Investment Banks Search for Partners

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

Goldman and Morgan Stanley have insisted in recent weeks they can go it alone. Yet Morgan Stanley Chief Executive John Mack was rattled enough last week that he entered merger talks with Wachovia, a commercial bank that is being pounded by problems related to its own adjustable-rate-mortgage portfolio.

On Wednesday, as Morgan Stanley shares were falling sharply, Mr. Mack fielded a call from Wachovia Chief Executive Robert Steel. Before he took the Wachovia job in July, Mr. Steel had worked as a senior official under Treasury Secretary Henry Paulson, which put him in the middle of the government's response to the credit crisis. Mr. Steel broached the idea with Mr. Mack of a potential tie-up between the two firms.

Morgan Stanley also reached out to U.S. Bancorp, another regional banking powerhouse, although the two sides only had the briefest of discussions, according to one person familiar with the matter.

The most fundamental problem is how to generate profit growth in a world that no longer tolerates high leverage on Wall Street. At Merrill Lynch, the leverage ratio—a measure of a firm's risk in relation to the equity on its balance sheet—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 proven difficult to find buyers for many distressed real-estate assets.

In contrast, Bank of America Corp. 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.

> *'They've been so close to a near-death experience, something needs to change.'*

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.

For Morgan Stanley, one of the biggest issues to sort out in its discussions with Wachovia is the bank's $122 billion adjustable-rate home-loan portfolio, which Wachovia inherited through its 2006 purchase of Golden West Financial Corp. The portfolio includes 448,000 loans, of which 58% are in California and 10% in Florida, two of the hardest-hit areas in the real-estate slump. Wachovia has predicted that losses on the loan pool could reach 12%, and some analysts fear even steeper losses.

Under Mr. Steel, its chief executive, Wachovia has created a distressed-asset resolution team to work through the loans, refinance what it can, and perhaps sell those it can't. What happens to those loans is one sticking point in a potential deal with Morgan Stanley, and could ultimately kill it, according to people familiar with the matter.

Analysts also wonder how well Morgan Stanley's blue-blood tradition would mesh with Wachovia's Southern roots and patchwork structure of brokers and financial advisers. Wachovia's brokerage unit is the product of a series of deals, most recently last year's purchase of St. Louis brokerage house A.G. Edwards & Sons Inc. Prudential Financial Inc. has a minority stake in the bank's brokerage unit, created in a joint venture in 2003.

—Dan Fitzpatrick and Deborah Solomon contributed to this article.