Breaking News from The Globe and Mail

What Goldman, Morgan gain by switching status

GLOBE AND MAIL UPDATE
MONDAY, SEPTEMBER 22, 2008

The U.S. central bank has approved the conversion of Morgan Stanley and Goldman Sachs Group Inc., the last two major U.S. independent investment dealers, into traditional bank holding companies. Reporter John Partridge looks at some of the issues.

What are the key advantages of such a move for the two Wall Street legends?

Many news reports have focused on the fact that the change in status will allow Morgan Stanley and Goldman to tap into more stable and less costly sources of capital, in the form of customer deposits instead of the bond market, while also being able to borrow more readily from the Federal Reserve.

On the other side of the coin, they will be subject to much tighter regulatory oversight and capital requirements.

Instead of being able to invest $25 or $30 for every $1 of capital they have, they will, over time, be cut back to much more conservative levels. For instance, Bank of America, which is buying former independent Merrill Lynch, has under $10 in assets for every $1 of capital.

Still, Campbell Harvey, a professor of finance at Duke University in Durham, N.C., notes that building a deposit base and reducing leverage are not going to happen overnight. He figures the single most important and immediate change facing the two firms is on the accounting front.

Specifically, they will no longer have to apply what's called “mark-to-market” accounting to their financial statements: That is, valuing every investment and position on their books – including the real-estate-related securities and derivatives that have sent investors scurrying for shelter –based on the current market price.

Instead, Prof. Harvey said in a telephone interview, like commercial banks they will be able to classify these positions as “held for investment.”

Why is this important?

“The key thing is that it buys them some time to unwind these illiquid assets,” he said, adding that this means there will not be “just a massive fire sale of stuff.”

What is the other side of the coin?

According to Prof. Harvey, if U.S. commercial banks were suddenly required to start using mark-to-market accounting to their books, many of them would prove to be way under water. “I'm not talking 10 or a hundred, but maybe a thousand [banks],” he said.

Is there a downside to the change in status for Morgan Stanley and Goldman, long the most highly regarded as well as the largest of the independents?

Prof. Harvey thinks so.

“The success of the U.S. economy has been its ability to fund high risk, highly innovative ideas, and the traditional investment banks were free-wheeling and willing to take on high-risk, high-expected payoff projects,” he said.

But the new capital requirements, leverage restrictions and heavier degree of regulation means Goldman and Morgan Stanley will not be able to take on the same degree of risk.

“While we might not see another financial crisis, it will likely change the character of U.S. business going forward,” he said.

Is the change in status out of step with the rest of the world?

No. In fact, the United States has been the anomaly in still having major independent investment banks, according to Lawrence Booth, a finance professor at the University of Toronto's Rotman School of Management. In just about every other country in the world, including Canada, investment banks are part of major chartered or commercial banks, with access to big deposit bases.

“We went through all of this 20 years ago, when CIBC bought Wood Gundy, the Royal bought Dominion, Scotia bought McLeod Young Weir, BMO bought Nesbitt Burns and TD bought a bunch of smaller investment bankers,” Prof. Booth said in a telephone interview.