

Policy Erosion and Policy Maintenance: The Case of Glass-Steagall

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Abstract

This paper offers a theoretical framework for thinking about why complex statutes may become less effective over time, and what sorts of governmental responses this process of *policy erosion* will prompt. Depending on the political circumstances, Congress, bureaucratic agencies, or the courts may attempt *policy maintenance*, reshaping the law to achieve the statute's original purposes. They may also engage in *policy repurposing*, in which the original statute is retained but adapted to uses unanticipated by the original authors. To explore this process and the interbranch dynamics that determine its course, the paper offers an in-depth account of the history of the Glass-Steagall Act, from its passage in 1933 through its gradual demise by erosion.

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In his second debate with Senator John McCain, President-elect Barack Obama declared that, “The biggest problem in this whole process [the banking crisis] was the deregulation of the financial system.” Later, he reiterated this theme, saying, “That is a fundamental difference that I have with Senator McCain. He believes in deregulation in every circumstance. That’s what we’ve been going through for the last eight years. It hasn’t worked, and we need a fundamental change.”

What policies did candidate Obama mean to reference with these remarks? There had been no significant piece of “deregulatory” legislation relating to banking passed since Bush took office in 2001. The most recent major financial laws passed were the Gramm-Leach-Bliley Financial Modernization Act of 1999 (GLB) and the Commodities Futures Modernization Act of 2000 (CFMA), both signed into law by President Clinton. This paper will have a great deal to say about GLB, but for now it is sufficient to note that most banking experts have agreed that the Act actually softened the blow from our current crisis rather than exacerbating it. The CFMA is a closer call, but not clearly “deregulatory.”² So was Obama merely blowing election-year smoke?

Perhaps—but not necessarily. This paper will argue that it is not unusual for important policy changes to occur without Congress having taken any action. This argument is not novel, but rather is a central theme of a growing body of work. For example, Paul Pierson (2004) has explored threshold effects at which unlegislated incremental changes may reach a tipping point and lead to rapid change. Jacob Hacker (2004) and others have examined policy “drift,” in which it becomes increasingly difficult to match “ground-level” operation of a policy to its legal basis. Most recently, Eric Patashnik’s *Reforms at Risk* (2008) has connected reform

² The CFMA seems to have prevented effective regulation of credit default swaps, but it isn’t clear that there was any clear basis for regulating these instruments before the act was passed, either. This question is returned to in the conclusion.

sustainability to the policy feedback literature and the necessity of creating self-reinforcing political dynamics that will safeguard the policy once in place.

This paper adds to this growing literature by showing the centrality of bureaucrats and courts in determining the actual impact of a policy after it has become law.³ This contrasts with the explicitly political focus in the works already mentioned, as well as with the “policy feedback” literature more generally (e.g. Campbell 2003; Mettler and Soss 2004).⁴ This perspective allows us to see that statutory interpretation, performed both by executive agencies and the courts, will shape the continuing involvement of Congress in a particular policy area. In order to understand this process, this paper offers the concepts of policy erosion, policy maintenance, and policy repurposing. What exactly do these terms mean?

Policy erosion is the process by which the intended policy effect of a particular law or regulatory system lessens over time as a result of private evasion. Central to this process are loopholes—legally sanctioned ways of avoiding the full force of a particular law. Loopholes are essentially the counterpart of “red tape,” which Herbert Kaufman (1977) described as minor regulations enacted to ensure various forms of fairness in bureaucratic action. Just as each piece of red tape is laid with good intentions, most loopholes are put into place because policymakers believe that creating a narrow exemption to a general scheme will serve the public interest. Of course, the loophole may also simply be an efficient way for lawmakers to deliver valuable services to influential constituents, but even then the general presumption should be that lawmakers are not seeking to undermine the overall operation of the statute in question.⁵

³ Of course this is a very old concern, if not one that has primarily captured the attention of recent congressional scholars. See, e.g., Alexander Hamilton, Federalist No. 22: “Laws are a dead letter without courts to expound and define their true meaning and operation.”

⁴ There are several works that do provide excellent analysis of the role played by courts and bureaucrats, most notably Derthick (1979) and Melnick (1983, 1994), and they are sources of inspiration for this essay.

