Citigroup Inc.’s capital plan was among five that failed Federal Reserve stress tests, while Bank of America Corp. (BAC) won approval for its first dividend increase since the financial crisis.

Lenders announced more than $60 billion of dividends and stock buybacks after the Fed approved capital plans for 25 of the 30 banks in its annual exam. Citigroup, as well as U.S. units of Royal Bank of Scotland Group Plc, HSBC Holdings Plc and Banco Santander SA, failed because of concerns about the quality of their processes, the central bank said yesterday in a statement. Zions Bancorporation failed after its capital fell below Fed minimums in a simulation of a severe economic slump.

The results show lenders may still face obstacles to boosting dividends and buybacks even as regulators say the firms have doubled their capital since the first public stress test in 2009. The Fed is increasing scrutiny of the industry’s controls and planning processes as concerns about capital levels wane.

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“Things are improving and the banking industry has turned a corner; it just might not be as far along as the market would like,” said Joseph Vitale, a partner at law firm Schulte Roth & Zabel LLP who represents financial firms. “You’ve still got some time to go before the regulators see things as business-as-usual again.”

Higher payouts may help bank stocks continue their recent rally. The KBW Bank Index (BXX) of 24 lenders advanced 4 percent this year through yesterday, compared with the 0.2 percent gain for the Standard & Poor’s 500 (SPX), and the KBW benchmark beat the broader measure in three of the past four years.

Bigger Payout

Banks in this year’s test collectively received approval to pay out about 60 percent of their estimated net income during the next four quarters, according to a Fed official. That ratio is closer to the 69 percent that lenders were returning to shareholders in 2005 before the crisis, according to data from
Citigroup (C) was denied in its attempt to quintuple its quarterly dividend to 5 cents and put in place a $6.4 billion buyback. Bank of America and Goldman Sachs Group Inc. each had to cut their planned capital return to gain approval.

Citigroup, which last year asked for the least capital return among the five largest U.S. banks, would have passed this year’s test on quantitative grounds alone. It had a 6.5 percent Tier 1 common ratio, above the Fed’s 5 percent minimum.

**Multiple Defects**

The central bank found defects in Citigroup’s planning practices that included areas the Fed flagged before. The regulator expressed concern with the New York-based company’s ability to project losses in “material parts of its global operations” and to reflect all business exposures in its internal stress test.

“Taken in isolation, each of the deficiencies would not have been deemed critical enough to warrant an objection, but when viewed together, they raise sufficient concerns regarding the overall reliability of Citigroup’s capital planning process,” the Fed said of the third-largest U.S. bank.

Michael Corbat, the bank’s chief executive officer, said in a statement that Citigroup is “deeply disappointed” by the rejection and will “work closely with the Fed to better understand their concerns so that we can bring our capital planning process in line with their expectations.” The timing of any resubmission hasn’t been decided, he said.

**Mexico Fraud**

The Fed made no mention of the bank’s discovery of a $400 million loan fraud last month at its Mexico unit, which had stirred speculation that regulators might fault Citigroup’s controls. Corbat has vowed that the people involved will be held accountable.

Citigroup shares fell the most in more than a year, sliding 5.7 percent to $47.28 at 12:22 p.m. in New York. Analysts from Stifel Financial Corp.’s KBW unit and Sanford C. Bernstein & Co. downgraded the stock today, while Mike Mayo at CLSA Ltd. said the company should increase its pace of restructuring.

“The Federal Reserve’s surprise qualitative rejection of Citigroup’s capital plan raises questions about the company’s relationship with its regulators and the necessary next steps and timing to restore confidence,” Bernstein’s John McDonald wrote in a note cutting his rating to market perform.

**Rejected Again**

It’s the second time the Fed has failed one of Citigroup’s capital plans. The last rejection came in 2012, when Vikram Pandit was the CEO, and the defeat played a role in Pandit’s ouster later that
year, a person with knowledge of the board’s discussions said at the time.

“It came as a surprise,” said Michael Scanlon, managing director at Manulife Asset Management in Boston, who helps oversee $3 billion, including shares of Citigroup. “It can be a significant ding to confidence when these companies have failed in the past. Sometimes it’s short-lived and they resolve the issues, resubmit and move forward, and ultimately that is what Citigroup is going to have to do.”

Two of the main gauges in the Fed’s test were the Tier 1 common ratio and the leverage ratio. The first measures a bank’s core equity, made up of common shares and retained earnings, divided by its total assets adjusted for risk using global banking guidelines. The leverage ratio makes no distinction among risks and is considered a stricter standard by some regulators.

