The Repeal of the Glass Steagall Act

How deregulation changed the banking culture in financial market

Table of Contents

Introduction to the Glass Steagall Act Repeal

The Glass-Steagall Act (GSA), officially known as the Banking Act of 1933, was a significant piece of financial regulation in US history. It was enacted in response to the Great Depression and the widespread failure of banks, with the aim of preventing another financial crisis. The act created a clear separation between commercial banking and investment banking activities. Commercial banks were limited to taking deposits and making loans, while investment banks were restricted to underwriting securities and engaging in other high-risk activities.

One of the main reasons for the enactment of Glass-Steagall was to prevent banks from engaging in risky practices that could put customers' deposits at risk. During the 1920s, many banks had speculated on the stock market with their customers' money, which led to widespread financial instability when the market crashed in 1929. Another reason for the enactment of the act was the perception that some banks were taking risks with their customers' money while others were not. This led to a sense of unfairness and distrust towards the banking industry, which helped to fuel the political momentum behind the act.

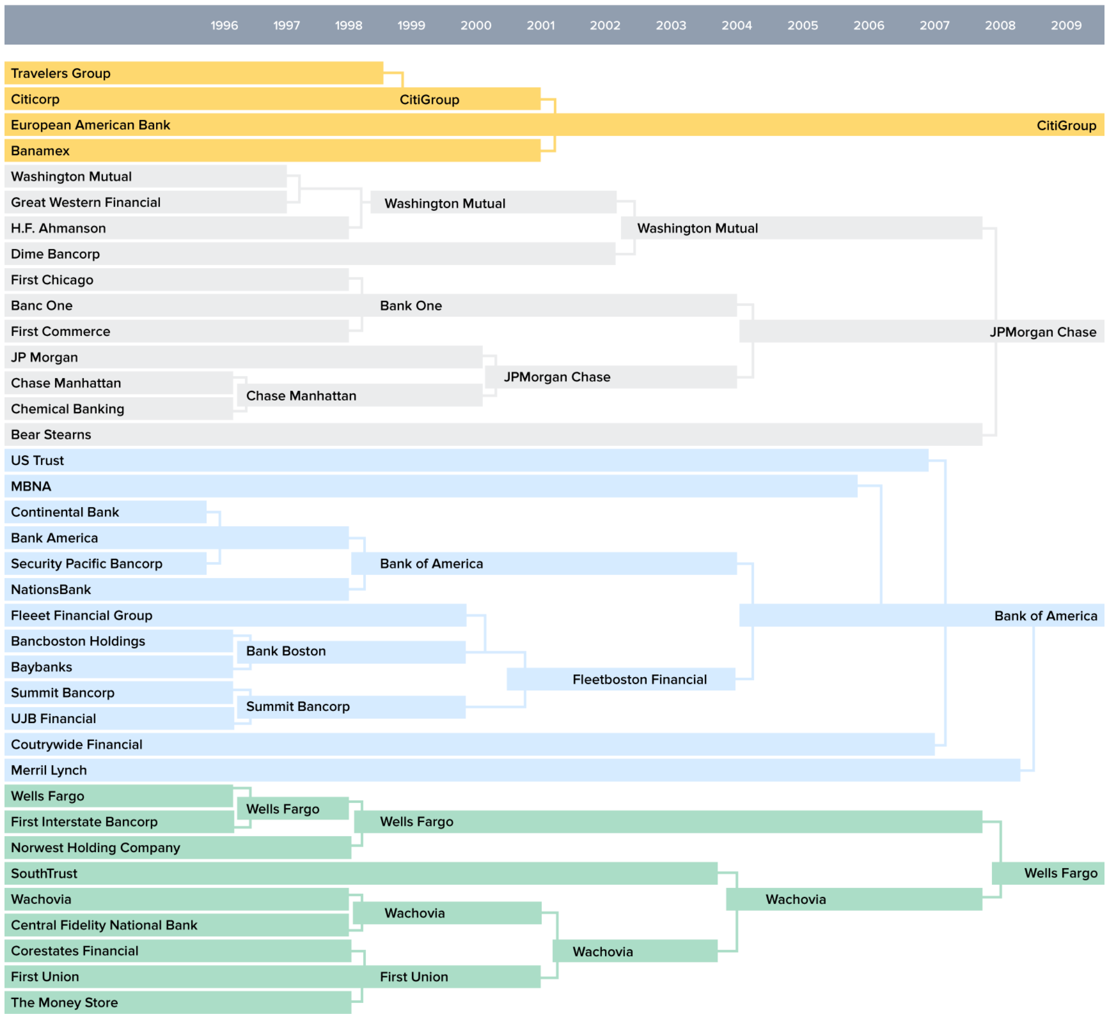
Glass-Steagall remained in place for several decades and was seen as a cornerstone of the US banking system. However, in the 1980s and 1990s, banks began to lobby for its repeal, arguing that it was outdated and prevented them from competing on a level playing field with foreign banks. The banking industry claimed that the separation of commercial and investment banking activities was no longer necessary, as banks had become more sophisticated in their risk management and compliance practices. In 1999, Congress passed the Gramm-Leach-Bliley Act, which repealed the Glass-Steagall Act. The repeal was widely supported by the banking industry, but it was also controversial. Supporters of the repeal argued that it would create more competition in the banking industry, leading to lower costs for consumers and greater innovation. However, opponents argued that it would lead to greater risk-taking by banks and increase the likelihood of another financial crisis.

