



Updated New York, Sep 11 08:03

## Wall Street Credit Costs Soar on Spread to U.S. Rates (Update2)

By Christine Harper



[+ Enlarge/Details](#)

Sept. 10 (Bloomberg) -- Wall Street is getting no benefit from the biggest bond market rally in five years.

Lehman Brothers Holdings Inc. faces higher borrowing costs today than it did in June, even after the steepest quarterly drop in U.S. Treasury yields since 2002 pushed interest rates down for everyone from Procter & Gamble Co. to AT&T Inc. Investors are so leery of Bear Stearns Cos. that its 10-year bonds trade at a discount to Colombia, the South American nation that's barely investment grade. Goldman Sachs Group Inc. is being punished with a higher yield than Caterpillar Inc., the heavy-equipment maker.

Bond buyers view the nation's largest securities firms as no safer than taking a flier on subprime mortgages. That's a nightmare scenario for the industry's chief executive officers, who relied on cheap financing for leveraged buyouts, real estate lending and proprietary trading to produce record profits -- and paychecks of \$40 million or more for themselves.

``There are so many unknowns, the doubt component is causing the rise in yields," said William Larkin, a fixed-income portfolio manager at Cabot Money Management in Salem, Massachusetts. ``It's crazy when you think about it, Lehman versus the country of Colombia."

Contagion from the highest delinquency rate on U.S. mortgages in five years is paralyzing some of Wall Street's most lucrative enterprises.

Job Cuts

Sales of U.S. asset-backed securities, such as bonds that repackage subprime loans or credit card receivables as well as collateralized debt obligations, fell 73 percent from a year earlier to \$30 billion last month, according to Deutsche Bank AG, Germany's biggest bank.

As mortgage applications drop, Lehman, the biggest underwriter of bonds backed by home loans, is retrenching. The New York-based firm plans to cut more than 2,000 jobs as it scales back mortgage lending at home as well as in the U.K. and South Korea. Countrywide Financial Corp., the largest U.S. mortgage lender, said Sept. 7 that it will eliminate as many as 12,000 positions in the next three months.

The five largest U.S. securities firms -- Goldman, Morgan Stanley, Merrill Lynch & Co., Lehman and Bear Stearns -- will have to fund \$75 billion of loan commitments to LBOs at a loss because most investors have stopped buying that kind of debt, Citigroup Inc. analyst Prashant Bhatia estimated last month.

### Third-Quarter Earnings

Of the group, only Goldman is likely to report an increase in third-quarter earnings when it releases results next week, according to a Bloomberg survey of analysts. Morgan Stanley, Lehman and Bear Stearns probably will say profit fell in the three months that ended in August, the survey shows. Merrill reports in October. All five companies are based in New York.

“They have been, to their ruin in some cases, borrowing short and investing long,” said Jim Cusser, who helps manage \$1.5 billion in fixed-income investments at Waddell & Reed Inc. in Overland Park, Kansas. “Now they're regretting that, because what they put their money into isn't panning out.”

Keefe, Bruyette & Woods Inc. analyst Lauren Smith cut her price targets for Lehman, Morgan Stanley, Bear Stearns and Goldman today because widening risk premiums on company bonds have slowed borrowing and stalled buyouts.

Standard & Poor's said less than a year ago that Lehman continued to merit an A+ credit rating because of its “exceptional liquidity, strong cost controls and excellent risk management.”

Lehman went on to earn more than \$150,000 per employee in 2006 and pay Chief Executive Officer Richard Fuld \$40.5 million.

### Lehman Versus Colombia

Today, bond yields show that Lehman is considered riskier than Colombia, where the government has been waging a four-decade war with drug-funded rebels and one in 10 members of the workforce is unemployed. Colombia is rated BBB- by S&P, the lowest investment-grade rating, and carries a Ba2 junk rating from Moody's Investor's Service.

Lehman's A-rated subordinated notes due in 2017 yielded 6.66 percent on Sept. 5, according to trades of more than \$1 million on NASD's Trace system. The same day, Colombia's senior debt maturing the same year, though rated four levels lower, was at 6.47 percent. Bear Stearns's

subordinated bonds maturing in 2017 also should command a premium over Colombia by virtue of their A rating, yet they trade at an even bigger discount.