⁵ This is a general assumption, not a hard and fast rule. Of course, there might well be reasons why a politician would want to outwardly support a law’s passage while working surreptitiously to undermine its effect. This will be

Regardless of intentions, it is a remarkably safe bet to assume that more private actors will take advantage of loopholes than the bill's authors anticipated. It also tends to be the case that laws can be evaded in ways wholly unanticipated by those crafting the original language; loopholes are discovered as well as created.

To adopt another metaphor that will be particularly apt for the case considered in this essay, imagine that enacting a public policy is like building a dike, and the goal of the policy is to keep the water on one side. When small holes are intentionally punched in the dike, they will mostly be incapable of letting out liquid with any selectivity. And some of those holes will, over time, expand to become gaping fissures. Furthermore, even when no one is intentionally creating holes, some will develop over time.

If policies are to survive over long periods of time, they will require maintenance, just as if a dike is to remain effective it will require reinforcement in weak spots and patching where holes have emerged. Policy maintenance can be attended to by legislators themselves, but also by bureaucrats entrusted with administering a regulatory scheme or by judges willing to give statutes expansive readings so as to preserve their intended operation rather than their literal application.

The case study in this essay examines the history of the Glass-Steagall Act, which is almost universally described as erecting a wall between commercial and investment banking activities and thus particularly well described by the metaphor of the dike. In general, the metaphor offers a useful way of thinking about systemic regulations, which require across-the-board structural integrity in order to be effective but are so complex as to make maintaining this

most politically expedient when an issue is highly salient to the voting public, a condition that will not obtain in the case of banking regulation.

difficult.⁶ Put in the terms of our metaphor, all of the putty used to plug holes in the dike will turn out to be permeable when, given time and adequate motivation, the water can change its chemical properties.⁷

The question of what characteristics push a policy toward erosion, stasis, or growth is one of such pervasive importance that it is hard to believe policymakers themselves do not consider it. Many works on the creation of bureaucracies already consider the ways in which agencies are built to reflect their enacting coalitions (Moe 1989; Lewis 2003), or put agencies on “autopilot” and thus ensure that they reach certain end-goals (McNollGast 1989). Nevertheless, the relevance of erosion, maintenance, and momentum to decisions of how to structure legislation is a subject that would reward further exploration.

Before turning to the interbranch dynamics of policy maintenance and erosion, we should stop to consider the following question: does Congress actually care about the long-term policy impact of the laws it passes, or the current impact of laws passed long ago? If we adopt the assumptions of Mayhew (1971) or Arnold (1990), in which legislators are motivated entirely by a desire for reelection, the answer may be a simple “no.” We know from Arnold that the public’s latent policy preferences affect legislators’ thinking about policy choices, but these considerations apply to voting decisions on new policy directions. For issues with enough potential political salience, lawmakers will want to be on the right side of the vote. But for legislators to care about longer term effects, they will have to believe that voters possess a fairly

⁶ See Schultze (1977) for further discussion along these lines, in considering the relative merits of command-and-control regulation and taxation for achieving policy goals.

⁷ More generally the metaphor will clearly not be applicable to all types of laws. When a city puts up a “No Standing” sign, there is little potential for complex legal arguments to erode the intended policy effect. Any problems in implementing the preferred policy will be in the execution, not in deciding whether the policy is applicable. On the other hand, there are some policies crafted so as to ensure not only their own maintenance, but also the growth in their absolute and relative importance over time. For example, the incentives created by the structure of Medicaid virtually guarantee that the program will ratchet ever-upward in scope and cost (Greve and Wallach, 2008). No maintenance will be necessary to secure these results. For these types of policies, a snowball rolling down a snowy hill and gathering momentum may be the appropriate metaphor.

high degree of sophistication. As Patashnik (2008, pp. 6, 23-24) explains, pre-passage advocacy of an issue could directly connect to a front-page news story and thus deliver electoral benefits, but fighting against later threats to the policy outcomes established by the law would be lucky to get even back-page coverage.⁸ The assumptions underlying the analysis in this paper will be somewhat less simplifying than the electoral connection assumed by Mayhew and Arnold, however. Whereas direct electoral considerations would lead us to believe that policymakers would spend little effort on the gritty details of regulatory policy, in fact as we shall see some congressmen devote tremendous amounts of effort to making sure that long-standing policies operate as intended—or don't, as the case may be.

