In Latest Citi Rescue, Government Spooks Investors With New Shift

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NEW YORK -(Dow Jones)- The government's new blueprint for bailing out crippled banks has investors thinking twice about sinking money into a sector once known for its steady returns and value.

For weeks, investors expected the government to simply take a larger stake in Citigroup Inc. (C) and dilute common shareholders. But, the decision to stop paying dividends on most of the bank's preferred shares caught many by surprise. Suddenly, bank preferred shares have lost their aura of safety.

Investors complain that the latest rescue of Citigroup represents yet another shift in the government's strategy.

"We all thought we had the game plan from the government just a couple days ago," said Anton Schutz, manager of the Burnham Financial Services Fund. "As portfolio managers, we can't do our job because they keep changing the rules."

Over the past year, the government has taken an ad-hoc approach to dealing with teetering financial firms. Bear Stearns was folded into JPMorgan Chase & Co. (JPM) with government assistance; Lehman Brothers was allowed to simply fail; and American International Group Inc. (AIG) is now struggling to repay the $150 billion in government loans.

Shares of financial companies plunged after the Treasury Department announced it is willing to convert up to $25 billion of its preferred holdings in Citgroup into riskier common stock. That conversion is contingent upon other preferred stock investors also converting. Citigroup said it will offer to convert nearly $27.5 billion in preferred stock sold to private investors and the public; in total, existing shareholders' stake could be cut to 26% of the company's stock.

Preferred shareholders like pension funds, sovereign wealth funds, and even big individual investors like former Citi Chairman Sanford Weill, do have a choice. Should investors choose not to convert their preferred shares to common stock, they are left to hope and pray that Citi will someday return to paying preferred dividends. (One type of preferred shares, so-called trust preferreds, will continue to pay dividends, and various classes of TruPs were trading between 20% and 66% higher in recent Friday trading, according to FactSet Research.)

Analysts say few investors are expected to hold on to their preferred shares. And, that has caused shareholders - both common and higher classes - to become much more wary about the banks that they have holdings in.

"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.

The Treasury Department's latest bid to quell fears about Citigroup had a punishing effect on its stock, which fell to an 18-year low. Wall Street was also worried about the chances other banks might be subject to similar federal intervention.

Shares of Bank of America Corp. (BAC) fell 15.8% to $4.48 in midday trading. Analysts have said the bank, which has received massive federal aid, might be another weak link in the ailing financial system.

Wells Fargo & Co. (WFC) fell 6.9% to $13.40 and Fifth Third Bancorp dropped (FITB) 7.4% to $2.12. Meanwhile, banks seen as not needing government intervention - like JPMorgan, Goldman Sachs Group Inc. (GS) and Morgan Stanley (MS) - were down less sharply.

"We know that the banking system is going to be smaller and simpler, we know that the regulatory environment is going to be harsher," said Jack Ablin, chief investment officer at Harris Private Bank. "Based on the cards being dealt right now, I'm not sure there's a hand to be had investing in banks."

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