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Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis

End of Traditional Investment Banking, as Storied Firms Face Closer Supervision and Stringent New Capital Requirements

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The Federal Reserve, in an attempt to prevent the crisis on Wall Street from infecting its two premier institutions, took the extraordinary measure on Sunday night of agreeing to convert investment banks Morgan Stanley and Goldman Sachs Group Inc. into traditional bank holding companies.

With the move, Wall Street as it has long been known -- a coterie of independent brokerage firms that buy and sell securities, advise clients and are less regulated than old-fashioned banks -- will cease to exist. Wall Street's two most prestigious institutions will come under the close supervision of national bank regulators, subjecting them to new capital requirements, additional oversight, and far less profitability than they have historically enjoyed.

Already, the biggest rivals of Goldman Sachs and Morgan Stanley -- Merrill Lynch & Co., Lehman Brothers and Bear Stearns Cos. -- have merged into larger banks or sought bankruptcy protection.

"This fundamentally alters the landscape," a Goldman Sachs spokesman said Sunday night. "By becoming a bank holding company and being regulated by the Federal Reserve, we have directly addressed issues that have become of mounting concern to market participants in recent weeks."

The rapid pace of change in recent weeks highlights the severity of the financial crisis, and suggests it is deeper than many on Wall Street were willing to admit. Some investors may view the move as a negative signal, for it suggests that Goldman and Morgan Stanley, two institutions who were once considered rock solid, may have been facing greater liquidity issues than was apparent.

Becoming a bank holding company can help both Morgan Stanley and Goldman organize their assets, and puts both in a much better position to be acquired, to merge or to acquire smaller companies with insured deposits. It also may allow Goldman and Morgan Stanley to avoid using of mark-to-market accounting --

which forces companies to value their assets based on the current market price. Instead, these firm may be able to classify assets as "held for investment," as many banks do.

The huge banking firms that have so far survived the credit-market turmoil -- Citigroup Inc., Bank of America Corp., J.P. Morgan Chase & Co., Wachovia Corp. and Wells Fargo & Co. -- each have bank holding companies overseen by the Fed, and national bank charters supervised by the Treasury Department's Office of the Comptroller of the Currency. They can count on their huge deposit bases to serve as an alternative source of funding to other, more unpredictable, liquidity sources.

"The Fed wanted to send a strong statement that they would not allow Goldman and Morgan Stanley to be 'Lehman-ized,'" said a person familiar with the discussions, referring to the bankruptcy of Lehman.

In the short term, the agreement with federal regulators is likely to place on hold Morgan Stanley's talks to merge with Wachovia Corp., the Charlotte, N.C.-based banking powerhouse.

As a bank-holding company, Goldman Sachs would become the fourth-largest such company in the U.S., behind Bank of America, J.P. Morgan Chase & Co. and Citigroup.

Morgan Stanley officials have been talking about this option internally for several months, and Fed officials have been stationed at the bank since the crisis intensified earlier this year. After last week's market crisis, Morgan Stanley officials asked the Fed to speed up its review and grant the bank designation sooner. "It became clear that the world had changed," said Morgan Stanley spokeswoman Jeanmarie McFadden.

She said that the firm would reduce its leverage ratios -- a measure of a firm's risk in relation to the equity on its balance sheet -- over the next few years from current levels to something more in line with that at commercial banks. Investment bank ratios now stand above 20, with commercial banks closer to 10.

The Fed said it would also extend additional lending to the broker-dealer arms of the two firms, as well as to that of Merrill Lynch, as they make the transition. The steps effectively mark the end of Wall Street as it's been known for decades. It also formalizes a quid-pro-quo that regulators have warned about in the months after Bear Stearns's near collapse -- that in return for access to the Fed's emergency lending facilities, the firms would need to subject themselves to more oversight.

The conversions of Goldman Sachs and Morgan Stanley to bank holding companies could deal a blow to Treasury Secretary Henry Paulson, who had tried to preserve the existing structure of financial institutions over the past several weeks. Now, the parent companies of almost all major U.S. financial institutions will be overseen by the Federal Reserve. Sunday night's development also further expedites the ascendancy of the Fed as universal supervisor, as it now has even more direct authority over nearly all big financial companies in the country.

These actions "constitute a powerful statement by the Federal Reserve as to its views on the safety and soundness of these institutions," said H. Rodgin Cohen, chairman of the Sullivan & Cromwell law firm and a top adviser to financial institutions.

