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HEADLINE: Wachovia Is Sold As Depositors Flee

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BODY:

The sale of Wachovia's banking business to Citigroup yesterday marked the second time in five days that a major U.S. bank was forced from existence in part by fleeing depositors, raising serious questions about the stability of other financial firms and the health of the banking system.

The deal also continues the rapid consolidation of an industry that has long been kept fragmented as a matter of public policy but now is being encouraged by the government to conglomerate.

In the latest rescue urged by federal regulators, Citigroup agreed to pay $2.16 billion for Wachovia, the nation's third-largest retail and commercial banking franchise. Wachovia was fast-growing and widely admired, run by Treasury Secretary Henry M. Paulson Jr.'s former deputy Robert Steel. Citigroup is a long-standing colossus of the American financial services industry.

Citigroup, based in New York, would become the largest bank in the Washington area. The deal would protect all deposits at Wachovia, according to a statement from the Federal Deposit Insurance Corp., which presided over the companies' shotgun wedding.

To consummate the deal, the FDIC promised to limit Citigroup's losses on a $312 billion portfolio of Wachovia's most troubled loans. The government agreed to absorb all losses beyond $42 billion, a threshold that could be exceeded based on the performance of similar groups of mortgage loans at other banks.

In exchange, the government would get a $12 billion stake in Citigroup, making it one of the largest shareholders in what would be the nation's largest bank. Sheila C. Bair, chairman of the FDIC, said the government's involvement was necessary "to maintain confidence in the banking industry given current financial-market conditions."

Citigroup will join Bank of America and J.P. Morgan Chase in a small group of giants that have emerged from the crisis to dominate American banking. The three companies together would hold more than 30 percent of the nation's deposits. They would hold more than 40 percent of bank loans to corporations. They would be the issuers of more than 50 percent of the nation's credit cards. And they would each number among the five largest investment banks.

The banking industry was fragmented by the government during the Great Depression and kept that way for most of a century, to promote competition, reduce prices and keep any one company from becoming too central to the health of the economy. Now those efforts have been upturned in the space of a frantic month.

Federal regulators said that they encouraged the consolidation because the alternative was a systemic collapse and that they will consider the ramifications once the crisis is resolved.

Critics, however, said that regulators, in attempting to fix the banking system, are repeating the same mistakes they made in allowing the crisis to spin out of control: They are ignoring the long-term interests of consumers and of the economy.

"I think we've learned in this crisis that there's a connection between making sure that customers are not abused and ensuring that banks can continue to earn profits," said John Taylor, chief executive of the National Community Reinvestment Coalition, a consumer advocacy group. "Ignoring those consumer protections is what got us into trouble in the first place."

Some analysts also question how the government will regulate companies with which it is increasingly intertwined. The government has helped to decide which banks will acquire fallen rivals. It has backstopped some of those deals with federal money, and it now owns a stake in Citigroup.

If a bailout plan passes Congress, the government could soon own stakes in many more banks because of provisions in the legislation awarding it the right to obtain stock in firms that sell their assets to the Treasury.

The tension between regulating banks and profiting from their success could influence a wide range of policy decisions, such as whether to lift the ban on short selling of financial stocks and how to reform banking regulations. It could also discourage the government from challenging the companies if they take advantage of their size to manipulate the market.

"Obviously, to the extent that you've created an oligopoly in the banking industry, you need to be concerned that the industry participants will not be using their market power at the expense of consumers," said David S. Ruder, a professor at Northwestern University School of Law and a former chairman of the

Securities and Exchange Commission. "Hopefully, the government will not take actions that are not in the public interest merely for the purpose of increasing its equity stakes."

Bair and other regulators pushed Wachovia to agree to a sale during a long weekend of talks with Citigroup and other bidders. The Charlotte company has been crushed by losses on mortgages, and regulators were increasingly concerned that it might collapse, forcing the FDIC to cover its depositors.

Wachovia bought many of its troubles in 2006 with the $25 billion acquisition of Golden West Financial, a major mortgage lender based in California. Like Washington Mutual, which failed late last week, Golden West specialized in "option" mortgage loans, which allow customers to choose how much they pay each month.

Yet also like Washington Mutual, Wachovia was ultimately laid low not by its mortgage losses but by a lack of cash. The bank basically foundered because people lost confidence in its ability to survive.

In the 10 days before regulators closed Washington Mutual, depositors withdrew $16.7 billion, leaving the bank without the money it needed to stay in business. And the failure of Washington Mutual on Thursday led to increased concerns about Wachovia because it held an even larger portfolio of troubled mortgage loans.

By Friday, customers were beginning to withdraw money, according to people familiar with the situation. The bank also was struggling to raise money from other sources, such as sales of short-term debt to investors and loans from other banks.

On Saturday, Wachovia's primary regulator, the Office of the Comptroller of the Currency, notified the FDIC that the company's situation was critical.

Wachovia's executives were in New York, negotiating with two possible suitors, Wells Fargo and Citigroup. As late as Sunday afternoon, federal officials believed that a sale would happen without federal intervention. But Wells Fargo declined to pull the trigger, and Citigroup insisted on federal aid.

Regulators worked through the night to hammer out the final deal.

Citigroup agreed to buy Wachovia's banking operations. The deal would leave the holding company with two smaller subsidiaries, the Wachovia Securities brokerage franchise and the Evergreen Investments asset-management division. Wachovia shareholders would continue to own the holding company.

In addition to the government backstop, Citigroup said it would raise $10 billion in new capital to help it absorb Wachovia's troubled loan portfolio. Citigroup also plans to reduce by half the dividend on its widely held shares.

"This gives us a dominant franchise in great markets," said Citigroup chief executive Vikram Pandit. He described the deal as offering a rare combination of high returns and low risk because of the government's involvement.

Investors were less excited, dropping Citigroup's shares by 12 percent, or $2.40, to $17.75, on one of the worst days in recent history for the broader stock market.

The FDIC's guarantee of deposits is not preventing bank runs at Wachovia and elsewhere in part because the agency guarantees only about 63 percent of the money on deposit at the nation's banks. The rest of the money, more than $2.5 trillion, is not guaranteed because the account balances exceed the insured maximum. At the nation's largest banks, the share of insured deposits is only 56 percent.

As concerns rise about a bank's financial health, those uninsured depositors -- often small businesses -- began to withdraw money. So do investors who regularly move money around in search of the highest yields on certificates of deposit.

"It becomes a self-fulfilling prophecy," said Michael Nix of Greenwood Capital, an investment advisory firm in Greenwood, S.C. "People start hearing about problems at a particular institution, and they start taking out their money."

After Wachovia's fall, concern yesterday shifted to several regional banks with portfolios of bad loans or other financial problems. Shares of Sovereign Bancorp, based in Philadelphia, fell 72 percent. National City, based in Cleveland, fell 63 percent. Fifth Third Bancorp, based in Cincinnati, fell 44 percent.

Bair said the FDIC would continue to deal with troubled institutions as necessary. She said a large number of investors remained interested in banks. And she emphasized that depositors are not at risk. Indeed, each of the FDIC's recent deals has also protected all of the bank's uninsured deposits.

"As the markets become more skittish, financial markets are all about confidence, even the stronger institutions can be subject to traditional runs," Bair said.

"That's the challenge we have now that even the healthier institutions are becoming more susceptible," she said. "To try and maintain that confidence."

Staff writer David Cho contributed to this article.

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