This then leads to the central questions of this paper: when and why will legislators engage in policy maintenance? Furthermore, when and why will bureaucrats and courts engage in policy maintenance or erosion themselves? To answer these questions, we will want to examine what changes occur in a policy outcome, determined by a) the content of the laws; b) private actors' compliance decisions; c) enforcement decisions; d) bureaucratic and judicial interpretation of the laws; and e) legislators' maintenance decisions (or lack thereof). Having determined the *what*, we will then attempt to understand the *why*.

Answering these questions does not yield a satisfyingly parsimonious theory, but we can develop a useful theoretical ideal type as follows. Given that erosion is occurring, bureaucrats and courts will advance their own purposes in interpreting the statute, which may facilitate erosion, maintenance, or redirection. Courts' interpretations are unlikely to be wholly policy-motivated, however, and concerns about judicial capacity, appropriate jurisdiction, deference to the political branches, and fidelity to statutory text are likely to significantly impact their choices.

⁸ And Patashnik's discussion is about fending off later legislative amendments, which are far more potentially visible and salient to voters than are the sorts of bureaucratic and judicial erosion that will be discussed in this paper.

Bureaucratic actors will be constrained by the law's text as well, but only to the extent that they fear being punished for transgressions. Congress, finally, will act to further its own interests—but because “it” is really a “they,” this may not always emerge as a coherent force. If the enacting coalition persists, they are likely to pass maintaining amendments. If there is a majority that sees an opportunity to turn the existing framework to their own ends, they are likely to effect policy repurposing by amendment. In the event that no majority is united, however, policy changes are unlikely to ever break into the congressional agenda, and Congress will passively tolerate the policy outcomes of erosion. As a result, outcomes are likely to obtain that no congressional majority would have ever actively sanctioned. Importantly, the choices bureaucrats, judges, and legislators make regarding erosion and maintenance will all be highly sensitive to those of the other branches.

This perspective will be compared to three other prominent models that might be used to explain the ebbs and flows of Glass-Steagall policymaking. The first is Keith Krehbiel's influential *Pivotal Politics* model (1998), which theorizes that Congress will only pass laws when the policy status quo is outside that region of the ideological policy space in which no movement will be approved of by each pivotal actor, the so-called “gridlock interval.” The second theory I will use as a point of reference is Baumgartner and Jones's *Politics of Attention* (2005). Their agenda-focused model explains congressional policymaking as an instance of punctuated equilibrium, in which scarcity of congressional attention leads to inaction on a topic is until some critical pressure is reached and it then bursts onto the agenda. The final theory is Kingdon's *Agendas, Alternatives, and Public Policies* (2nd Ed., 1995), which offers two separate points. First, there is the idea that the players who control the agenda (which issues get addressed) are different from those who populate the pool of available alternatives. Second,

Kingdon argues that three independent “streams” must come together to produce successful policy change: problems, policy proposals, and politics. Each of these theoretical perspectives has something to offer, and the theory of erosion and maintenance will not seek to displace them so much as offer an important corrective.

Before finally turning to the case study, the limitations of the paper must be admitted at the outset. Deep engagement with the case study will elucidate the dynamics of maintenance and erosion and will cover enough time and policy change to allow observation of several distinct patterns. What it cannot do is provide convincing evidence that this phenomenon also exists at all times and for all policy areas. Showing this must be left to future work.

The rest of the paper proceeds as follows. Section I gives a fairly detailed chronological account of the history of Glass Steagall, from its inception in 1933 to its demise in 1999.⁹ Section II briefly revisits this account from the perspective of each of the actors involved in order to pin down their guiding motivations. Finally, Section III concludes by tying the paper’s themes together, presenting an overarching theoretical perspective, and suggesting some ways in which this theory might inform an inquiry into the current financial crisis.

