Section

U.S. Forces Nine Major Banks To Accept Partial Nationalization; Dow Soars 11 Percent; Biggest Point Gain Ever

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The U.S. government is dramatically escalating its response to the financial crisis by planning to invest $250 billion in the country's banks, forcing nine of the largest to accept a Treasury stake in what amounts to a partial nationalization.

News that European governments also planned to take stakes in their banks and anticipation of new U.S. measures unleashed a tremendous surge in U.S. stock prices yesterday, with the Dow Jones industrial average soaring to the biggest percentage gain since the 1930s, up 11.1 percent. It ended 936.42 points higher, the largest point gain ever, just days after the Dow had its steepest weekly decline in history.

The Treasury Department's decision to take equity stakes in banks represents a significant reversal, coming just weeks after Treasury Secretary Henry M. Paulson Jr. had opposed the idea. In a momentous meeting yesterday afternoon in Washington, Paulson, flanked by top financial regulators, told the executives of nine leading banks that they needed to participate in the program for the good of the national economy, two industry sources said on condition of anonymity because they were not authorized to speak publicly.

The government's initiative, which was to be announced this morning before the markets open for New York trading, is part of a wider plan that goes beyond the $700 billion rescue package approved by Congress earlier this month. The Federal Deposit Insurance Corp. is also set to announce today the launch of an insurance fund to guarantee new issues of bank debt. It will provide unlimited deposit insurance for non-interest-bearing accounts, which are widely used by small businesses for payroll and other purposes.

In pressing the bank executives to accept partial government ownership, Paulson's message was clear: Though officially the program was voluntary, the banks had little choice in the matter. In exchange for giving the Treasury minority stakes, the nine firms would jointly receive an investment worth $125 billion. The government would make another $125 billion available for the next 30 days to thousands of other banks and thrifts across the country.

Federal officials set conditions, telling the banks they could not raise their dividends without government permission and could not offer their executives new retirement packages, though the old packages would remain intact.

Paulson told them the moves would shore up confidence in their own institutions, spark lending throughout the system and send a message to smaller institutions that there is no stigma in accepting federal funding. Though some were reluctant, all of the executives complied.

There is a risk that banks will take the new government capital and use it to bolster their balance sheets but still not resume lending, and the Treasury is not getting any specific contractual guarantee to prevent that from happening. But bank regulators, particularly the Federal Reserve, will lean heavily on the firms receiving infusions to use the capital to increase their lending to businesses and consumers.

Taken together, the steps planned by the Treasury, the FDIC and the Federal Reserve amount to a monumental effort to jump-start the business of lending, which all but dried up in recent weeks as banks have lost faith in one another and their customers. Global markets began to melt down. Some emerging nations teetered on the brink of financial collapse.

Over the weekend, global leaders agreed in meetings in Washington to launch a coordinated program of injecting cash into the world's banks and guaranteeing their debt. The action by U.S. officials yesterday represented the U.S. version of those broad principles, and it was matched by similar efforts in Europe yesterday.

As part of the effort to flood the financial system with cash, the Federal Reserve made unlimited funds available early yesterday to other major central banks so they could inject money into banks in their countries and ease the shortage of dollars they face. Previously, the Fed's program of lending dollars to the European Central Bank, Bank of England, Bank of Japan and others had been capped at a total of $380 billion.

Under the rescue legislation signed into law earlier this month, the Treasury is allowed to take equity stakes in banks.

During debates on Capitol Hill, Paulson repeatedly described that measure as a way to shore up ailing financial institutions by buying their troubled mortgage securities and other assets.

Now that he has decided to use the $250 billion installment to pump capital directly into the banking system, he is planning to immediately ask Congress for a second installment of $100 billion to buy or insure the assets from institutions, according to congressional staff and banking industry executives briefed on the plan.

"When I was talking to members of Congress back then, they believed they were voting to buy up troubled assets, not to make capital infusions in banks," said Alan Blinder, a Princeton economist and a former Fed vice chairman. "If I were a member of Congress, I would be wondering about bait and switch because that was not really discussed."

Among the first to push the idea of injecting money into banks in exchange for an equity stake was Rep. Spencer Bachus (R-Ala.), who proposed the idea at a Sept. 18 night meeting on Capitol Hill that included legislators as well as Paulson and Federal Reserve Chairman Ben S. Bernanke.

After Paulson described his plan for the Treasury to buy up mortgage backed securities, Bachus suggested there were certainly other ways to address the crisis. "There has to be alternatives," he recalled telling the group, in an account that is consistent with accounts of others who were present at the meeting. "Why not inject capital into the institutions?"

At the meeting, Rep. Barney Frank (D-Mass.) and Sen. Jack Reed (D-R.I.) expressed support for the idea, according to people at the meeting.

But Treasury officials "said this is a crisis and that there was no time," Bachus said. Paulson "was very fearful that if we didn't do something immediately, we were going to see terrible things happen."

He said he thought that Paulson had acted with "integrity" but that "I do believe they had this one plan, and they were saying 'This is it.' "

Bachus answered the objection by saying that the government could take a non-voting stake in the institutions. But opponents in the meeting, including Treasury, were unmoved.

"I do think there were some ideological predisposition against capital injections," Sen. Charles E. Schumer (D-N.Y.) said of the meeting. Also, "their view was that it would take too long because you'd have to do it on a bank-by-bank basis."

Yesterday, few lawmakers took issue with the plan to recapitalize banks. But key Democrats argued that strict executive compensation limits should apply to any institution that accepts government money.

"Restrictions on executive compensation will ensure that taxpayer money is not wasted enriching the same people whose poor decision-making created this crisis," Schumer wrote in a letter to Paulson yesterday. "It is imperative that these restrictions, including limitations on the incentives for executives to take excessive risks and the elimination of golden parachutes, should apply to any capital injection program."

The new insurance program that will be launched by the FDIC to insure non-interest-bearing accounts is aimed mainly at small businesses, which tend to keep the largest balances in bank accounts and therefore are particularly likely to withdraw money if they believe their bank is having financial problems. Because banks are barred by law from paying interest on business accounts, the new guarantee will basically encompass all such accounts.

The extended guarantee matches similar guarantees by European countries, easing a concern that businesses would move money to overseas accounts. But the move also raises questions again about whether the FDIC will have enough money to meet its growing obligations as banks continue to fail.

The FDIC's bank debt guarantee would be open to newly issued bonds and other forms of debt that are issued before June of next year. The government's guarantee would last three years.

Earlier yesterday, while speaking to international bankers, Neel Kashkari, who is temporarily overseeing the government's $700 billion rescue package, laid out some details of the Treasury's efforts on that plan and acknowledged the need to move quickly. Kashkari, who was appointed interim assistant Treasury secretary for financial stability last week, said that key appointments, including a "prime contractor" company to oversee and run the purchase of troubled assets from banks, will be announced as early as today. It has also received "hundreds" of applications from firms seeking to become asset managers for the securities that Treasury will purchase. Other officials added that the department has hired law firm Simpson Thacher & Bartlett and investment consultants Ennis Knupp & Associates to help with the selection of contractors for the program.

Kashkari said the Treasury will be clarifying conflicts of interests among any firms that it hires because "firms with the relevant financial expertise may also hold assets that become eligible for sale."

Staff writers Binyamin Appelbaum, Zachary A. Goldfarb and Lori Montgomery contributed to this report.