Instead of being overseen just by the Securities and Exchange Commission, Goldman Sachs and Morgan Stanley will now face much stricter oversight from numerous federal agencies. The Federal Reserve will regulate the parent companies, the Comptroller of the Currency will oversee the national bank charters, and the Federal Deposit Insurance Corp. will likely play a bigger role because the companies are expected to seek much higher volumes of federally backed deposits.

It had become increasingly clear to Fed officials in recent days that the investment-banking model couldn't function in these markets. Investment banks depend on short-term money markets to fund themselves, but that had become increasingly difficult, particularly in the wake of the collapse of Lehman Brothers. As bank holding companies, Morgan Stanley and Goldman Sachs will be allowed to take customer deposits, potentially a more stable source of funding.

Officials held a series of talks with Morgan Stanley and Goldman Sachs executives over the weekend. While Fed Chairman Ben Bernanke stayed in Washington for meetings on Capitol Hill about the government's plan to buy hundreds of billions of dollars of distressed assets, Timothy Geithner, president of the Federal Reserve Bank of New York, and Kevin Warsh, a Fed governor and former Morgan Stanley executive, worked in New York to sort out the details with Goldman and Morgan Stanley.

Officials had become more alarmed about the positions of both firms as their share prices continued to fall in recent days. One person involved in the talks said last week's bankruptcy filing by Lehman Brothers, and Merrill Lynch's agreement to be sold to Bank of America Corp., served as a wakeup call to the two investment banks. One person involved in the talks said the two firms had been flirting with the idea of becoming bank holding companies for some time, and that took on a new urgency in recent weeks.

Morgan Stanley Chief Executive John Mack engaged in serious discussions with

Wachovia Corp., whose new CEO, Robert Steel, recently left a top post at the Treasury Department to take the reins of the regional banking powerhouse.

Goldman -- and to a lesser extent, Morgan Stanley -- has maneuvered through the credit crisis better than other investment banks. But its business model, which relies on short-term funding, is under attack. Some stockholders worry that its strategy of making big investments with borrowed money will go wrong someday, which would make it more difficult for the firm to get favorable borrowing terms. Such problems could also prompt the firm's clients, including big hedge funds, to move their assets to other banks, including larger commercial players.

To many analysts and investors, Morgan Stanley and Goldman still depend too much on leverage, or the use of borrowed money, and don't set aside enough cash against the bets they make on everything from commercial mortgages to non-U.S. stocks.

"They've been so close to a near-death experience, something needs to change," says Glenn Schorr, a brokerage-industry analyst at UBS. Surviving as independent companies is possible only if their business models become less risky, he adds.

Lots of commercial banks also blundered on risky mortgages, including Citigroup, UBS AG and Wachovia. Their salvation has been their size and their ho-hum source of reliable funding -- bank deposits.

Goldman has expressed wariness about joining up with a big commercial bank. When asked about the idea on a conference call Tuesday, the firm's chief financial officer, David Viniar, downplayed the attractiveness of the idea. "It is not the business model, it is the performance that matters," he said.

The most fundamental problem is how to generate profit growth in a world that no longer tolerates high leverage. At Merrill Lynch, the leverage ratio soared to 28 last year, from 15 in 2003, according to UBS. Morgan Stanley's leverage ratio climbed to 33, while Goldman's hit 28.

When markets were booming, borrowed money fueled record earnings. Investors showed few signs of concern. The ugly flip side of leverage is now obvious, and massive write-downs have shattered confidence in Wall Street's risk-management machinery.

Morgan Stanley and Goldman have been taking steps to reduce their leverage, but that hasn't been easy in a market where prices are dropping for many assets. It has proved difficult to find buyers for many distressed real-estate assets.

In contrast, Bank of America and Wachovia had leverage ratios of 11 as of the second quarter, less than half the average of the four big investment banks. The profit upside isn't as high as it is on Wall Street, but the downside isn't as steep. If a bank loses $1 billion on a loan, it has twice the capital an investment bank might have to absorb it.

The ascendancy of commercial banks largely reflects their use of customer deposits to fund much of their business. Retail depositors tend not to yank their money out, even in turbulent times, thanks to backing by federal deposit insurance. Even at Washington Mutual Inc., a Seattle thrift-holding company battered by mortgage losses, deposit levels are basically unchanged so far this year.

Still, plain-vanilla banking isn't a cure-all for what ails Wall Street. Commercial banks also run securities units that are highly leveraged and that have little to do with bank deposits. Also, the track record of so-called financial supermarkets such as Citigroup is so-so.

"It's not obvious that there's a clear economic benefit" to investment banks merging with commercial banks, says Campbell Harvey, a finance professor at Duke University.

—Dan Fitzpatrick and Deborah Solomon contributed to this article.

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