BETSY GRASECK: That's it for the polling. Two questions.

JOHN GERSPACH: Now you're polling me.

BETSY GRASECK: Two and through. That's right. Okay. Trading revenues. Volatility is still low, volumes are down, headwinds to what looks like Equities and FICC, but maybe you can give us a sense as to what you're seeing at Citi since we're only two weeks left.

JOHN GERSPACH: Yeah. I think as you pointed out and others have pointed out, volatility has been very low this quarter which has certainly led to somewhat of a softer trading environment. Especially in, again, the Fixed Income and Equity Markets across both franchises, that is what we're seeing. And it's kind of in sharp contrast to what we saw last year. A lot of activity with the onset of Brexit and then just leading up to the U.S. primary elections. So given that, I guess I'll call it a slower trading environment, we would expect revenues in our Fixed Income and Equity Markets to be down year-over-year in the I guess I'd call it the low double-digit range, maybe 12% to 13%. And so that would mean that we were down 12% to 13% this year. Of course, that also means we'd be down sequentially and maybe just a little bit more than we otherwise would have anticipated given the environment.

I'd also say, though, at the top of the house for the overall firm, expenses should also be down sequentially, probably not enough to completely offset the seasonality in revenues, so you might see our efficiency ratio pop up to 59% this quarter. But, again, it should decline in the second half of the year and then we're still very, very comfortable with our target of 58% for the full year.

BETSY GRASECK: For the full year? Okay. So just one question on trading revenues.

JOHN GERSPACH: Yeah.

BETSY GRASECK: FICC versus Equity?

JOHN GERSPACH: Both are going to be down. Let's call it a blended rate of down 12% to 13%.

BETSY GRASECK: And that's actually a little bit better than some of the numbers we've heard from others.

JOHN GERSPACH: Well I think others have kind of put it in that range of 10% to 15%, so we're kind of in the middle there. If it comes in at 10%, that's great. If it comes in at 15%, that's not that far away from 12% to 13%. As you said, we still have a full two weeks to go in the quarter. Let's see.

BETSY GRASECK: What about some of the other targets that you have out there? Your RoTCE target that you've got? And you've got an interim RoTCE target of about 10%, I think, ex-DTA.

JOHN GERSPACH: For next year.

BETSY GRASECK: Right. And then including DTA for the year after. Could you talk through what some of those drivers are? And as you do that, some of the expense guidance you've just given us as well. Remind us of some for the second half of this year.

JOHN GERSPACH: Yeah. So let's start with the RoTCE. And if you take a look at where we are, in the last 12 months our RoTCE has come out to be about 7.8% on an ex-DTA basis excluding the capital that we've got tied up to support DTA. That brings you closer to 9.3%, so we're on track to get to that 10% number for next year. And importantly, going into 2019, we would think that we would be able to get 10% all-in capital including the capital supporting the DTA. So we feel good about that.

I think that from an RoTCE point of view, you need to look at two things. From a denominator point of view, obviously we've got $29 billion of our capital tied up supporting DTA. That's $29 billion of capital which we cannot put to work in the business and so on that capital we earn nothing. Also, when you look at where we are right now, we have an incredibly strong CET1 ratio at 12.8%. It's probably too strong. We believe that we should be able to run the firm at around an 11.5% CET1 ratio. When you think about the regulatory requirements, put on a bit of a management buffer to cover volatility and OCI, we should be very comfortable at an 11.5% range.

That gives us then a 130 basis points of extra capital or roughly $15 billion to $16 billion of capital that, again, we don't think that we need, and we should be able to return to the shareholders over time. That's probably what shareholders are thinking about or investors are thinking about when they were answering that second polling question and talking about a payout ratio of as high as 120% in the next cycle.

When you think about those two things together, that would mean that right now the 29 and, call it, 16, that's $45 billion of our TCE or 25% of our TCE of which we're earning nothing. So if you think about that 7.8% that we're currently earning, it's really on putting 75% of our TCE to work which means that the 7.8% is really tracking more like that 10% that is probably closer to our cost of capital. Not that we're satisfied with that 10%, but just from a denominator point of view that's the way the numbers play out.

