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Citigroup gets a monetary lifeline from feds

Kathleen Pender

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The bailouts keep coming, and they seem to be getting worse for taxpayers.

The deal worked out over the weekend to prevent the collapse of Citigroup "is a terrible deal for taxpayers," says Campbell Harvey, a Duke University global finance professor. "Some intervention was necessary. But the terms of the intervention basically shafted the U.S. taxpayer."

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Analysts at CreditSights estimate the government could lose up to $230 billion on the assets, but expect actual losses "would be significantly less."

Under the deal, the U.S. government will invest $20 billion in Citigroup preferred stock (on top of its previous $25 billion capital injection from the Troubled Asset Relief Program) and guarantee up to $306 billion in mortgage and other assets.

Citigroup would absorb the first $29 billion in losses on that asset pool, which would remain on Citigroup's balance sheet but be "ring fenced" or segregated. Losses exceeding $29 billion would be shared 90 percent by the government and 10 percent by Citigroup.

Of the government's losses: the first $5 billion would come from the TARP fund. The Federal Deposit Insurance Corp. would shoulder the next $10 billion. Any further losses would be financed by the Federal Reserve using a nonrecourse loan.

What do taxpayers get for taking on this risk?

Citigroup will pay an 8 percent dividend on the preferred stock or $560 million a year.

By comparison, when Warren Buffett's Berkshire Hathaway recently invested $5 billion in Goldman Sachs and $3 billion in General Electric, it got preferred stock that pays a 10 percent dividend.

The government also gets warrants to purchase about $2.7 billion worth of Citigroup common stock at $10.61 per share. Citigroup's shares closed at $5.95 per share Monday, up $2.18 from Friday. For the warrants to become profitable, the common shares would have to nearly double.

By comparison, Berkshire got warrants to purchase common stock in Goldman and GE at

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a price that was *below* the market price at the time the deals were struck, giving the warrants instant value. Since then, both stocks have fallen well below the price at which the warrants can be converted.

In the Citi deal, Harvey sees enormous risk and little upside for taxpayers. If the government is able to convert its warrants into common stock, it will own less than 5 percent of the company.

When the government bailed out AIG, it got almost 80 percent of the insurer's stock. "That's a clear upside," he says.

The government tied few strings to its Citi investment. It did limit Citigroup's quarterly common stock dividend to 1 cent per share. It had been paying 16 cents.

And it required the company to submit "an executive compensation plan, including bonuses, that rewards long-term performance and profitability, with appropriate limitations."

But it didn't force a management change like it did with AIG. Its preferred shares carry almost no voting rights and it didn't demand a seat on the company's board.

Barry Eichengreen, an economics professor at UC Berkeley, says "it was essential for the government to intervene (in Citigroup). I think the way it was done was terrible. This is a company with a $2 trillion balance sheet into which we are injecting $20 billion. That's a drop in the bucket."

Using a military analogy, he says the government should have followed the Powell Doctrine, attributed to Gen. Colin Powell: "You only engage the other side if you deploy overwhelming force. We certainly didn't do that."

Eichengreen says the government should have made a larger investment and done more to protect taxpayers. "Why didn't we ask for voting shares and put someone on the board of directors?" he says.

Not everyone says taxpayers got the short end of the stick.

"The deal Citigroup received is a win-win situation for everyone involved," says Morningstar stock analyst Jaime Peters. "Citigroup represented a significant systemic risk to the financial industry. Their problems were beginning to leak into other major banks. About 50 percent of its revenues come from outside the United States. If Citigroup had problems, we would have had a worldwide problem.

"The government's bailout of Citigroup has taken the short-term risk associated with it off the table," she adds. Citi "is going to take a major hit before the government spends a dime," she adds. The government "is getting $560 million worth of dividends to take this risk. Overall, we think it's a fairly balanced risk/reward."

Banking consultant Bert Ely says he's doesn't know if Citigroup "is out of the woods yet." Details of the plan are sketchy, and he's not sure the company "has the right management in place."

But he thinks Citi could be the last of the big bank bailouts. The other big four banks - JPMorgan Chase, Bank of America, Wells Fargo and U.S. Bancorp. - are in better shape than Citi. Below that are smaller banks that could be acquired by large ones.

But Eichengreen fears there will be many more bailouts and hopes Citigroup won't serve as a template. "What we are seeing is in a deep recession. There will be more banking problems. They have loaned to commercial real estate, the auto companies, more of those loans are going to go bad. The silver lining here is, there is another chance to get it right."

Stocks soar on news of the Citigroup bailout, which will also include mortgage relief for some struggling homeowners. **D3**

Net Worth runs Tuesdays, Thursdays and Sundays. E-mail Kathleen Pender at kpender@sfchronicle.com.

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