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Citi, U.S. Reach Accord on a Third Bailout

Government Puts Itself on Hook for More Losses; Stake of Up to 36% Stops Short of Nationalization

By DAVID ENRICH and DEBORAH SOLOMON

Citigroup Inc. and the federal government agreed to a third rescue that will give U.S. taxpayers as much as 36% of the bank but expose their ownership stake to greater risk from the recession and housing crisis.

Friday's agreement shows how hard the Obama administration is trying to stabilize the U.S. banking industry without a full-fledged nationalization that would wipe out investors and leave the government in charge. But the deal will punish existing shareholders of Citigroup, who will see their stake diluted by 74%, and likely do little to change the awkward relationship between federal officials and management of the New York company.

Government officials don't see the latest agreement with Citigroup as a template for other rescues, though bank stocks fell on worries that the agreement will be cloned at other suffering U.S. financial institutions.

According to Citigroup executives, the Treasury Department and other banking regulators didn't try to squeeze new concessions from the New York bank. For example, the company wasn't pushed to make more loans, rein in foreclosures or curb executive pay beyond previously agreed or required levels, these people said.

Over the past several days, Treasury Secretary Timothy Geithner and other government officials discussed whether to require the removal of Citigroup Chief Executive Vikram Pandit, according to a person familiar with the discussions. But government officials concluded it was impractical to oust him, partly because of a lack of strong potential successors. A boardroom shake-up already is in motion, largely due to pressure from the Fed.

This rescue also was more palatable because the government isn't pumping in additional taxpayer dollars. Instead, as much as $25 billion in preferred shares held by the U.S. government will be converted into common shares as Citigroup struggles to stabilize itself following more than $37 billion in net losses during the past five quarters.

Depending on how many current holders of Citigroup preferred stock agree to a similar move, the company's tangible common equity could surge to $81.1 billion from $29.7 billion at Dec. 31. That would reverse the recent slide in tangible common equity -- a gauge of what shareholders would have left if the company were liquidated -- that fueled a downward spiral in Citigroup shares.

The conversion leaves taxpayers exposed to the risk of greater losses. The government's preferred holdings had stood ahead of common stock in Citigroup's capital structure, meaning they were less likely to lose value if the company's woes continue to mount. In addition, by converting much of the U.S. stake to common shares, Citigroup won't have to pay the hefty dividend payouts that were attached to the preferred stock.

"The government is bending over backwards to not go along the lines of nationalization," said Bernie Sussman, chief investment officer of Spectrum Asset Management, a unit of Principal Financial Group Inc. that manages about $6.9 billion in assets. "They had the alternative to completely zero out the common stock."

Citigroup shares tumbled 96 cents, or 39%, to $1.50 in 4 p.m. New York Stock Exchange trading Friday, reflecting that current holders of the bank's common stock will hold as little as 26% when the deal is completed.

Some investors were especially rattled by news that Citigroup will stop paying dividends on most of the bank's preferred shares. At many banks, preferred shares have been a haven from the epidemic of dividend cuts and eliminations on common stock. "The cost of doing this with one bank is that it makes shareholders at other banks nervous," said Campbell Harvey, professor of finance at Duke University's Fuqua School of Business in Durham, N.C.

Instead, financial institutions that need to bolster their balance sheets following regulatory "stress tests" now under way at the 19 largest U.S. banks can get new convertible preferred shares from the government or convert existing shares under terms announced by the Treasury Department this past week. The conditions include converting preferred shares to common equity at a 10% discount to the prevailing price as of Feb. 9.

Wall Street also is worried about "whether the company will be run in the interest of private shareholders or for the public good," said John McDonald, a banking analyst at Sanford Bernstein & Co. "It's a valid question what the priorities will look like."


VIKRAM PANDIT

Messrs. Geithner and Pandit began discussing details of the stock-conversion plan last Sunday evening, according to people familiar with the situation. Agreement on a basic framework was reached relatively quickly, but Citigroup and officials from the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corp. and Treasury then haggled over issues such as what would happen to $20 billion of taxpayer-owned preferred shares not included in the deal.

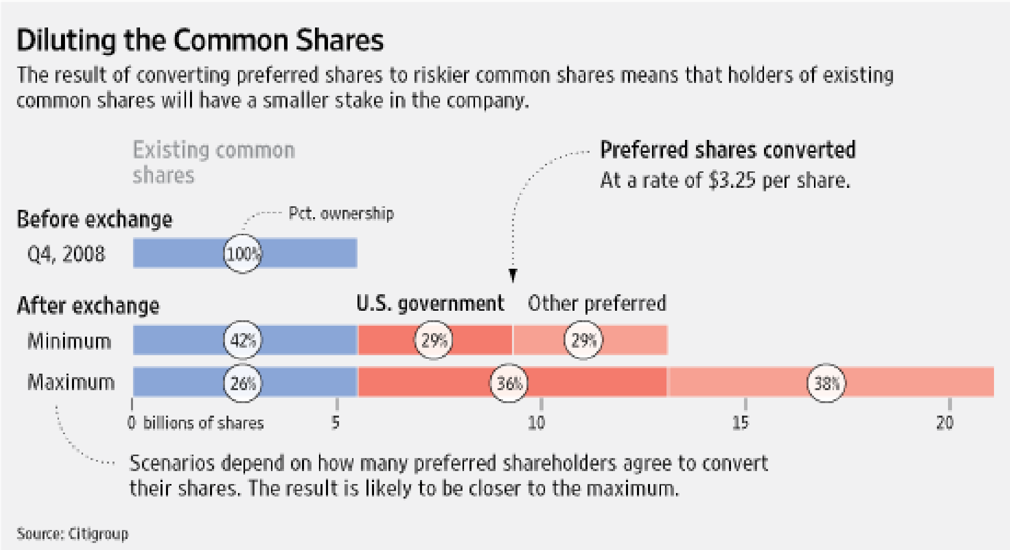
At times, Citigroup executives grew frustrated by what they viewed as slow responses from Washington. Asked Friday about the back-and-forth of the negotiations, one Citigroup executive responded: "There isn't one. We just wait." Some executives worried that private investors needed to go along with the deal might get cold feet if an agreement wasn't reached quickly.

On Friday, Citigroup said that most of the private institutions that hold a combined $12.5 billion in Citigroup preferred shares have agreed to convert their shares to common stock at $3.25 apiece. Among them are Singapore's sovereign-wealth fund and Prince Alwaleed bin Talal of Saudi Arabia. The New Jersey pension system, which bought Citigroup preferred shares in January 2008, is "still reviewing" the agreement, a spokesman said.

After the U.S. government's rescue of Citigroup in December, federal officials made it clear to bank executives that they needed to revamp their strategy. That led to a spinoff of the Smith Barney brokerage unit and cordoning off a big part of Citigroup into a unit marked for disposal.

This time, Citigroup executives say Washington is comfortable with their turnaround plans. "They understand what our strategy is and what our structure is," a top Citigroup executive said Friday.

Citigroup agreed to have "a majority of new independent directors as soon as feasible," according to a statement from Richard Parsons, Citigroup's chairman. People briefed on the matter said it might not be possible to recruit enough



directors in time for Citigroup's annual meeting in April. It is "a long-term goal," one person said. The task may be easier than it appears, however, because Citigroup views two directors who joined the board since 2007, Lawrence Ricciardi and Robert L. Ryan, as "new," the people said

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