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Investors Flee From Banking Stocks

National City, Wachovia Plummet

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A day after the collapse of the nation's largest thrift, [Washington Mutual](#), investors scurried yesterday from the stocks of [Wachovia](#), National City and other banks with

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large portfolios of troubled loans, as concerns were rekindled that those banks have yet to acknowledge the full extent of their probable losses.

The stock market's major indicators climbed modestly on hopes that Congress will approve a big-dollar bailout for the financial system. The [Dow Jones industrial average](#) gained 121.07 points, or 1.1 percent, to close at 11,143.13, recouping about a third of its losses from earlier in the week.

But that broader confidence did not extend to Wachovia, whose shares lost 27 percent of their value yesterday, or to National City, which was down nearly 26 percent. The combined declines erased about \$10 billion in shareholder value.

Investors also sold off Wachovia's bonds and bought insurance against the possibility of a default on those bonds. The cost of insuring a Wachovia bond against default soared as high as one-third of the value of the bond itself. At these prices, buyers were paying more for the insurance than they would earn from the bond.

Donn Vickrey, co-founder of Gradient Analytics, an independent research firm, said investors are punishing

companies that hold high-risk mortgage loans.

"The ones that are the most vulnerable are the ones that have engaged in the most creative lending," Vickrey said.

Washington Mutual was seized by the government Thursday after depositors withdrew billions of dollars, leaving the Seattle mortgage lender short on cash. Much of the company was immediately sold to [J.P. Morgan Chase](#), but the terms of the sale have frightened investors in other troubled banks.

Commercial banks were previously regarded as unlikely to fail during the current crisis because their ample deposits offer a source of funding even if they cannot borrow from investors.

Now it is clear that a run on those deposits can destabilize even a large bank and that the government will act swiftly to shutter such an institution, putting concerns about the stability of the financial system and the security of deposits above the interests of investors.

In the case of Washington Mutual, shareholders and bondholders are likely to be left empty-handed.

"Now it's clear that you could get wiped out if you invest in the wrong bank," said Ed Fredericks, a finance professor at [Pepperdine University](#). "That's what really rattled the market today. It's the understanding that if Wachovia does go into financial distress, the [FDIC](#) might do the same thing they did with Washington Mutual."

Also, J.P. Morgan immediately marked down the value of Washington Mutual's mortgage-related investments by \$31 billion, suggesting that similar assets at other banks are being held at highly inflated values.

Investors are concerned about Wachovia, the largest bank in the Washington area, because the company owns large numbers of the same kind of loans that crushed Washington Mutual. These "option" mortgages allowed borrowers to pay less than the outstanding balance each month, as on a credit card. It was a disastrous idea. Many borrowers could not afford to make the full payment when they were finally required to do so, and they are now defaulting in droves.

Wachovia bought its way into trouble with the 2006 acquisition of [Golden West Financial](#), which had been one of Washington Mutual's largest rivals. The Charlotte company posted a loss of \$8.9 billion in the second quarter, largely because of the declining value of the Golden West mortgage portfolio, and analysts say that further losses are likely.

Wachovia is a much larger and more diverse company than Washington Mutual, and its executives have emphasized that it remains strong. But the company recently discussed a possible merger with [Morgan Stanley](#).

Wachovia chief executive [Robert Steel](#) sent an e-mail to employees yesterday saying that the company was "aggressively addressing our challenges" and expressed hope that Congress would approve some version of a plan to buy mortgage-related securities from Wachovia and other banks. A spokeswoman said customers are continuing to open bank accounts.

The concern over National City, based in Cleveland, centers on its former role as one of the nation's largest subprime lenders, through its subsidiary [First Franklin](#). National City has sold off the business and shuttered its lending operations in high-risk states such as Florida, where real estate prices are tumbling, but the company retains large quantities of mortgage-related investments.

National City said in April that it would review its options, which is what companies say when they're putting themselves up for sale. But no buyers emerged. While Washington Mutual was prized for its large network of branches in growing areas, National City operates mainly in the Rust Belt, and so even its core banking business is considered less desirable.

The uncertainty surrounding banks continues to freeze the flow of loans between banks.

A measure of the cost of borrowing money from another bank remained at historic highs overnight Thursday. The

London interbank offered rate (LIBOR) showed that banks continue to pay about 3 percentage points more than the federal government to borrow money.

The pricing is prohibitive, forcing banks to curtail lending to customers, experts say.

Banks borrow from one another to meet regulatory requirements that dictate how much money they must keep on hand. The requirement is based on the volume of outstanding loans; banks that cannot reliably borrow from one another at day's end are forced to limit their lending based on the money they already have in hand.

Amiyatosh Purnanandam, a finance professor at the [University of Michigan's Ross School of Business](#), said banks are refusing to lend to one another because they are no longer sure that the money is merely needed to balance the books. They are now plagued by the fear that the borrowing banks simply lack money.

"Are you borrowing money because you are in trouble or because you are smoothing things? Banks cannot tell," Purnanandam said. "And right now, they do not want to take the risk."

In an attempt to keep loans flowing to customers, the [Federal Reserve](#) has opened its vaults to banks that can't borrow from one another, lending out more than \$200 billion last week, a record sum.

The Fed also has tried to make money available to banks in Europe through arrangements with other central banks. Early yesterday morning the Fed said it would increase the amount of money available to European banks to \$290 billion.

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