Direct Consequences of the Glass Steagall Act Repeal

The repeal of Glass-Steagall had a significant impact on the banking industry. Prior to the repeal, banks were required to choose between being a commercial bank or an investment bank, but now, banks were able to engage in a wide range of financial activities that were previously prohibited. This led to a wave of mergers and acquisitions as banks sought to expand their operations and take advantage of the new regulatory environment.

One of the most notable mergers that occurred after the repeal was the merger of Citibank and Travelers Group in 1998 . The merger created Citigroup, one of the largest financial institutions in the world. Citigroup was seen as a major beneficiary of the repeal of Glass-Steagall, as it was able to merge its commercial banking operations with its investment banking activities. The merger between Citibank and Travelers Group was controversial at the time, as many critics argued that it was illegal under the Glass-Steagall Act.. The merger was seen as a major victory for the banking industry and a sign that the era of Glass-Steagall was over. Citigroup continued to expand its operations afterwards acquiring numerous other financial institutions and engaging in a wide range of financial activities.

Figure 1. Mergers and acquisitions after the GSA repeal.



Source: Bettermarkets.com

The repeal of Glass-Steagall also had a significant impact on the regulation of the banking industry. Prior to the repeal, the Federal Reserve was responsible for regulating commercial banks, while the Securities and Exchange Commission was responsible for regulating investment banks. Afterwards, the regulatory landscape changed, with the creation of a new regulatory framework that was more complex and required greater coordination between multiple agencies.

Overall, the repeal of Glass-Steagall was a significant moment in US financial history, with long-lasting effects on the banking industry and the regulatory landscape. While the repeal was controversial, it was supported by the banking industry and seen as a way to promote greater competition and innovation in the industry. However, the consequences of the repeal remain a subject of debate and continue to shape the ongoing discussion around financial regulation in the US.

Implications of the Repeal on the 2008 Financial Crisis

The repeal of Glass-Steagall has been cited as one of the factors that contributed to the financial crisis of 2008. Critics argue that the repeal allowed banks to engage in risky activities that contributed to the creation of risky mortgage backed securities. Due to the complexity of the crisis it is difficult to pinpoint the exact contribution that the act repeal had, however, certain conclusions can be drawn.