We also have two businesses. We currently have the ICG operating at an RoTCE of about 13%. We do believe that that business should be able to earn a return of 14% plus, so they're getting closer to where we would put their targets at. And with the continued growth in the TTS business, some of the monetization that we should be able to get on the investments that we've made in Equities, we feel good about the path on ICG to get to that 14% target.

Consumer, little bit more of a stretch. Consumer's also operating at about 13% RoTCE right now. Our target for Consumer is to operate 20%-plus RoTCE. Obviously, in the past couple of years we've been investing in the Cards business. We've talked about an inflection point for that business in the second half of this year. As we begin to see some of those early investments mature, the investments that we made on our proprietary cards portfolio about midway through 2015. And then the acquisition of the Costco portfolio in June of last year, and we said it's going to be a great acquisition but it will not be accretive to earnings for at least a year. That means second half of 2017. So, again, we think that we'll be in a better position in the second half of this year to actually lay out a credible path for a consumer to go from the current 13% up to the target of 20% that we've established for that.

BETSY GRASECK: So just drilling in a little bit to the capital management piece of that question. I think you've mentioned in the past that your plan is returning $15 billion to $18 billion this year.

JOHN GERSPACH: I did not say that, but what I said is we believe we need to get into that range of $15 billion to $18 billion to be credible.

BETSY GRASECK: Okay. Credible for your plan?

JOHN GERSPACH: For the plan.

BETSY GRASECK: Right, okay. So, over time, $15 billion to $18 billion?

JOHN GERSPACH: Right now, if you take a look we're generating more than $15 billion of regulatory capital a year right now. In order for us then to be able to return that $15 billion, $16 billion of extra capital that we're carrying, you've got to get something north of $15 billion to even paint the path for investors. Hopefully, you'll see a proof point on that in a couple of weeks and we'll see where we end up.

BETSY GRASECK: Right. Because your goal of going from 10% RoTCE ex-DTA to 10% including DTA I would think comes with an expectation that you should be able to pay out more than 100% of earnings.

JOHN GERSPACH: I don't think that I'm going to surprise everybody saying yes because we absolutely have to in order to begin to address that 25% of the TCE on which we're earning nothing.

BETSY GRASECK: Right. And then the expense ratio discussion that we had briefly, 58%, but for the full year, right? That means you've got a nice pick-up in the second half of the year of operating efficiency?

JOHN GERSPACH: First quarter was a little under 58%. Second quarter, as I've said, might drift up to 59%. But then we do think that in the second half of the year the performance then should be adequate to get us into that 58% range for the full year.

BETSY GRASECK: And that's primarily a function of the Consumer side of the business with revenues in the Card space or maybe you could drill into certain drivers?

JOHN GERSPACH: Well it's obviously going to be both the numerator and the denominator of an efficiency ratio. We should be able to evidence good expense discipline. I think we have been. As I mentioned, even in the second quarter, our expenses will be down from the first quarter; it's just that they won't be down enough to completely offset the impact of the seasonality and the revenues. But we continue to see that trend build throughout the year then as expenses continue to decline. And then with the pick-up in the second half of the year in revenues, specifically in North America Consumer, don't forget we will still have growth even in this quarter in Asia and in Mexico, so really it becomes North America Consumer that becomes a bit of an inflection point.

BETSY GRASECK: Okay. One of the questions I get a lot on expense improvement opportunities for Citi has to do with risk, controls, compliance, regulatory, and I think you've been very clear about the fact that your compliance staff has almost doubled pre-crisis to now.

JOHN GERSPACH: Yes.

BETSY GRASECK: How do you think about that? Do you feel like there's opportunities to continue to run the business with a lighter head count touch as you automate or is that really not part of the picture?

JOHN GERSPACH: No, that really is the lion's share of it. When you first get faced with a series of new regulations, what you do in order to make sure that you can come in to compliance with those regulations in the timeframe that you're given, you tend to throw bodies at it. And you're not thinking necessarily in terms of efficiency, you're thinking in terms of I've got to meet the standard. And if that means hiring consultants, putting on temporary staff, adding people, that's what you do. Fortunately, the onslaught of new regulations has been lessened, so we've got a chance now to look at how we have structured every one of our departments, whether it's finance, whether it's risk, whether it's compliance, whether it's internal audit, and say no, wait a minute, is this the most efficient way of actually meeting all of the regulatory expectations? And so when you have a chance to sit back, you have the chance not just to automate but to actually just standardize processes, standardize the platforms on which you're currently conducting these staff functions. And so you've got multiple levers on which to address expense reductions.

