

# **A Study on Correlations between the Repeal of the Glass-Steagall Act (GSA) and the Financial Crisis of 2007**

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**Abstract:** There has been a heated discussion about the repeal of the Glass-Steagall Act (GSA) that caused the financial crisis of 2007. In order to understand whether the repeal of the GSA caused the financial crisis of 2007, this paper will analyse how the repeal of the GSA influenced commercial banking and investment banking activities, the complexity of new financial products and other institutions. In addition, this paper will investigate how the crisis was influenced by the three factors. The role of GSA's repeal in the crisis will be discussed as well. This paper will argue that the repeal of the GSA was a trigger in the crisis.

## **1. Introduction**

The original Glass-Steagall Act (GSA) was established in the United States in 1933, which was sponsored by Senator Carter Glass. This act was established in the Great Depression, which aimed to prohibit commercial banks from engaging in the investment banking industry. This was an extreme measure countering the failure of almost five thousand banks and drew a distinct line between banking activity and investment banking activity. However, the GSA was partially repealed by Graham Leach-Bliley Act (GLBA) in 1999. The repeal of GSA eliminated the restrictions on commercial banking involvement in investment banking activities. The result was the banks became greedy and taking on excessive risk, commercial banks started to pool funds to speculative operations and involved in the stock market in expectation of high return. Some Americans argued that the repeal of GSA was the main cause of the 2007 financial meltdown and called for it to be brought back. In recent years, Donald Trump also wants to revive the GSA, while this practice raises a wide range of questions. This paper will analyse how the repeal of GSA influence financial crisis of 2007, and the role of investment banking and commercial banking activities, financial products and other institution played in the crisis.

## **2. The Analysis of Commercial Banking and Investment Banking Activities**

The repeal had changed the functions of commercial banks, which contributed to the financial crisis. It is true that commercial banks were allowed to participate in underwriting or dealing with securities activities, which exposed the firm to excessive risk and contributed to the crisis. For instance, Wachovia, a traditional commercial bank, ventured into insurance and securities activities and suffered bankruptcy in the crisis. However, the collapse was attributed to the acquisition of Golden West, not because of involving such security businesses [1]. It shows that the commingling of bank services nearly had no direct influence on commercial banking business. In addition, despite commercial banks engaging in security business, they were permitted to do derivatives before the GSA's repeal, for example, mortgage-backed securities (MBS) and Collateralised Debt Obligations (CDO) [2]. Furthermore, it appears that the repeal has no direct influence on the investment banking activities. To be more specific, many investment banks, such as Lehman Brothers and Goldman Sachs, went into crisis and had done investment banking before the GSA repeal [1]. Korotana also pointed out that the high leverage of the investment bank was the main reason for the collapse. The leverage of investment banks was restricted to 12 times of the capital by the US Security and Exchange Commission (SEC), whereas its leverage ratio attained to fifty times before the crisis, which caused an unbalance in terms of the real economy. This particular

case possibly illustrates that the high leverage rate of investment banks made the financial crisis worse, but the repeal had nothing to do with investment bank activities. Overall, it is clear that the repeal of the GSA had little influence on the relationship of commercial banking and investment banking, it was just a minor contributor to the crisis.

### **3. The Analysis of New Financial products' Complexity**

It is generally considered that the elimination of the GSA restrictions encouraged further risks in the innovation of financial products with high risk, which seems to result in the financial crisis. Specifically, people used houses as mortgages, banks distributed them to the secondary markets and to securitize loans, which were packed into MBSs and CDOs and then sold to investors. As Korotana stated this practice might be dangerous and tends to threaten the whole financial system [2], since the housing market meltdown, default rates would have largely increased due to the difficulties in accessing the true value of securities. As a consequence, these securities became illiquid and their prices experienced a sharp decrease. However, 80% of the derivatives were sold at over-the-counter markets or in an opaque atmosphere, transacted by negotiating between clients and banks [2]. Therefore, these transactions were outside of regulation of the GSA, even without the GSA repeal, this behavior might still have happened. Furthermore, Korotana also finds that such derivatives existed before the GSA repeal, but the repeal had made it legal and expanded the influence. Furthermore, it is important to take into consideration the fact that subprime mortgages had more influences on exacerbating the financial crisis. One significant factor was the performance of financial products, such as CDOs and MBS, relied heavily on the subprime mortgages. This point was also made by Sissoko [3]; he suggested that subprime defaults exceed anticipation between 2006 and 2007; nearly each bank lost at least \$12-\$14 billion. This case appears to illustrate that when the housing market was in a gloom, these subprime mortgages have a poor performance on CDOs and MBSs, the investors may have a severe loss. It is apparent that the repeal had an indirect impact on the financial products, which worsened the situation.

### **4. The Analysis of Other Institutions**

Even though financial products worsened the situation, it appears that ratings institutions were the root factor to the crisis. It is certainly true credit agencies were likely to be paid by the institutions and issued mismatched ratings to the institutions' financial products to satisfy managers. Both Verschoor and Korotana contend that credit agencies played a damaging role in the crisis [4]. Korotana also claims that banks were required to have an 8% core capital to prevent the risk and to hold some capital to sustain triple-A-securities, according to the Basle rules. However, credit agencies gave high ratings to financial products in seeking massive bonuses and huge fee earnings. If credit agencies did not do that, they would have lost their business and banks might change to another rating agency. This example seems to show that the repeal encouraged credit agencies to take excessive risk to a large extent thus, these credit agencies gave mismatched ratings to financial products that triggered the crisis. One significant aspect worth considering is the deregulation of regulatory bodies. It is said that supervision of regulatory bodies was difficult because some financial products were complex and their true value was unavailable to access. Both Wellston [4] and Claudia [5] point out the supervision applied to the financial institutions was inadequate, which contributed to credit agencies' aggressive behaviors and triggered the crisis. According to Korotana, some regulators were organized to design a Value at Risk (VAR) method, which was introduced to banks and used to access banks maximum loss in a period. However, the data was out-of-date and the results were inaccurate in accessing the real risk of financial products. As shown in this example, even though some methods had been used to restrict the risk, it was not enough and along with insufficient supervision of financial institution's behavior. Overall, it seems that the other institutions played a damaging role in the crisis.

## 5. Conclusion and Discussion

In conclusion, there were a number of contributors to the crisis. This essay appears to claim that the GSA's repeal was a minor contributor to the crisis and influence the crisis in an indirectly way. For investment and commercial banks, the repeal of the GSA only enables banks to become larger. Investment banks had done investment banking activities as they were after the GSA repeal. However, the GSA repeal provides excessive risk-taking opportunities to individuals. In order to make high rewards, complex and high risky financial products were designed and sold to consumers, especially the subprime mortgages. These financial innovations worsened the financial environment and amplify the risk of financial institution. The low requirements for the borrower result in these low-income borrowers could not afford the mortgage, which leads to high default rates and the financial crisis. The most important reason for the crisis is the lack of supervision of the financial institution. For example, credit agencies gave high ratings to high-risk financial crisis and regulation bodies were unable to access the true value of financial products. In this crisis, the regulatory bodies should have shouldered the responsibility of supervising the actions of financial institutions. However, this essay just focused on three factors that might have influenced the crisis, it would be worth undertaking further research into other significant aspects, which might have caused the crisis of 2007.

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