I. The Career of the Glass-Steagall Act

A. *Origins*

The Banking Act of 1933 was a complex statute meant to reform practices thought to have contributed to the economic collapse and guard against future downturns. Notably, thanks to the entrepreneurship of Representative Henry Steagall (D – AL), the act gave life to national

⁹ Several articles have noted the general dynamic described herein, most notably Kaufman and Mote (1990), which gives an excellent descriptive account up to that date. This article in particular proved a great help as a starting point, but does little in the way of probing systemic causes or larger theoretical themes.

deposit insurance, an idea that had been pursued unsuccessfully for many years, and which was still not terribly popular among leading politicians, including President Roosevelt (CQ 1988, p 238-9; Schroedel 1994, ch. 3; see also Kennedy 1973). Sections 16, 20, 21, and 32, which became known as the Glass-Steagall Act, legally mandated the separation of commercial and investment banking, which had until then most often been conducted by the same powerful firms. They were primarily the work of Senator Carter Glass (D – VA), who was known as the legislative architect of the Federal Reserve System. The law was meant to combat the following supposed risks: 1) Banks making risky investments in securities, thereby endangering deposits; 2) Unsound loans made to prop up companies in which a bank was invested; 3) Conflicts of interest in pushing underwritten securities onto banking customers (Bentson 1990, p 11-12).

The question of whether the law was a well-targeted intervention is a complicated one, and a full discussion is beyond the scope of this paper, but a brief discussion is necessary. Most of the rationale for the bill grew out of congressional hearings conducted from 1931 to 1933, and especially those known as the Pecora Hearings in 1933. These hearings purported to give extensive evidence of the abuses mentioned above, and for many years their findings of abuse were taken as authoritative (Bentson, 4). In fact, however, the evidence offered was largely anecdotal, and the anecdotes mostly misleading or false. Bentson (1990) offers a painstakingly detailed refutation of the arguments made in 1933, debunking each with remarkable specificity. These arguments' speciousness does not make Glass-Steagall's passage a mystery, however.

First, as we are relearning since 2008, in the wake of a banking crisis the public demand for action is high, and so Congress was eager to offer some stern solution as a cure for the nation's economic woes. In this environment, Senator Glass brought strong ideas about what

ailed the banking system he had engineered.¹⁰ In the event, these ideas happened to be highly congenial to the securities industry, which would greatly benefit from having most of its competition banned.¹¹ Just as important, the banking industry itself was not deeply hostile to the change in 1933, as many banks with troubled balance sheets were contracting their operations and would not have been conducting any securities activities in any case. In addition, bankers were not oblivious to their political situation, and may have thought that bowing to this reform was a relatively painless way to avoid more retributive measures (Bentson, Ch. 11). It bears noting that these bankers were not wrong: until the 1950s, banks were fairly happy to maintain symbiotic relationships with investment houses and were therefore a conservative force in the immediate post-passage environment. Although the shaky basis for Glass-Steagall was thus irrelevant to its operation for many years, as banks began to chafe under the Act in later years the Act's shaky foundations would become relevant. This is getting ahead of the story, however.

B. Early Erosion: 1933-1956

The erosion of Glass-Steagall's "wall of separation" between commercial and investment banking began as soon as the law was passed. The first two decades after its passage featured maintenance attempts by courts, bureaucrats, and Congress, which struggled to concretely define the act's applications in sustainable terms that prevented easy evasion.

One early challenge to the law's efficacy grew out of its central language, which prohibited anyone "primarily engaged" in securities activities from also engaging in commercial banking. In *Board of Governors v. Agnew* (1946), the Supreme Court was asked to review the

¹⁰ In the terms of Kingdon (1995), banking was necessarily catapulted onto the agenda by the crisis, and there was a paucity of available alternatives that seemed serious enough to answer the need of the moment.

¹¹ The securities industry is personified in this narrative by two trade groups, the Investment Company Institute (ICI) and Securities Industry Association (SIA).

Federal Reserve Board's decision to remove as directors of a national bank several men who were indisputably involved in securities activities.¹² First, the Court had to decide whether Federal Reserve decisions made under Glass-Steagall were subject to judicial review, which the Board of Governors disputed. Justice Douglas and a unanimous Court decided this momentous question in the affirmative without offering much in the way of reasoning (at 444). Second, the Court had to decide whether "primarily engaged" would be given a broad or narrow meaning. As the Fed read it, "primarily" meant "substantial," whereas the removed directors argued it should mean "principal," that is, "greater than fifty percent" (at 446). The Court ruled that the Board's broad reading was both reasonable and fully consonant with the purposes of the statute, and therefore due deference (at 447). Justice Rutledge, joined by Justice Frankfurter, offered a concurrence arguing that the Court's opinion was required wholly on grounds of deference, as

¹² A note on the various banking regulators involved is in order here.

