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NYT: Banks' bailouts may convert to equity

White House: Approach will prevent need to seek more cash from Congress

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WASHINGTON - President Obama's top economic advisers have determined that they can shore up the nation's banking system without having to ask Congress for more money any time soon, according to administration officials.

In a significant shift, White House and Treasury Department officials now say they can stretch what is left of the $700 billion financial bailout fund further than they had expected a few months ago, simply by converting the government's existing loans to the nation's 19 biggest banks into common stock.

Converting those loans to common shares would turn the federal aid into available capital for a bank — and give the government a large ownership stake in return.

While the option appears to be a quick and easy way to avoid a confrontation with Congressional leaders wary of putting more money into the banks, some critics would consider it a back door to nationalization, since the government could become the largest shareholder in several banks.

The Treasury has already negotiated this kind of conversion with Citigroup and has said it would consider doing the same with other banks, as needed. But now the administration seems convinced that this maneuver can be used to make up for any shortfall in capital that the big banks confront in the near term.

More risk to taxpayers

Each conversion of this type would force the administration to decide how to handle its considerable voting rights on a bank's board.

Taxpayers would also be taking on more risk, because there is no way to know what the common shares might be worth when it comes time for the government to sell them.

Treasury officials estimate that they will have about $135 billion left after they follow through on all the loans that have already been announced. But the nation's banks are believed to need far more than that to maintain enough capital to absorb all their losses from soured mortgages and other loan defaults.

In his budget proposal for next year, Mr. Obama included $250 billion in additional spending to prop up the financial system. Because of the way the government accounts for such spending, the budget actually indicated that Mr. Obama might ask Congress for as much as $750 billion.

The most immediate expense will come in the next several weeks, when federal bank regulators complete "stress tests" on the nation's 19 biggest banks. The tests are expected to show that at least several major institutions, probably including Bank of America, need to increase their capital cushions by billions of dollars each.

The change to common stock would not require the government to contribute any additional cash, but it could increase the capital of big banks by more than $100 billion.

The White House chief of staff, Rahm Emanuel, alluded to the strategy on Sunday in an interview on the ABC program "This Week." Mr. Emanuel asserted that the government had enough money to shore up the 19 banks without asking for more.

"We believe we have those resources available in the government as the final backstop to make sure that the 19 are financially viable and effective," Mr. Emanuel said. "If they need capital, we have that capacity."

If that calculation is correct, Mr. Obama would gain important political maneuvering room because Democratic leaders in Congress have warned that they cannot possibly muster enough votes any time soon in support of spending more money to bail out some of the same financial institutions whose aggressive lending precipitated the financial crisis.

The administration said in January that it would alter its arrangement with Citigroup by converting up to $25 billion of preferred stock, which is like a loan, to common stock, which represents equity.

After the conversion, the Treasury would end up with about 36 percent of Citigroup's common shares, which come with full voting rights. That would make the government Citigroup's biggest shareholder, effectively nudging the government one step closer to nationalizing a major bank.

Nationalization, or even just the hint of nationalization, is a politically explosive step that White House and Treasury officials have fought hard to avoid.

Administration officials acknowledged that they might still have to ask Congress for extra money. Beyond the 19 big banks, which are defined as those with more than $100 billion in assets, the Treasury has also injected capital into hundreds of regional and community banks and may need to provide more money before the financial crisis is over.

Treasury officials say they have more money left in the rescue fund than might be apparent. Officials estimate that the fund will have about $134.5 billion left after the Treasury completes its $100 billion plan to buy toxic assets from banks and after it uses $50 billion to help homeowners avoid foreclosure.

In practice, the toxic-asset programs are not expected to start for another few months, and it could be more than a year before the Treasury uses up the entire $100 billion. Likewise, it will be at least a year before the Treasury uses up all the money budgeted for homeowners.

But the biggest way to stretch funds could be to convert preferred shares to common stock, a strategy that the government seems prepared to use on a case-by-case basis.

Ever since the Treasury agreed to restructure Citigroup's loans, officials have made it clear that other banks could follow suit and convert their government loans to voting shares of common stock as well.

Setting yardsticks

In the stress tests now under way, regulators are examining whether the big banks would have enough capital to withstand an economic downturn in which unemployment climbs to 10 percent and housing prices fall much further than they already have.

As their yardstick, regulators are expected to examine a measure of bank capital called "tangible common equity." By that measure of capital, every dollar a bank converts from preferred to common shares becomes an additional dollar of capital.

The 19 big banks have received more than $140 billion from the Treasury's financial rescue fund, and all of that has been in exchange for nonvoting preferred shares that pay an annual interest rate of about 5 percent.

If all the banks that are found to have a capital shortfall fill that gap by converting their shares, rather than by obtaining more cash, the Treasury could stretch its dwindling rescue fund by more than $100 billion.

The Treasury would also become a major shareholder, and perhaps even the controlling shareholder, in some financial institutions. That could lead to increasingly difficult conflicts of interest for the government, as policy makers juggle broad economic objectives with the narrower responsibility to maximize the value of their bank shares on behalf of taxpayers.

Those are exactly the kinds of conflicts that Treasury and Fed officials were trying to avoid when they first began injecting capital into banks last fall.

This article, "U.S. May Convert Banks' Bailouts to Equity Shares," first appeared in The New York Times.

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