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Devil Is in Bailout's Details

Government's $250 Billion Cash Injection Sparks Welter of Issues

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WASHINGTON -- Upending the government's relationship with the financial sector, the Bush administration outlined a plan Tuesday to prop up banks by injecting $250 billion into U.S. financial institutions, including nine of the nation's largest banks, and to guarantee new debt issues and deposit accounts used by businesses.

The sweeping steps create a thicket of issues, most pressingly whether the banks will step up lending. The government is making clear it expects banks to lend out the funds it gets from Uncle Sam. Further exercising its clout, Treasury also extracted a promise that the financial firms would help struggling homeowners, continue lending and would sign up for loan guarantees offered by the Federal Deposit Insurance Corp.

"What we're doing is making clear to the banks how important it is to deploy the capital," Treasury Secretary Henry Paulson said in an interview.

Analysts, investors and some bankers applauded the government rescue. They said it would help rebuild confidence in the industry and could set the stage for a wave of consolidation in which stronger companies take over their weaker rivals.

Officials with some of the giant banks, whose CEOs were briefed Monday on the government's plan, said they don't expect that the government's new role as a major shareholder will subject them to additional regulatory restrictions. They noted that top banks already face rigorous government scrutiny, with bank regulators permanently stationed at their headquarters.

Bankers and industry experts said that aside from a handful of token restrictions, the capital injections more closely resemble a blank check. "I don't think their intent is to micromanage," said Richard J. Herring, co-director of the Financial Institutions Center at University of Pennsylvania's Wharton School. "I don't think they have the manpower or the skill to do that."

Bank of America Corp. Chairman and Chief Executive Officer Kenneth Lewis was supportive of the new plan, while acknowledging that some conditions for the government help were not ideal. "Our interest is in anything that helps the system operate more normally at this point," said Bank of America spokesman

Robert Stickler. As for the possibility of government interference, "Who knows?" he said. "We are in unchartered territory."

Edward J. Wehmer, chief executive of Wintrust Financial Corp., a bank-holding company in Lake Forest, Ill., said the government financing is likely to attract smaller banks that haven't been able to raise new capital at reasonable prices. "The market was becoming very predatory with the private-equity guys," Mr. Wehmer said. "You basically had to sell your soul."

The Treasury Department said it intended to remain a passive investor in the financial institutions that get government cash. But its tentacles will influence aspects of how banks do business, by placing restrictions on dividend payments, executive compensation and the types of private investments that banks can receive.

In somber remarks in the Treasury Department's ornate Cash Room, Mr. Paulson said the government's latest moves were necessary given the deep financial crisis.

While he had been reluctant to take such steps, his actions Tuesday, coupled with the administration's moves over the past six months, have injected the government more deeply into the financial sector than at any time since the 1930s. Mr. Paulson and other regulators said the steps were temporary.

But, historically, it's often hard to undo new rules in Washington after businesses, consumers and policy makers adjust to changes.

Mr. Paulson said the government was not seeking an active role in the companies where it invests. "We're not looking to come in and take meaningful ownership percentages," he said. "We're looking to put in place a very good private-sector money manager to manage these equities to be sold."

At the core of Tuesday's announcement is a plan to buy $250 billion worth of preferred stock in banks, a step the government sees as crucial to getting banks to make new loans and to lure private capital from the sidelines.

While the program is voluntary, Treasury essentially forced nine major U.S. banks to agree to take $125 billion from the federal government. Treasury will buy $25 billion in preferred stock from Bank of America -- including soon-to-be acquired Merrill Lynch -- as well as from J.P. Morgan Chase & Co. and Citigroup Inc.; $25 billion from Wells Fargo & Co.; $10 billion from Goldman Sachs Group Inc. and Morgan Stanley; $3 billion from Bank of New York Mellon; and about $2 billion from State Street. The remainder will be available to small and medium-size institutions that apply for an investment.

The money will come from the $700 billion that Congress recently approved for Treasury to buy bad loans and other troubled assets from financial institutions. Treasury still intends to proceed with that program within the next few weeks.

The government's preferred stock will pay a 5% dividend for the first five years and then convert to 9%. Firms will not be able to increase their dividends for three years while the Treasury is an investor and cannot get rid of the investment for three years unless they raise high-quality private capital. Firms must also get Treasury's consent to buy back their own stock.

Treasury also has the right to buy common stock equal to 15% of its total investment in the firm. Treasury can convert these so-called warrants to buy stock, which would give it a bigger stake in the company and dilute existing shareholders. It can also sell the warrants, which could make Treasury money if the stock price goes up.

The decision whether to convert the shares into common stock or sell the warrants will be made by the Treasury secretary. It is expected to be based on the health of the financial institution and what's in the best interest of taxpayers, according to people familiar with the matter.