First of all, one of the major determinants of the financial crisis was the crash of the housing market: following an unprecedented rise in the housing prices between 1998 and 2006. A major factor in the housing boom was the growth of subprime mortgage loans and the low lending standards. A large majority of the mortgages were given out to individuals which did not qualify for prime loans: doubling the percentage of borrowers who defaulted on their mortgages from 2006 to late 2007.

Some argue that the repeal led to a decline in the underwriting lending standards. The act contained provisions which controlled potential abuses of universal banks. Following the deregulation universal banks aimed to establish a market share in the securities market by lowering underwriting standards. Even though the Glass Steagall act had no direct provisions for regulating loan qualification standards, the lack of regulation provided opportunities for universal banks to engage in more risky loans. Empirical analysis conducted by the European Central Bank showed that the default rates contained in securities in universal banks were significantly higher than those issued by investment companies, clearly illustrating evidence of underestimating default risk.

Secondly, following the repeal investment culture swept into commercial banks. Without a clear division between commercial and investment activities within banks, many universal banks prioritized investment activity. With new possibilities and lack of regulation, behavior of banks changed: hoping to get a share of the securities market, they engaged in risky lending behavior with excessive leverage. There was a major demand for high returns fast, that could only be achieved through high leverage and high risk taking. According to Nobel prize winner Joseph Stiglitz the crisis was “largely a result of misguided incentives unrestrained by good regulation.” After allowing commercial and investment banks to come together, “investment bank culture came out on top.”

Lastly, another major topic of discussion related to the Glass-Steagall act and the 2008 crisis is the contribution of the repeal to the “too-big-to-fail” (TBTF) mindset. Following the repeal of the act, the US baking sector embarked on a period of mega-mergers. It changed the structure of the US financial sector: the new six largest banks grew their assets from 20% of GDP in 1997 to more than 60% of GDP in 2008. Since the financial institutions controlled so many assets, they expected to receive assistance in case of excessive trouble. As a result the institutions took on more risk than desirable, expecting to be saved if anything were to go wrong.

Moreover, the failure or near-failure of TBTF institutions highly disrupted financial markets. Due to the fact they control so many assets, a failure of a large institution significantly impacted consumer confidence: led to bank runs, impeded credit flows, and induced sharp decline in asset prices. One of the huge financial conglomerates, Citigroup, required one of the largest financial bailouts in history, of 476.2 billion in funding. Following its merger, Citi engaged in highly risky behavior and became the second largest underwriter of securities based on subprime mortgages in 2006. Due to its TBTF mindset, Citi knew that their failure would leave the financial market in shambles, inducing them to engage in even riskier behavior.

The repeal of the GSA and general deregulation of the financial market contributed to the 2008 financial market. It allowed for investment culture to take over the banking system, contributed to the TBTF mindset, and led to a decline in underwriting lending standards.

However, some critics argue that the repeal of GSA had little to no contribution to the financial crisis, and that other factors played a much more significant role. First of all, the Glass Steagall Act was never intended to address or regulate loan qualification standards. The provisions on the act solely focused on separating the commercial and investment banking activities. The banking system was always exposed to high default rates in residential mortgages, even when the act was in place. The act limited investment activities but it did not address securitizing mortgages or underwriting standards that caused the housing boom of the early 2000s.

Secondly, to counter the argument that the deregulation led to mass-mergers and excessive risk taking by TBTF financial conglomerates, not all of the institutions that failed were regulated by the act. Failures of banks such as Lehman Brothers, Bear Stearns, and Merrill Lynch, considered as the very illustrations of the crisis of the financial system, would not have been changed by the Glass-Steagall Act. These banks can be considered as pure investment banks as they were not correlated with their links with commercial banks.

Moreover, the repeal of the act actually contributed to the rescue of many large institutions after the crisis, which would not be possible if the act was still in place. Large institutions rising from the wave of mega-mergers such as JP Morgan or Bank of America rescued banks such as Bear Stearns and Merrill Lynch.

