Financial Institutions

E-ALERT

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Federal Reserve Approves Goldman Sachs and Morgan Stanley Applications to Become Bank Holding Companies

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On September 21, 2008, the Federal Reserve Board approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies. Both investment banks currently own depository institutions that do not constitute "banks" for purposes of the Bank Holding Company Act. By converting these institutions into full service commercial banks, Goldman Sachs and Morgan Stanley will become bank holding companies subject to ongoing Federal Reserve oversight.

In connection with the Federal Reserve's approval of Goldman Sachs' and Morgan Stanley's applications, the Federal Reserve authorized the Federal Reserve Bank of New York to extend credit to the U.S. broker-dealer subsidiaries of the two investment banks to provide increased liquidity support as they transition to managing their funding within a bank holding company structure. Also, shortly after the Federal Reserve's announcement of its approval of the investment banks' applications, Morgan Stanley and the Japanese banking group Mitsubishi UFJ Financial Group announced that they had entered into a letter of intent to pursue a "strategic alliance" that would include an investment by Mitsubishi in Morgan Stanley that would eventually represent a 20 percent interest of Morgan Stanley's equity on a fully diluted basis.[1]

Goldman Sachs and Morgan Stanley's move to a bank holding company structure has implications for investors, depository institutions, and customers. The following is a brief overview of the benefits and costs of the bank holding company structure for the two firms.

Benefits of the Bank Holding Company Structure

- Goldman Sachs and Morgan Stanley, through their new full-service commercial bank subsidiaries, will be able to develop substantial bank deposit bases to augment their existing funding mechanisms.

- Goldman Sachs and Morgan Stanley will have expanded funding support from the Federal Reserve through the Federal Reserve Bank of New York.

- Goldman Sachs and Morgan Stanley will now be able to acquire and control additional U.S. banks and bank holding companies, subject to the Federal Reserve's approval, as attractive opportunities present themselves.

- Goldman Sachs and Morgan Stanley will presumably join the Federal Reserve's internal list of banking organizations that are "too big to fail" (if they did not already have that status in some form).

[1] The letter of intent is nonbinding and subject to definitive documentation and due diligence. Completion of the transaction also is subject to regulatory approvals.

Costs of the Bank Holding Company Structure

- Goldman Sachs and Morgan Stanley, and all of their subsidiaries, will become subject to the restrictions on non-banking activities under section 4 of the Bank Holding Company Act. Section 4 of the Bank Holding Company Act (BHCA) prohibits bank holding companies from engaging in activities other than banking, managing or controlling banks and other subsidiaries, and furnishing services to or performing services for its subsidiaries, and activities that have been deemed by the Federal Reserve to be closely related to banking. In addition, both organizations will elect financial holding company status. Assuming they qualify as financial holding companies, both organizations will be permitted to conduct, in addition to the foregoing activities, non-banking activities that are financial in nature, incidental to a financial activity, or complementary to a financial activity. Both organizations will initially have two years to bring their existing activities and investments into compliance with these and other BHCA restrictions. The Board can grant up to three one-year extensions of this statutory two-year compliance period.

- Goldman Sachs and Morgan Stanley will become subject to the Federal Reserve's detailed capital adequacy guidelines, which include both risk-adjusted and leverage capital adequacy ratio standards.

- Goldman Sachs and Morgan Stanley will become subject to ongoing Federal Reserve supervision and regulation, including examinations and reporting requirements. The Federal Reserve will have the power to enforce its requirements on the investment banks through a variety of enforcement mechanisms, including cease and desist orders, civil money penalties, and prohibition orders.

- Goldman Sachs and Morgan Stanley will become subject to the Federal Reserve's "source of strength" doctrine. The source of strength doctrine is a Federal Reserve expectation and quasi-requirement that bank holding companies serve as a source of financial strength to its insured bank subsidiaries.

Attorneys in Covington's Financial Institutions Group have advised many clients on bank holding company issues. The Financial Institutions Group's expertise with respect to bank holding company issues derives from advising clients on bank acquisitions and investments over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our financial institutions practice group:

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