While securities firms, including Lehman, can compensate for declining revenue by cutting jobs, they have less control over credit costs.

### Dismissing Bear Stearns

Investors dismissed Bear Stearns's corporate A+ rating when it sold \$2.25 billion of five-year notes in August, after two of the firm's hedge funds collapsed because of bad bets on subprime mortgages. They demanded a near-junk yield 2.45 percentage points higher than the comparable Treasury, four times the risk premium Bear Stearns paid on a similar sale in January.

When Goldman raised \$2.5 billion of senior 10-year debt on Aug. 30, bond buyers considered it little better than a BBB borrower, even though the firm has a AA- rating. Goldman paid a premium, or spread, of 1.67 percentage points to sell the bonds, almost double what it cost the firm for a lower-rated subordinated issue in January.

Just six days later, Caterpillar sold 10-year bonds rated two levels lower at a spread of 130 basis points. The gap between them has since widened from 37 to 42 basis points.

### Spread Explosion

The explosion in credit spreads on Wall Street may take an even heavier toll on profit next year, when the five firms have almost \$133 billion of bonds maturing, according to data compiled by Bloomberg. Bond indexes maintained by Merrill show that the cost of refinancing that debt has swelled by about \$1.3 billion since the beginning of 2007, excluding the cushioning effect of any interest-rate hedges.

“Any securities firm is an institution that requires access to capital to fund itself,” said Mitch Stapley, who helps manage \$12.7 billion at Fifth Third Asset Management in Grand Rapids, Michigan. Wider spreads “will impact their profitability,” he said.

Goldman is the only firm to have distributed its refinancing obligations so there's no outsized amount of debt coming due in a single year.

Merrill has \$42 billion of bonds maturing next year, the most on Wall Street and about 50 percent more than in 2009. Morgan Stanley is next at \$34 billion.

“It has always been a competitive advantage for Wall Street firms to have a lower cost of capital,” said Roy Smith, a finance professor at New York University and former partner at Goldman. “Right now Lehman might be a little pressed. If Goldman and Morgan Stanley are doing better, that gives them a comparative advantage.”

### More Leverage

The securities industry has relied increasingly on borrowed money to boost profits and returns for investors. In the first quarter, Goldman had 24.7 times more in assets than it had in shareholders' equity, and the firm's return on the tangible portion of that capital was 44.7 percent. Five years earlier, in the first quarter of 2002, the leverage ratio was 16.8 and return on equity was 15.4 percent.

Goldman CEO Lloyd Blankfein, who led the firm to a Wall Street record \$9.54 billion in earnings last year, said in June that low interest rates and easy credit helped fuel the five-year boom in real estate, LBOs and emerging-market investments. He also warned them what to expect when spreads widen.

### Unraveling Wealth

You'd see ``a lot of that wealth, which was created over the years, unravel very quickly," he said at a June 27 conference at the New York Stock Exchange. ``You wouldn't enjoy that."

Blankfein, 52, was paid \$54 million last year. James Owens, Caterpillar's 61-year-old chief executive officer, earned \$14.8 million.

Following are 10-year bond yields for each of the five largest Wall Street firms as of Sept. 7, according to trades of more than \$1 million on Trace. The yield for Lehman is as of Sept. 5.

Yields on senior and subordinated debt aren't comparable.

Goldman Sachs 6.25% senior notes due 9/2017:	6.040%
Morgan Stanley 5.45% senior notes due 1/2017:	5.926%
Goldman Sachs 5.625% subordinated notes due 1/2017:	6.167%
Merrill Lynch 5.7% subordinated notes due 5/2017:	6.110%
Lehman Bros 5.75% subordinated notes due 1/2017:	6.658%
Bear Stearns 5.55% subordinated notes due 1/2017:	6.720%

To contact the reporter on this story: Christine Harper in New York at [charper@bloomberg.net](mailto:charper@bloomberg.net) .

*Last Updated: September 10, 2007 11:30 EDT*