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Expanded Rescue Of Banks Outlined

U.S. to Help if Firms Can't Find Capital

By Binyamin Appelbaum

The Obama administration yesterday detailed its expanded aid plan for the banking industry, laying the groundwork for the government to take large ownership stakes in the most troubled banks and giving other banks up to seven years to repay taxpayers.

President Obama said Tuesday night that the goal was to increase lending and restore investor confidence. Obama said the expanded rescue probably will cost more than the $700 billion already approved by Congress.

Federal regulators yesterday launched "stress tests" of 19 of the largest banks to determine how much more money they will need. The results are expected no later than the end of April. Banks then will have six months to raise the money from private investors or accept federal aid.

Although the administration says it is determined not to seize control of large banks, Federal Reserve Chairman Ben S. Bernanke said the government may take "a substantial minority share" in Citigroup and other troubled banks that can't get money anywhere else.

Even as his administration moved to end the current crisis, Obama yesterday described principles for a vast revamp of financial regulation, signaling that the government would oversee a much wider range of financial activity and take a stronger hand in doing so.

"While free markets are the key to our progress, they do not give us free license to take whatever we can get, however we can get it," the president said. "Strong financial markets require clear rules of the road, not to hinder financial institutions but to protect consumers and investors."

Speaking after a meeting with key lawmakers and senior advisers, Obama said the government needs to overhaul the frayed patchwork of regulatory agencies that oversee the financial industry. He expressed support for increased consumer protections. And he indicated that he favored empowering the Federal Reserve as a regulator of systemic risk, with authority over any financial firm or instrument that could destabilize the economy.

The administration hopes to present a more detailed plan for regulatory reform by early April, when leaders of the wealthiest nations are scheduled to meet in London.

By then, the depth of its plunge into the banking industry may be more clear. Retail giants such as Bank of America, investment banks such as Morgan Stanley and specialty banks such as State Street are all now required to measure its likely losses in the event that the economy gets much worse.

Officials said yesterday that the tests will assume that the unemployment rate reaches 10.3 percent by the end of 2010 -- the January rate was 7.6 percent -- and that average home prices would decline 47 percent from the peak of the housing bubble, compared with a 27 percent decline so far. The test will also assume that economic activity as measured by gross domestic product shrinks by 3.3 percent this year before recovering slightly in 2010.

Regulators have calculated that there is roughly a 10 percent chance that economic conditions would reach this extreme of deterioration. The parameters were based on a consensus of economic forecasts, though some prominent economists said the government should test an even more catastrophic scenario.

Banks required to accept government money must issue preferred shares that pay annual interest of 9 percent. That is higher than the 5 percent interest rate on the government's existing investments of almost $200 billion in more than 400 banks. The government had been criticized for investing money at below-market rates, in effect creating an undisclosed subsidy worth tens of billions of dollars.

The new shares differ in another key respect: They can be converted into common shares, which carry ownership rights.

The shares convert automatically if banks do not repay the government in seven years, but banks can also opt to make the conversion sooner.

Citigroup already is negotiating with the government for permission to do this because of an important accounting advantage: In calculating how much money banks hold in their capital reserve against future losses, many investors include only money raised through the sale of common shares.

The government is hoping that investors will treat the right to convert the shares as though the institutions had actually been given more capital. If institutions are forced to convert their shares to appease investors, the government could quickly become the majority owner of those banks.

The goal of the plan is to restore investor confidence in banks, attracting new private investments that would allow companies to repay the government.

But the details were panned yesterday by some investors, who warned that the plan leaves the banks shrouded in uncertainty because it won't be clear for six months which ones need government money, and it might not be clear for seven years how much of an ownership stake the government eventually will take.

Dan Alpert, managing director of Westwood Capital, said the government should immediately take an 80 percent stake in banks that need federal aid, the maximum stake the government can take without being forced to put a company on the federal balance sheet.

Knowing the worst already had happened, he said, would give private investors the confidence to commit their own money. "The government needs to come in and say: 'You are going to be saved. We'll fund you. We'll keep you alive. And at the very start, this is all of the dilution we're ever going to do,' " Alpert said. Anything short of that, he said, is not likely to work.