Paulson needs to lay out his plan

Buying bank shares could help fuel a recovery, but only if the treasury secretary stops surprising equity investors.

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NEW YORK (Fortune) -- It's time for Henry Paulson to show his cards.

The Treasury secretary is considering buying shares of U.S. banks in the government's latest bid to calm frenzied markets and prevent a deep recession. By easing fears about bank capitalization and creditworthiness, a share purchase could nudge the money that banks are sitting on back into circulation among consumers and businesses.

But if Paulson's latest move is to restore markets to health, equity investors will have to be lured back into the financial sector as well.

And before they come back, they will have to have a clearer view of which institutions the government will stand behind, and how much that support will cost.

To date, Paulson has had a rough time painting that picture, instead coming up with ad hoc, inconsistent responses to crises in which a troubled firm might be saved, nationalized or allowed to die.

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Paulson must make clear which banks are eligible for government support and how much that aid will cost.

"Investing is playing Russian roulette if the government might show up at the door," says Andrew Moloff, chief investment officer at Evercore Asset Management in New York. "It's not in anybody's best interest to have equity holders running for the hills."

No details are yet available on how the U.S. might proceed, but Paulson noted Wednesday that recently enacted economic stabilization legislation gives him "broad, flexible authorities" to take actions including injecting capital into financial institutions of all sizes. Reports Thursday say the government would make preferred stock investments in U.S. banks in coming weeks.

If so, the U.S. plan could resemble one unveiled in London Wednesday. The U.K. Treasury said it would make 50 billion pounds ($88 billion) in funding available to eight big banks, including Barclays (BCS), HSBC (HBC) and Royal Bank of Scotland (RBS).

Banks that raise the requisite capital, whether in the private market or from the government, will get the bonus of having the Treasury stand behind their debt as they roll over billions of pounds in maturing loans in coming months. An analyst report estimates shareholders could see their investments diluted by as much as 30%.

But that might not be the worst thing for those investors. By naming the eight participants in its program and saying they must raise an undetermined amount of capital, the U.K. provides the markets with a clear picture and avoids the stigma involved in a strictly voluntary plan.

In a voluntary plan, banks that tap the government for funding might be seen as riskier than those that sit by and insist, whatever investors might suspect, that they remain well capitalized.

But whatever form its actions take, the feds must make clear what their standards are for determining when firms are eligible to receive capital - and when capital injections are mandatory. Knowing which firms are seen as undercapitalized is crucial in the wake of last month's nationalization of Fannie Mae (FNM, Fortune 500) and Freddie Mac (FRE, Fortune 500), the subsequent failures of Lehman Brothers and Washington Mutual and the near collapse of AIG (AIG, Fortune 500), each of which elicited different responses from the government.

U.S. banks could use help

A well-communicated U.S. recapitalization plan could come at a good time for the biggest U.S. banks. Bank of America (BAC, Fortune 500) this week raised $10 billion in new funds to help pay for rising credit losses and to restock its coffers as it prepares to acquire Merrill Lynch (MER, Fortune 500). But the Charlotte-based bank had to sell shares at an unusually steep 30% discount to recent market prices.

Citi (C, Fortune 500) and Wells Fargo (WFC, Fortune 500), the two big banks competing to take over BofA's stricken crosstown rival Wachovia (WB, Fortune 500), are also expected to raise tens of billions of dollars in new capital in coming weeks. There are signs they could use a hand: Citi shares have lost 38% and Wells 27% this month.

Adding to the uncertainty are the ever-shifting evaluations of the firms the government has already intervened with. The Federal Reserve Bank of New York said Wednesday it would lend as much as an additional $38 billion to AIG, the insurer that nearly collapsed last month after ratings downgrades subjected it to calls for cash collateral it didn't have. The new loan comes just three weeks after the Fed offered to lend AIG $85 billion to keep it from filing for bankruptcy, and just days after it came to light that AIG had already drawn down $61 billion of that loan.

AIG's problems may be unique, though the market doesn't seem to think so. Shares of other insurers have tanked over the past week, with Prudential (PRU, Fortune 500) down 56% since stocks started their slide last week.

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An alternative to the targeted injection plan comes from Duke University finance professor Campbell Harvey, who says the government should make small purchases - worth, say, 2% to 5% of the common equity - into all the banks the feds deem worthy of saving. Doing so, he says, offers the advantage of recapitalizing not only the weak banks but also the strong ones.

And while stronger institutions may protest that they don't need the money and that they don't want their shareholders to have to take a haircut, making an across-the-board investment in solvent banks could pay off by giving the strong banks excess funds that they can then lend out, boosting economic activity.

"That's the best way to get credit creation going," he says.

Harvey says the advantage of widespread equity investments is that they can be made quickly and, by shoring up banks both big and small, should help expand lending to job-creating small and midsize businesses. But he adds that the government must also decide which institutions will fail, and must not put funds into them.

He says it's reasonable to expect that hundreds of smaller banks will go under before the cycle turns. Harvey says the feds must set up a bad bank along the lines of the Resolution Trust Corp. of the 1980s savings-and-loan debacle to dispose of problem bank assets over a period of years. Japan's failure to recover from an asset bubble that inundated its banking system in the early 1990s shows that clearing out the deadwood is crucial to any economic recovery, Harvey says.

"You don't want to be prolonging the inevitable," Harvey says.

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