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Goldman, Morgan Stanley Bring Down Curtain on Wall Street Era
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By Christine Harper and Craig Torres

Sept. 22 (Bloomberg) -- The Wall Street that shaped the financial world for two decades ended last night, when Goldman Sachs Group Inc. and Morgan Stanley concluded there is no future in remaining investment banks now that investors have determined the model is broken.

The Federal Reserve's approval of their bid to become banks ends the ascendancy of the securities firms, 75 years after Congress separated them from deposit-taking lenders, and caps weeks of chaos that sent Lehman Brothers Holdings Inc. into bankruptcy and led to the rushed sale of Merrill Lynch & Co. to Bank of America Corp.

"The decision marks the end of Wall Street as we have known it," said William Isaac, a former chairman of the Federal Deposit Insurance Corp. "It's too bad."

Goldman, whose alumni include Henry Paulson, the Treasury Secretary presiding over a \$700 billion bank bailout, and Morgan Stanley, a product of the 1933 Glass-Steagall Act that cleaved investment and commercial banks, insisted they didn't need to change course, even as their shares plunged and their borrowing costs soared last week.

By then, it was too late. As financial markets gyrated -- the Dow Jones Industrial Average whipsawed 1,000 points in the week's last two days -- and clients defected, executives at the two firms concluded they had no choice. The Federal Reserve Board met at 9 p.m. yesterday and considered applications delivered that day, said Michelle Smith, a spokeswoman for the central bank. The decision was unanimous, she said.

'Blood in Water'

"There's blood in the water in the industry and the sharks are circling," Peter Kovalski, who helps oversee about \$10 billion at Alpine Woods Capital Investors LLC, said at the end of last week. "It all comes down to perception and the current trust within the community."

Wall Street hasn't had such a shakeup since the 1980s, when firms including Morgan Stanley and Bear Stearns Cos. went public and London's financial markets were altered forever with the so-called Big Bang reforms implemented in 1986. Bear Stearns disappeared in March, when it was bought by JPMorgan Chase & Co.

The announcement paves the way for the two New York-based firms, both of which will now be regulated by the Fed, to build their deposit base, potentially through acquisitions. That will allow them to rely more heavily on deposits from retail customers instead of using borrowed money -- the leverage that led to the undoing of Bear Stearns and Lehman.

Morgan Stanley has taken \$15.7 billion of writedowns and losses on mortgage-related securities and other types of loans since the credit crunch started last year. Goldman's tally stands at about \$4.9 billion. While both companies have remained profitable and avoided money-losing quarters suffered by Lehman and Merrill Lynch, their revenue from sales and trading and investment banking have been declining this year.

Depositors Rule

"Deposit-banking is king right now," said David Hendler, an analyst at CreditSights Inc. in New York. "It's the only meaningful critical-mass way to make money."

Morgan Stanley may feel it has more time to contemplate alternatives to the deal that it began to shape last week with Wachovia Corp., said Tony Plath, a finance professor at the University of North Carolina at Charlotte.

``This means Morgan Stanley is reassessing its plan for a merger with Wachovia," Plath said. ``Morgan Stanley is going to try to go it alone, and I expect it will try to buy a bank with a market-to-book ratio that is next to nothing. It means they are walking away from Wachovia."

Morgan Stanley, the second-biggest securities firm until this week, had \$36 billion of deposits and three million retail accounts at the end of August. The company plans to convert its Utah-based industrial bank into a national bank.

`Certainty'

``This new bank holding structure will ensure that Morgan Stanley is in the strongest possible position," Chairman and Chief Executive Officer John Mack, 63, said in a statement last night. ``It also offers the marketplace certainty about the strength of our financial position and our access to funding."

Goldman, the largest and most profitable of the U.S. securities firms, will become the fourth-largest bank holding company. The firm already has more than \$20 billion in customer deposits in two subsidiaries and is creating a new one, GS Bank USA, that will have more than \$150 billion of assets, making it one of the 10 largest banks in the U.S., the firm said in a statement last night. The firm will increase its deposit base ``through acquisitions and organically," Goldman said in a statement last night.

``Goldman Sachs, under Federal Reserve supervision, will be regarded as an even more secure institution with an exceptionally clean balance sheet and a greater diversity of funding sources," Lloyd Blankfein, 54, Goldman's chairman and CEO, said in the statement.

Citigroup, JPMorgan

The Washington-based Fed is the primary regulator of bank- holding companies, which are firms that own or control banks.

Citigroup Inc., Bank of America Corp. and JPMorgan are bank- holding companies regulated by the Fed.

Securities firms, by contrast, had been regulated by the Securities and Exchange Commission. The SEC's future becomes dimmer with the change in Goldman and Morgan Stanley's structures.

``You can't kiss goodbye to the last two important investment banks without noting that the house is empty," said David Becker, a former SEC general counsel who is now a partner at Cleary Gottlieb Steen & Hamilton in Washington. ``It's a downward spiral where the less significant the population you regulate, the less your available resources."

Less Risky

The change is also likely to lead to less risk-taking by the companies and possibly lower pay for their employees. Both Goldman and Morgan Stanley held more than \$20 of assets for every \$1 of shareholder equity, making them dependent on market funding to operate.

Goldman, in particular, has been remarkable for the high bonuses it pays to its employees. Goldman's CEO and two co- presidents were each paid more than \$67 million last year.

``They're going to have to protect their deposit bases by law, and the days of high leverage are gone," said Charles Geisst, a finance professor at Manhattan College in Riverdale, New York, who wrote ``Wall Street: A History." ``The days of the big bonuses are gone."

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--With reporting by Jesse Westbrook and Alison Vekshin in Washington and David Mildeberg in Charlotte. Editors: Alec D.B.

McCabe, Otis Bilodeau.

To contact the reporter on this story:

Christine Harper in New York at +1-212-617-5983 or charper@bloomberg.net.

To contact the editor responsible for this story:

Otis Bilodeau at +1-212-617-3921 or
obilodeau@bloomberg.net.