Overall, the repeal of the GSA did not directly contribute to the financial crisis of 2008; the provisions written in the articles did not address loan qualifications standards or securitization of loans which were at the heart of the crisis. However, the deregulation of the market led to a change in behavior and incentives of big banks. Investment culture and demand for high gains swept the market leading to large risk taking and excessive leverage. The lack of solid regulation resulted in uncontrolled risky investment behavior and a crash of the financial markets.

Implications of the Repeal on the Current Financial Situation

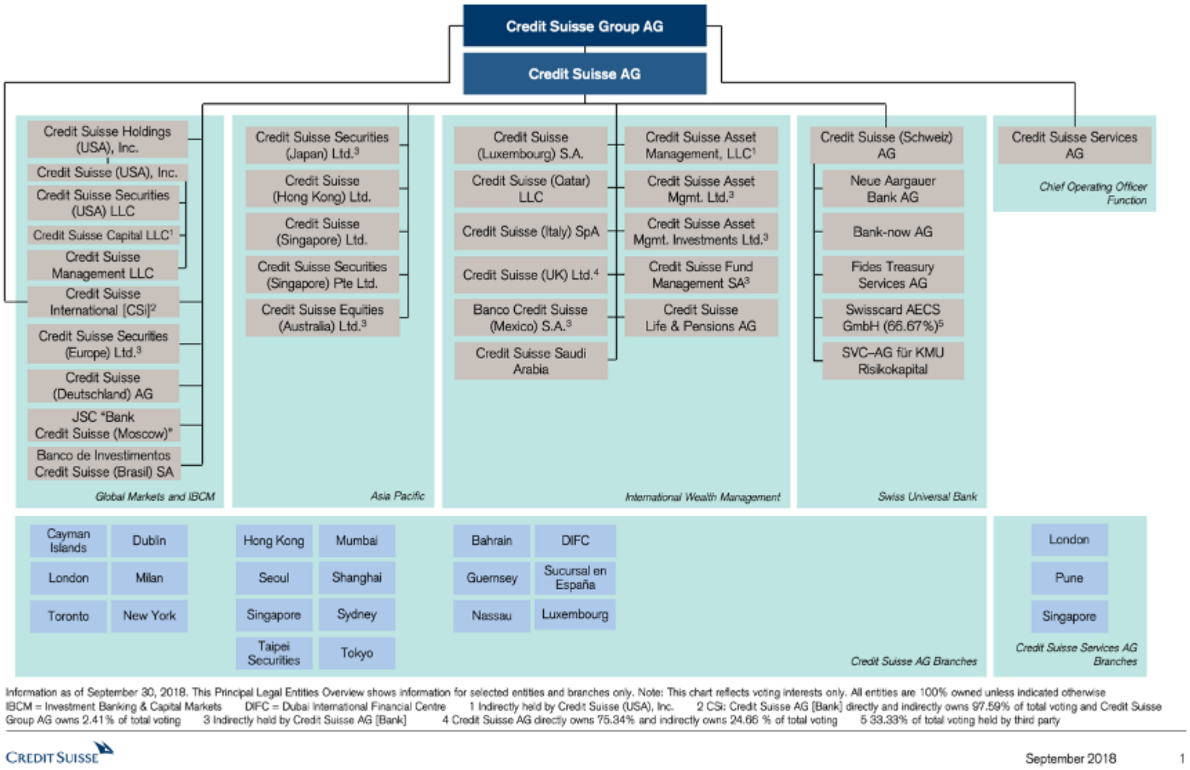
March 2023 will go down in history as a disastrous month for the global finance industry with the consecutive collapses of the Silicon Valley Bank and First Republic Bank, followed by the 166-year-old Credit Suisse. Although these "too-big-to-fail" banks failed for various reasons, all of them led professionals to ask the same question: "How would better regulatory authorities could have prevented the banking turmoil?" To understand, we must deeply dive into the underlying reasons for the recent bank failures.