BETSY GRASECK: And that will play out over...?

JOHN GERSPACH: Yeah. We're not going to be able to get that all done in six months, but I think that that should be a nice continuing expense improvement story that will play out over the, I'll call it, medium-term.

BETSY GRASECK: Okay. What about the LCR? Just talking about a different form of regulatory rules that you're well in excess of meeting. Just wanted to understand is there an opportunity here to optimize and could you talk about how you think the LCR will traject as the Fed shrinks their balance sheet?

JOHN GERSPACH: Yeah. I don't think the Fed shrinking the balance sheet is really going to impact our LCR. When we look at the constraining factors on LCR right now, it's really more driven by resolution requirements as we need to pre-position liquidity throughout the firm in order to make sure that we've got a very good resolution plan. And so do we have opportunities to improve on that in the future? I'd say yes. I'm not going to give you a target or a date by which we're going to hit that target, but it's the same as what I described when any time you're trying to meet regulations; you tend to overcompensate in the beginning and then you get to have a chance to go back and figure out more efficient ways of meeting the requirements.

BETSY GRASECK: So it looks like you're not as invested in the agency piece of the opportunity set as maybe you could be?

JOHN GERSPACH: When you say the agency piece...

BETSY GRASECK: The rule is agency holdings have to be capped at about 40%, I think, it is of total HBLA, and it looks like you're a little low there.

JOHN GERSPACH: We are, we are. But, again, for us right now it's really more about resolution and less about just thinking about what we require in the U.S. We've got to think about every one of our MLEs.

BETSY GRASECK: Yeah. I got it, okay. Just talk a little bit about the long end of the curve. There's been a pullback here recently. Is that something that we're going to see in the quarter on NIM or revenues?

JOHN GERSPACH: We're not really exposed much to the long end of the curve. When you take a look at our exposure to interest rates, we've put out the disclosure that a 100-basis point rise in interest rates should impact us by about $2.2 billion. $1.6 billion of that really comes from exposure to U.S. rates. And with the U.S. rates, 90% of that exposure is on the short end of the curve, so I really think Fed fund is for us.

BETSY GRASECK: So later this week, we might get another hike?

JOHN GERSPACH: With any luck, with any luck.

BETSY GRASECK: Good for you.

JOHN GERSPACH: Good for us, very good for us. I think good for the industry. I think it actually is good for the overall economy because it says that somehow we're returning perhaps to a bit more of a normal environment.

BETSY GRASECK: Okay. I'll pause and see if there's any questions in the room. And if you do have a question, just raise your hand and we'll call on you. A couple of other questions here. On Card, one of the major tenets of, obviously, the organization growth driver that we're looking for especially in the back half of this year and into 2018. Could you just tell us how you are managing the tension there around new products and the need to be competitive? We've got reward offerings that are obviously a little bit more expensive than they have been in the past versus the rate side of the equation with cards.

JOHN GERSPACH: So when you think about Cards, I think one of the keywords becomes balance. And so when we look at our U.S. Branded Cards business, in order for us to optimize our performance we've put out a ROA target of 225 basis points. Now, that assumes a certain balance between Co-Brand Cards. We did the Costco acquisition, we re-upped our relationship with American Airlines last year. It gives us two powerful co-brand partners. However, there's a reason for the "co" in co-brand and so, therefore, there's a sharing of economics that goes along with that. So you can't have your entire business really focused around co-brand relationships; you need to have a vibrant proprietary offering.

We began to develop that about three years ago – Double Cash, Rewards Cards in a couple of different flavors, Simplicity – and then began to really put some marketing dollars behind those offerings midway through 2015. That's the way that we are trying to achieve that balance. We've seen some other competitors go into the market very recently with some very high rewards offerings; we did not react to that. We like where we are right now. It doesn't mean that we won't at some point in time re-engage, but there's really no need for us to re-engage right now. We like where we are, we like the customer segmentation that we've done, and we feel that we've got the right value proposition to meet client needs across the entire spectrum.