Banking has been subject to federal regulation longer than any other part of the economy. Over time, it has acquired a multitude of separate regulators, each of which has its own distinct "personality" in addition to having different responsibilities. This means that each pursued its own unique agenda as it enforced the Glass-Steagall law. For the Comptroller of the Currency, which is responsible for the chartering and regulation of national banks, this tended to mean craft innovative regulatory solutions in order to satisfy its "customers" (Khademian 1996).¹² This culture tends to overwhelm any effects of partisanship, and Comptrollers of both parties tend to be highly sympathetic to banking interests. The FDIC, which is built and acts like an insurance company, is charged with regulating state banks that choose not to become members of the Federal Reserve System (Khademian 1996). Because its insurance function was not directly implicated by Glass-Steagall issues, it tended to follow the lead of the other regulators on them. The Federal Reserve Board of Governors is responsible for ensuring the safety and soundness of its member banks, and the BHC Act of 1956 also vested it with regulatory responsibility for Bank Holding Companies, which became increasingly important. The Fed, which functions somewhat like an academic institution, can be seen as the repository of the nation's best technocratic impulses regarding banking (Khademian 1996). For several decades after Glass-Steagall's passage, the Board's strong support for its policy goals was decisive to securing maintenance via congressional action. The Chairman's testimony was highly influential in the passage of the Bank Holding Company Act of 1956, and in subsequent amendments to that statute. Similarly, when the Fed's support for the objectives of Glass-Steagall faltered in the late 1970s and 1980s, its support for erosion of the statute was decisive.

Because bankers seeking a new charter are faced with a choice of either national or state regulation, seeing the regulated interests as customers or clients is somewhat less of a stretch in banking than in other areas of regulation. But it should also be noted that banks do not have a general preference against all regulation. Indeed, the existence of some capital requirements is generally welcomed, as it takes the edge off of competition, as do other types of regulation (including Glass-Steagall). Should regulators' solicitous stance lead us to conclude that banking regulators are simply "captured" agents of private interests? Anything but a perfunctory answer would require an examination well beyond the scope of this paper, but we should ask what exactly capture theory would tell us about situations in which interests conflict—which is nearly every situation faced by banking regulators.

for such technical matters the Board's judgment should be conclusive for any matter "open to reasonable difference of opinion" (at 450).

"Maintenance" seems a strange way to describe this early case, as it is merely upholding agency enforcement of one of the statute's major provisions, but to presume that this is trivial misses the point. Since the statute's plain language, "primarily engaged," was not at all clear, court rulings such as this one were necessary to make Glass-Steagall's wall between commercial and investment banking practically meaningful. The pattern of deference established early on, while probably inevitable given the complexity of the subject matter, was also hugely important, as it meant that the courts' position on maintenance issues would mostly follow the regulators'. Viewed through the theory of erosion and maintenance, we see continuity among the relevant bureaucrats, who supported Glass-Steagall's passage and remained constant to its original purposes in interpreting its language. The Supreme Court deferred to this authoritative stance, which it viewed as a reasonable interpretation of the text.

The other important development in the early years of Glass-Steagall was the migration of many bankers to the bank holding company (BHC) corporate form, in large part because it was not covered by the main provisions of the Glass-Steagall Act or indeed by much of any regulatory control.¹³ Congress was well aware of this source of potential erosion of the separation between commercial and investment banking, and bills were introduced into almost all sessions of Congress since 1938, when Franklin Roosevelt specifically called for regulation of BHCs. Major efforts in 1938 (Glass-McAdoo), 1947 (offered by Fed Chairman Mariner Eccles), and 1949-50 (Maybank-Robertson) died in committee after opposition by the American Bankers Association (ABA) and its sympathetic regulator, the Office of the Comptroller of the Currency

¹³ The Glass-Steagall Act put BHCs under very weak Federal Reserve Supervision, and never covered one-bank BHCs (Jessee and Seelig 1977, 8).

(OCC) (Worsham 1996, 90-6). By the early 1950s, the Federal Reserve was continually advising Congress to pass strong regulation of all BHCs (Jessee and Seelig, 9 FN b). A critical source of disagreement that doomed these bills in committee was the question of whether regulation should extend to BHCs controlling just one bank (Worsham, 99).