Bank failures are generally caused by decreased confidence in the liquidity levels of financial institutions. When investors sense that the bank lacks liquidity, they tend to withdraw their money, creating a snowball effect called a bank run. SVB has suffered from this phenomenon, eventually filing for a Chapter 11 bankruptcy after announcing that they sold their US treasury bond portfolio with a $1.8 loss during FED's long-lasting rate hike cycle in an attempt to offset the imbalance between their assets and liabilities. First Republic has followed SVB, although they were bailed out by a government-encouraged alliance of bigger US banks due to similar balance sheet concerns as SVB's.

On the other hand, Credit Suisse has experienced a different scenario, though the banking turmoil in the US triggered its impending collapse. The staple bank of privacy-led traditional Swiss banking has been struggling since nearly a decade ago when it pleaded guilty to helping wealthy Americans to evade taxes from the IRS. Following its scandal, the bank was once again shaken in 2020 by a poorly handled corporate espionage scandal, which led to the suicide of one high-level employee. In 2021, CS incurred a $5.5 billion loss due to the collapse of Archegos Capital, the dominating borrower of the CS Group. After three fiascos, the bank's collapse was considered a ticking bomb. In 2022, the CDS of corporate bonds skyrocketed, and the bank's inquiry for $54 billion debt from its top backers was denied. Thus, as soon as a global banking crisis started, the bank's shares plummeted, resulting in a Swiss-government-forced takeover by its rival UBS for a quarter of its valuation. AT1 bond investors lost all their money in a credit default event, and currently, CS group is being restructured, with their investment banking division on the verge of being shut down.

The Glass-Steagall Act suggested a firewall between commercial banking and investment banking to ensure that conventional customers can remain safe during a stock market crash. After the repeal of the act, banks increased the intertwinement of their commercial bank activities and investment banking operations. Credit Suisse Group's corporate structure is definitive evidence of how banks engage in shadow banking by using non-bank financial subsidiaries to use them as intermediaries. Deregulating the financial market allowed for such structures to be in place, without clear standards for large financial conglomerates such as Credit Suisse.

Figure 2. Principal legal entities overview: Credit Suisse Group AG



Using non-bank financial companies (NBFCs), Credit Suisse was able to continue its tax evasion operations in the US after its 2014 trial, according to whistleblowers. Legal consultants working on the ongoing case state that the bank owes $1.3 billion at minimum to the US treasury for the CS top bankers have helped hide. Replacing the act with the Gramm-Leach-Bliley Act created more autonomous banks, arguably run by risk-insensitive bankers who grew up in a "*Do not Ask, Do not Tell*" corporate culture. However, it would be unjust to the new act to say that it sparked all the crises after 1999. Keeping the FDIC and increasing the deposit insurance to $250,000 after the 2008 crisis is one of the reasons why we did not experience immense chaos in the recent bank failures.

Conclusion

Overall, the repeal of Glass-Steagall was a turning point in the US financial history, changing the structure of the banking industry and establishing new standards of the regulatory landscape. Following the repeal, a wave of mergers swept through the banking sector as investment and commercial banks were coming together creating large financial conglomerates. Much discussion has been held about the long-term contributions of the repeal to the financial crisis of 2008. Despite there being no direct provisions that regulated how much risk banks could take on or controlled lending standards, deregulating the financial market established a new banking culture: newly formed universal banks sought the opportunity to gain market share fast. The demand for high returns resulted in risky lending and underwriting lending standards, being one of the major contributing factors to the 2008 crisis. The effects of the repeal can be seen in the financial markets to this day: the lack of a regulation between commercial and investment activities allows for complex corporate structures, often leaving room for shadow banking activities such as in the Credit Suisse group. The repeal of the Glass Steagall act was a significant moment in the US financial history, changing the banking culture in the financial sector.