BETSY GRASECK: When you say some others have been going places you're not interested in going, is that a reflection of what happened with Hilton, for example?

JOHN GERSPACH: No, Hilton was another thing. I mentioned the fact that we want a nice balance between co-brand and proprietary products. Though when we began to look at the economics that it was going to take in order to secure that Hilton portfolio, the economics just didn't make sense to us and so we opted not to compete past a certain level.

BETSY GRASECK: Okay. And what about just on the FICO credit quality? Can you give us an update there because it does look like the industry's mix shifted a bit lower in the FICO bands. What about Citigroup?

JOHN GERSPACH: We've actually stayed fairly high in those FICO bands. When you take a look at our U.S. branded cards portfolio right now, something around 88% of our portfolio have FICO scores in excess of 660 and it's like 70-plus percent have got scores above 720. So it's a very creditworthy portfolio.

BETSY GRASECK: And what about on the retail partner card side?

JOHN GERSPACH: Similar. Not quite as heavily-weighted towards those higher FICOs but, again, we've given disclosure in the 10-Q on those portfolios and you'll also find them more than weighted towards that plus 660.

BETSY GRASECK: And is that an area you're interested in reinvesting or just supporting what you have?

JOHN GERSPACH: No. If the right portfolio comes on the market, we're open for business.

BETSY GRASECK: And are there things you can do to help your retailers that you're partnering with right now today?

JOHN GERSPACH: Well one of the things that we – again, I mentioned the "co" in co-brand has a reason – we call that business retail partners because we do partner with the retailers, and so it's very much it isn't just a fact that we run the card for them; we help them with promotions, we help them with financing tools, so it is very much a partnership where we're both looking to grow not just the through-put on the cards but the revenues for the retailer as well. It's one of the reasons why we were a great partner with Best Buy a couple of years ago when Best Buy sought a different owner for their card business. Our approach is very much one of working with the retailer to really help them with their overall sales effort.

BETSY GRASECK: And so when we hear that, sometimes people will jump to the conclusion of, okay, that must be going deeper into the credit side of the perspective. But what else is in there?

JOHN GERSPACH: Yeah. Again, if you take a look at those FICO scores, that would argue against it. Over 60% of the scores are above 660 and we still maintain a good ROA in that business. I mentioned a 225-basis point target for Branded Cards; the target that we've put out for our retail partners is 250 basis points.

BETSY GRASECK: And what happens when a retailer gets into some trouble? What are you – like, restructuring or something like that? What would you do in those situations?

JOHN GERSPACH: What will happen then is, again, you would tend to work with the retailers; it depends on whether or not they emerge from the bankruptcy or not. Many of our cards have use outside of the store, so they're not just cards that can only be use within the store. They've got utility outside the store, so depending upon how the retailer is resolved through bankruptcy we either have a chance to convert that card to just an outside the store card either through one of the other networks or else we can work with the retailer as part of their restructuring plan. So we've got a couple of different options that we can put to work.

BETSY GRASECK: Okay. Let's turn to institutional. SLR ratio is best-in-class, right? Highest in class. 7.3%, I think?

JOHN GERSPACH: 7.4%.

BETSY GRASECK: 7.4%. How do you utilize that in the business? What opportunity sets do you have that you're going after?

JOHN GERSPACH: Well, again, it helps us to continue to compete in the rates business certainly. The rates business is one that is a little bit more balance sheet-intensive. I've mentioned earlier about monetizing some of the investments that we've made in Equities. Equities would be another business where we have the opportunity now to put some balance sheet especially through Prime Brokerage. So as we begin to deepen those relationships with investor clients, having that freedom under the SLR means that we can put some of the balance sheet to work there.

BETSY GRASECK: And what if they take cash and treasuries out of the denominator of the SLR?

JOHN GERSPACH: That'll be interesting. The guys are running some numbers for me but I didn't get a chance to get the numbers though, so exactly what that would do to our ratios. Like with so many of these things that you saw come out yesterday, the devil a little bit will be in the details so we'll have to see what we get out of it, but it should be beneficial. It doesn't mean that it would be beneficial just for us; it'll be beneficial for everybody. But I still think that we'll come out of it okay.