Banks will also face restrictions on what they can pay senior executives as long as Treasury is an investor. Companies can't structure compensation programs that "encourage unnecessary and excessive risks" and must prohibit so-called golden-parachute payments to senior executives. Firms also are limited to $500,000 in executive-compensation tax deductions for each senior executive. They will also be restricted in the type of stock they can issue to private investors -- no investment will be allowed to be senior to Treasury's preferred stake.

The plan includes a move by the FDIC to temporarily offer banks unlimited deposit insurance for non-interest-bearing bank accounts, which are typically used by small businesses. A spate of bank failures and the market turmoil have raised anxiety levels for many account holders who could cause greater concerns for banks if they start to pull accounts from otherwise healthy institutions.

The FDIC also will guarantee, for three years and for a fee, the new senior unsecured debt issued by a wide range of banks, thrifts and financial holding companies through June 30.

The FDIC's guarantees should ease anxiety about institutions' creditworthiness, analysts said. The agency's backing of deposits above the current $250,000 limit in non-interest-bearing checking accounts is intended to stem the tide of business owners yanking their money out of troubled financial institutions.

The Federal Reserve said Tuesday it would open a program on Oct. 27 to fund purchases of commercial paper -- a form of short-term corporate borrowing -- with three-month maturities. The commercial-paper market has come under intense pressure in recent weeks, constraining businesses and consumers from receiving credit.

The extent of government involvement in the banking sector now exceeds the role played by the U.S. during the savings-and-loan crisis in the late 1980s. Some in the banking industry say they are unsure what the new relationship will bring.

"Will the government be looking over my shoulder and second-guessing my lending policies and compensation policies?" said American Bankers Association President Edward Yingling. Most banks are well capitalized, he said, and do not need new cash infusions.

Wells Fargo Chairman Richard Kovacevich was among the bankers present during Monday's meeting at the Treasury who expressed reservations, according to a person briefed on the meeting, because his bank wasn't in need of government funding.

The San Francisco-based company released a statement saying: "In general we believe the Treasury's plan is a positive step toward providing much needed capital for financial institutions that are in the best position to deploy it effectively to stimulate the U.S. economy and strengthen confidence in the U.S. banking system."

Ron Hermance, president of Paramus, N.J.-based Hudson City Bancorp Inc, said he stayed away from subprime mortgages during the housing boom and stuck to "dull and boring" lending that now supported the $51 billion bank. He said he worried the U.S. is propping up banks that would fail on their own, or may fail even with a new infusion of public money.

With many banks crippled by billions of dollars in losses on exotic loans and securities, and no longer able to sell their troubled assets, institutions have gone back to basics. They are now concentrating on making loans that are of high enough quality that they can reside on the banks' books for years.

Some experts predicted that having the government as a major shareholder would spur banks to stop engaging in some risky behavior.

Comptroller of the Currency John Dugan, one of the nation's top bank regulators, said the moves were necessary "because we did a number of very substantial, 'one-off' things, and they weren't having a lasting effect."

A key question is which midsize banks will be able to obtain the government funds. Treasury officials said Tuesday that the program is intended for "healthy" banks, but they didn't clearly define what that means.

The government's capital infusions could provide some struggling lenders with a bit of breathing room. In recent months, lenders like BankUnited Financial Corp. and Downey Financial Corp. have tried in vain to line up new capital, despite heavy pressure from regulators.

Dozens of regional banks have mountains of bad loans that are likely to keep growing at least until 2010, say bankers, analysts and investors. In a report Tuesday, analysts at Sanford C. Bernstein & Co. forecast that, in terms of loan losses, "2009 will rank as the weakest year since the Great Depression."

During the Depression, the Reconstruction Finance Corp. bought billions of dollars of preferred stock that came with voting rights. The government then barred banks from paying dividends until they had bought out the government's stakes. This time, the government stakes are nonvoting and the dividend restrictions are less onerous.

"It looks like a pretty good deal for the recipients and probably a pretty tough deal for taxpayers," said John Kanas, who was CEO of North Fork Bancorp until selling it to Capital One Financial Corp. in 2006. "It seems quite explicit that there's no strings attached to this money...It seems like a gift."

Mr. Kanas said banks are likely to use the government capital to retire outstanding debt that pays a higher yield than the 5% on the government's preferred shares. That will reduce funding costs, boosting profits. Such moves will pad bank profits without supporting the overall economy, he said.

Already some politicians, including both presidential nominees, are suggesting the government's investment should merit additional requirements.

"We will not merely inject billions of dollars into companies and walk away hoping for the best. We will require that those companies be reformed and restructured until they are sound assets again, and can be sold at no loss -- or perhaps even a profit -- to the taxpayers of America," said Republican presidential nominee Sen. John McCain.

Democratic nominee Sen. Barack Obama said, "We must make sure this plan is implemented in a way that helps homeowners and does not enrich Wall Street CEOs at the taxpayers' expense."

—Daniel Fitzpatrick contributed to this article.

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