References

Credit Suisse pleads guilty to conspiracy to aid and assist U.S. taxpayers in filing false returns. The United States Department of Justice. (2014, October 9). Retrieved April 21, 2023, from https://www.justice.gov/opa/pr/credit-suisse-pleads-guilty-conspiracy-aid-and-assist-us-taxpayers-filing-false-returns

Delabarre, M. (2020, October 25). Could the 1933 Glass-Steagall Act Have Prevented the Financial Crisis? *SSRN*. Retrieved from http://dx.doi.org/10.2139/ssrn.3726739

Evers-Hillstrom, K. (2023, March 21). *What to know about first republic bank*. The Hill. Retrieved April 21, 2023, from https://thehill.com/business/3911002-what-to-know-about-first-republic-bank

Federal Reserve History. (n.d.). Glass-Steagall Act. Retrieved from https://www.federalreservehistory.org/essays/glass-steagall-act

Focarelli, D. (2011, January). Are universal banks better underwriters? Evidence from the last days of the glass-steagall act. *European Central Bank*. Retrieved from https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1287.pdf?09b2c4eba47768c81d6bb53a500f6761

HeinOnline. (2021). Nova Law Review, 23(1), 31. https://heinonline.org/HOL/Page?handle=hein.journals/novalr23&div=31&g_sent=1&casa_token=&collection=journals

History.com Editors. (2019, October 16). Glass-Steagall Act. Retrieved from https://www.history.com/topics/great-depression/glass-steagall-act

Javers, E. (2023, March 29). *Credit Suisse Whistleblowers say Swiss bank has been helping wealthy Americans Dodge U.S. taxes for years*. CNBC. Retrieved April 21, 2023, from https://www.cnbc.com/2023/03/29/credit-suisse-whistleblowers-say-bank-has-been-helping-americans-dodge-us-taxes.html

Lin, M. (n.d.). Glass-Steagall Act: Did Its Repeal Cause the Financial Crisis? *Toptal.com*. Retrieved from https://www.toptal.com/finance/investment-banking-freelancer/glass-steagall-act

Nathanial, P., & Van der Heyden, L. (2023, March 28). *Credit Suisse and SVB: Where were the Regulators and who governs them?* I by IMD. Retrieved April 21, 2023, from https://www.imd.org/ibyimd/finance/credit-suisse-and-svb-where-were-the-regulators-and-who-governs-them/

Neate, R., & Kollewe, J. (2019, October 1). *Credit Suisse chief operating officer fired over spying scandal*. The Guardian. Retrieved April 21, 2023, from https://www.theguardian.com/business/2019/oct/01/credit-suisse-spying-scandal-investigation

Philadelphia Fed. (1996, July-August). Loan Market Strategies: Moving from Idea to Action. *Business Review*. Retrieved from https://www.philadelphiafed.org/-/media/frbp/assets/economy/articles/business-review/1996/july-august/brja96lm.pdf

Revill, J. (2021, July 25). *Credit Suisse settles spying case with former Star Banker*. Reuters. Retrieved April 21, 2023, from https://www.reuters.com/business/finance/credit-suisse-settles-spying-case-with-former-star-banker-2021-07-25/

Stiglitz, J. (2009, June). The anatomy of murder: Who killed America's economy?. *Columbia Economics*. Retrieved from https://academiccommons.columbia.edu/doi/10.7916/D8SB4GKJ

Thiam, T. (2023, March 23). *Credit Suisse's fate casts a shadow over the European Banking Sector*. Financial Times. Retrieved April 21, 2023, from https://www.ft.com/content/2a65f3eb-bb99-4739-870d-0cb77fca39a7

Zarroli, J. (2015, October 14). Fact Check: Did Glass-Steagall Cause The 2008 Financial Crisis? *NPR*. https://www.npr.org/sections/thetwo-way/2015/10/14/448685233/fact-check-did-glass-steagall-cause-the-2008-financial-crisis