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Election 2008

Paulson Buys Up The Banks

Posted by: Jane Sasseen on October 13

by Jane Sasseen and Theo Francis

U.S. Treasury Secretary Henry Paulson appeared close to completing a deal on the next stage of the massive package to rescue the financial sector and get the frozen credit markets working again. Paulson called in the heads of six major banks to discuss the plans on the afternoon of Monday, Oct. 13. Soon thereafter, the Wall Street Journal reported that regulators plan to devote $250 billion of the $700 billion recently approved by Congress to buy direct equity stakes in financial institutions in return for preferred shares.

Treasury is expected to use half of the $250 billion to take the stakes simultaneously in a handful of the nation's largest banks, according to a source closely following the discussions. This source expects the rest of the $250 billion – which is the amount of the first tranche Congress authorized Treasury to spend— to be invested quickly in other banks, after which Treasury would ask Congress to authorize the next $100 billion in funding it approved.

Among the firms expected to get the funding: JP Morgan Chase, Citigroup and Bank of America were to receive $25 billion apiece; Wells Fargo was to get between $20 and $25 billion; Goldman Sachs and Morgan Stanley were down for $10 billion each, and the Bank of New York and State Street were slated for $2 to $3 billion apiece. A spokesperson for Citigroup declined to comment, as did one for Goldman Sachs. The other banks could not be reached for comment.

The cash infusions, intended to help recapitalize the troubled sector, were widely anticipated by the markets and helped fuel Monday's historic market surge. Paulson, FDIC Chairman Sheila Bair, Federal Reserve Chairman Ben Bernanke, and other officials were scheduled to outline the program's details at a press conference scheduled for 8:30 Tuesday morning. The program is expected to be run jointly by all three agencies.

The substantial sums involved make clear that Uncle Sam could be on the way to owning a vast chunk of the U.S. banking sector. A government investment of $250 billion amounts to perhaps 25% to 30% of the market capitalization for publicly-traded banks, says Rajiv Sobti, chief investment officer for Nomura Global Alpha LLC, a unit of Nomura Asset Management USA. Ultimately, hundreds of banks could eventually receive such equity funding.

Analysts say the decision to invest simultaneously in nine banks was aimed at eliminating any stigma attached with applying for the voluntary program. For any one bank to ask for help in isolation, points out Daniel Clifton, the Washington analyst for institutional broker Strategas Research Partners, would have been akin to a firm's management signaling to the world that it knew it was couldn't survive and had no hope of attracting private capital. Even deeply troubled firms may have resisted such a move for fear of the intensified pressure that would put on their already battered shares.

There was only one way to get around that problem, which could have caused the program to stall out even before it began. Treasury had little choice but to "jawbone them into taking the money in a coordinated fashion, all at same time," Clifton says. "They're staking all their hopes on this plan now – it has to work."

Clifton thinks that a few struggling regional banks will likely be next on the Treasury's list for an equity stake, so that the program is not perceived by the public – or by Congress – as only assisting Wall Street. To maintain political support, Treasury officials are said to be acutely aware of the need to support such banks, which play a big role in many smaller local communities.

The FDIC is also expected to temporarily boost the deposit insurance limits on non-interest bearing bank accounts. General deposit insurance was already lifted from $100,000 to $250,000 in the legislation recently passed by Congress to authorize the $700 billion industry rescue. But with European banks having agreed this weekend to lift the insurance limits on all deposits, the U.S. had little choice but to follow suit or see a flood of money head into foreign banks.

The higher limits on non-interest bearing accounts will cover payroll accounts, mortgage escrow accounts, and other accounts that might not otherwise have been covered, says Scott Talbott, a senior vice president at the Financial Services Roundtable, an industry group.

“Once the European countries came out with these moves, the U.S. had to as well,” says Brian Gardner, a Washington policy analyst with Keefe Bruyette & Woods, which specializes in the financial services sector. “Otherwise, you would have had depositors arbitraging between countries, which you just couldn’t have.”

Moreover, the FDIC is expected to guarantee new funds raised by banks and thrifts, in exchange for new senior preferred debt. That is intended to help jump start the stalled market for interbank lending, while also giving the agency a high priority among creditors should a bank fail. Many analysts believe that such guarantees are necessary to get the banks lending again, as they are hoarding capital an no longer trust that other institutions will be able to repay their loans if the credit squeeze continues.

The cumulative moves represent a big shift from just two weeks ago, when Congress and Treasury agreed that the rescue package would largely focus on buying up troubled mortgage related assets from the banks and other institutions. But as the Standard & Poor's 500 stock index tumbled 22% last week – its second worst one-week performance ever – it rapidly became clear that investors had little faith that asset purchases alone would shore up the industry. Over the weekend, the European Union also moved to broadly guarantee lending between banks; the United Kingdom and others have also moved to take equity stakes in their own banks.

The Treasury’s expected moves mirror what Europe has done, though they are slightly different in detail.

“Other countries have skipped the asset purchase stage altogether and moved directly on to investing in their banks and guaranteeing their deposits,” says Bert Ely, who runs Ely & Co, a financial services consultancy. “A lot of the issue is simply resolving the short term (funding) problems; many banks aren’t insolvent. We need to stabilize them first, then we can sort through which institutions are healthy enough to survive.”

That, of course, will raise plenty of thorny issues. Few expect the government to invest indiscriminately, and the Treasury and other regulators are now essentially in the position of deciding which of the thousands of banks in the U.S. will survive, and which are goners. That enormous power raises big questions, both economically and politically.

Certainly, many see it as a prudent position; as Campbell Harvey, a Duke University business professor puts it: “You don’t want to throw the good money at the bad.” But it also a fact that leads some to oppose government investment in the first place – particularly as Treasury has given little indication of what criterion it will use to perform that triage.

“I just think it’s a bad idea,” said John Douglas, a former FDIC general counsel and chair of the banking and financial institutions group at Paul, Hastings, Janofsky & Walker LLP law firm in Atlanta. “For the government to look at that list of 8,000 [banks and thrifts] and say, I’m going to save you and not you – that’s tough.”

Moreover, by investing in some banks and not others, the government could give those in which it invested a market advantage. Even unsupported banks that survive could find themselves losing business to those that do, as borrowers and depositors favor institutions that have the government's backing.

But given the sectors' overwhelming problems and the risks to the global economy of a failure to stem the credit crisis, that's a risk Paulson and his fellow regulators are resigned to taking.

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