Second Chance

Bank of America and Goldman Sachs each saw their Tier 1 leverage ratios drop to 3.9 percent in their original capital plans, below the required 4 percent. Both firms lowered their requests and were approved, meaning they don’t have to resubmit.

The two firms asked for too much in buybacks and dividends after their own internal stress tests showed better performance than in the central bank’s exam. New York-based Goldman Sachs predicted its Tier 1 common ratio would be about 3.8 percentage points stronger than the Fed estimated in a worst-case scenario. The gap for Bank of America was 2.7 percentage points.

Bank of America, ranked second by assets, raised its quarterly payout to 5 cents from 1 cent after the Fed’s decision and authorized a $4 billion stock buyback. The increase is a victory for CEO Brian T. Moynihan, who has pressed to raise the payout from the token level that prevailed since the financial crisis.

The Fed blocked plans in 2011 for an increase by the Charlotte, North Carolina-based company, which didn’t ask for anything the following year and won permission for a $5 billion stock buyback last year.

Loss Tally

Goldman Sachs said yesterday that its capital plan “provides flexibility,” without saying what it seeks to pay out to shareholders.

Projected losses for the 30 banks under a scenario of deep recession would total $366 billion over nine quarters, the Fed said last week. The aggregate Tier 1 common capital ratio would fall from an actual 11.5 percent in the third quarter of 2013 to a minimum of 7.6 percent, before accounting for capital plans.

“The banking system is much better capitalized at this point in time compared to where it was in 2009,” Sameer Gokhale, an analyst at Janney Montgomery Scott LLC, said in a Bloomberg Television interview with Carol Massar. “The risk that you see large-scale bank failures has
diminished significantly."

**JPMorgan Chase & Co. (JPM)**, the biggest U.S. lender by assets, had its capital plan ratified as it maintained a Tier 1 common ratio of 5.5 percent, a half a percentage point above the minimum. Last year, approval for the New York-based bank came with an order to resubmit the plan to fix qualitative weaknesses. The quarterly dividend will rise to 40 cents a share from 38 cents, and the company authorized a $6.5 billion stock buyback, according to a bank statement.

**Wells Fargo**

The Tier 1 common ratio at **Wells Fargo & Co.**, the biggest U.S. home lender, was 6.1 percent and **Morgan Stanley (MS)**’s was 5.9 percent. Wells Fargo boosted its dividend 5 cents to 35 cents a quarter. Morgan Stanley doubled its quarterly payout to **10 cents** and announced a $1 billion buyback.

Zions, the Salt Lake City-based bank that had a 4.4 percent Tier 1 common ratio in the test, said before yesterday’s results were announced that it planned to resubmit its capital plan.

The Fed broke new ground on governance and transparency on this round of tests. For the first time, the board held a vote on the qualitative objections that resulted in a 4-0 approval, with Fed Governor Sarah Bloom Raskin abstaining. Raskin was confirmed by the **U.S. Senate** as deputy **Treasury secretary** on March 12.

### Detailed Objections

The board’s descriptions of its qualitative objections were also more detailed than before. In their remarks on Santander Holdings USA, for example, they cited “specific deficiencies” including governance, internal controls and risk management in capital planning.

The central bank also faulted HSBC North America Holdings Inc. and RBS Citizens Financial Group Inc. for estimates of revenue and losses in the test. The rejection means the lenders won’t be able to increase dividends to their European parent companies, freezing them at current levels, according to a Fed official.

The dividend raises will boost yields closer to the norms that prevailed before the financial crisis, when the stocks were favored by income-oriented investors. The average yield for the 24 companies in the KBW Bank Index stood at 4.9 percent at the end of 2007. It’s now under 2 percent.

### Higher Yields

The $60 billion of payouts includes dividends that were already being paid in addition to increases and new repurchase plans.

JPMorgan’s increase boosted its yield to about 2.7 percent annually based on yesterday’s close. Its payout ratio -- dividends plus buybacks -- equals about 56 percent of earnings over the next four quarters, according to figures from the banks and KBW estimates. That’s up from 48 percent in the
last four quarters, said KBW, which made its estimates before stress-test results were announced.

Bank of America’s payout ratio climbed to about 39 percent from 34 percent, bringing the dividend yield to 1.2 percent. U.S. Bancorp’s payout jumped to about 70 percent from 59 percent, and the yield would be 2.3 percent.

SunTrust Banks Inc. doubled its dividend yield to 2 percent, according to data compiled by Bloomberg. Discover Financial Services boosted its yield to 1.7 percent from 1.4 percent and American Express Co.’s climbed to 1.2 percent from 1 percent.

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