BETSY GRASECK: There is a push amongst a bunch of guys including Giancarlo of the CFTC and Jeb Hensarling for more market liquidity. Do you think that more supply would help or do you feel like that the demand is there to...?

JOHN GERSPACH: No. Look, I still think that some liquidity has drained out of the market. The couple of times where we've seen – you go back to the Taper Tantrum, you go back to the Fat Finger – whatever you want to go back to you've had more extreme reactions in indices coming from those events just because with all the regulation that has been put on. And, again, a lot of it is well-intentioned; it's just that we still haven't done a really good test of what all of these regulations together mean.

In the very brief read-through that I gave to yesterday's 150-page, you know, it looked like they were trying to rationalize some of those things. I saw references to LCR. I saw references to let's not go forward with the NSFR until we actually have thought through what it means. God, what a concept, don't put in a regulation until somebody actually understands it as opposed to, no, first we've got to implement it then we'll figure out exactly what it does. So there's a lot of common sense there. Again, we'll see.

BETSY GRASECK: Tough timing coming out right before the Warriors game.

JOHN GERSPACH: Yeah. I have to admit but LeBron, Treasury Report. LeBron, Treasury Report. I got to tell you, LeBron won. Although he did lose the game, but...

BETSY GRASECK: Yeah, yeah, yeah. And that's the first of six Treasury Reports. Apparently, there's going to be five more.

JOHN GERSPACH: Yeah, I can't wait. It's going to be really compelling summer reading.

BETSY GRASECK: It's exciting. Right, I know. You needed something for the beach time, right? Last question from me is on just the TTS business. You've seen really strong growth there. Part of the question is how much of that is what's going on in the rates environment? How much of that is going on with increased functionality that you're offering? And then I wanted to just ask a question about could Blockchain upset that whole applecart.

JOHN GERSPACH: Yeah. So the TTS business, I think that's less of a function of rates and it's more a function, really, of our deepening our relationship with our client base. You've seen our TTS business grow revenues on a compound growth rate of 6% or 7% over each of the last two years, and that just doesn't come about because there's suddenly some rate movement. No one has the capabilities that we do to really link our clients with the clearing systems and process payments across 95-plus countries around the world. And so it really is a client-focused business.

BETSY GRASECK: Should we see revenue growth accelerate then with rates rising?

JOHN GERSPACH: It could, it could. Again, that would be a nice add-on to that business, but I also don't want to say that we're always going to be able to grow the underlying business at 6% to 7%. Naveed Sultan, the Head of our business, would kill me if I committed him to 7% plus an add-on for rates, so I don't want to make too big of a commitment for Naveed. And then your other one was?

BETSY GRASECK: Well the question is on Blockchain and what that could be as a disruptor potentially.

JOHN GERSPACH: Absolutely. Blockchain is something – again, it's a technology that we are very much involved with. We've got at least three different experiments going on in our Dublin lab with Blockchain. The question has always been how do you commercialize Blockchain? Is it something only to be used for crypto currencies or digital currencies? And the answer is we don't think so. It's one of the reasons why we just announced a partnership with NASDAQ in the last week or the week before to actually utilize their Blockchain ledger connected to our pipes so we can actually move real money through their Blockchain ledger and help them with some private equity capital.

BETSY GRASECK: Okay. And that's something that you would be looking to leverage throughout your system, you think?

JOHN GERSPACH: Yeah, without a doubt. I mean, we understand about fintech, we understand about disruptors, we're not dismissive of it at all. We try to engage with the fintech community, we've got an operation out in California. We've invested in 50 different startups, we've got commercialization deals with 35 to 40 of them. So we're very much part of fintech.

BETSY GRASECK: All right. Well thanks. Thanks very much, John, for joining us.

JOHN GERSPACH: No, thank you very much Betsy. That was quick.

BETSY GRASECK: Looking forward to a couple of fun weeks in the upcoming month here.

JOHN GERSPACH: Can't wait for CCAR.

BETSY GRASECK: All right. Thank you.

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