With President Eisenhower's support, a bill finally made it out in 1956 and Congress overwhelmingly passed the BHC Act, creating Federal Reserve regulation and prohibiting BHCs from managing or controlling non-banking assets other than those directly related to the banking business. Crucially, BHCs controlling only one bank would continue unregulated, a source of disappointment for the President and the Federal Reserve. At time of passage, only 46 bank holding companies were subjected to regulation, while 116 mostly very small BHCs were exempted (CQ 1956, 557). The Act's definition of a BHC is worth noting because of what we might call "anticipatory maintenance," or shutting down potential loopholes before they are allowed to open. A BHC was defined as a company that: (1) directly or indirectly owned or controlled 25 percent or more of the shares of two or more banks; or (2) controlled the election of the majority of the directors of two or more banks; or (3) had 25 percent or more of two banks held in trust for it. As we shall see, anticipatory maintenance is never enough, especially when so many loopholes were included intentionally. Although power was granted almost entirely to the Fed, state regulators and the OCC or FDIC were allowed to challenge Fed decisions, leading to a Fed Board hearing subject to judicial review (CQ 1956, 558).

What had changed to lead to maintenance after many years of false starts? One possibility is that the magnitude of erosion had simply passed some critical threshold. While BHCs were always able to avoid the force of the law, the form was still relatively inconsequential until the 1950s, when larger firms began to rapidly migrate into it. The second

major possibility is that there was some change in the configuration of interests supporting maintenance as opposed to erosion. Some interests remained stable: Chairman of the Senate Banking Committee, A. Willis Robertson (D – VA) described the act as “pleasing and acceptable to the independent bankers. They were the ones who for 18 years were asking Congress to enact legislation on this subject” (CQ 1956, 560). By 1956, though, maintenance legislation was also supported by the Fed, OCC, Independent Bankers Association of America (IBAA), and ABA, and opposed only by banking giants, especially Transamerica. While there was still significant debate over what exemptions should fairly be granted, there was little controversy over the basic need to stop erosion before it got out of hand (CQ 1956, 560).¹⁴ Consequential as it was, the BHC Act was able to be a consensus effort because of all the exemptions it retained. The price of this consensus was relative weakness, and by 1958 the Fed would be lobbying Congress again to close the act’s loopholes, especially the one-bank exemption (Jessee & Seelig, 12).

How do our theories do in making sense of this series of events? *The Politics of Attention* seems wide of the mark: the issue had Congress’s attention for many years, with serious consideration of bills occurring every few years.¹⁵ Kingdon’s three streams provide a useful organizing framework: the problem and policy proposals remained on the table, but the politics changed to lead to passage. Unfortunately, Kingdon’s theory does not explain why this

¹⁴ Worsham (1997) argues that the net effect of the BHC Act of 1956 was to facilitate erosion. His interpretation is that the New Deal coalition that had passed Glass-Steagall in 1933 was no longer energized to protect its own regulatory regime for banking, and therefore was not prepared to expend political capital to secure true, stringent maintenance. While maintenance certainly could have been more complete, his argument is misleading in two ways. First, to decide whether the BHC Act itself represented erosion or maintenance we need to use the status quo as our point of comparison, not the hypothetical provision of complete maintenance. Second, following on this point, it really doesn’t seem that Congress included the exemptions in order to undermine the whole system. Indeed, when the loopholes came to be understood as serious threats in the following decade, Congress closed them. Rather, they believed that including the loopholes was beneficial to their constituents (especially the IBAA) without being detrimental to the system’s ability to achieve its goals.

¹⁵ One way to understand this is by reference to the “fire alarm” theory of McCubbins and Schwartz (1984). Throughout the period, there were regulated banks that resented the competition of the unregulated BHCs, and were able to effectively communicate their concerns to members of Congress. The scarcity of congressional resources can thus be overcome by constituent-driven monitoring.

change should have occurred. Krehbiel's theory might make sense of things in two ways. First, it might posit that the law passed because of a reconfiguration of pivotal players. This makes little sense, however, as legislation saw little political opposition on either chamber's floor. Perhaps what happened was that the policy status quo exogenously moved outside of the gridlock interval, at which point Congress swung into action. This last explanation seems basically correct—but we need to ask what it means for the status quo to move, and in approaching this question, the theory of erosion and maintenance has a great deal to offer.

A "shifting status quo" could be many things: a) the law and its effect stay constant, but political preference of actors across the spectrum change, possibly because of replacement; b) the statute stays the same, but there are changes in enforcement, implementation, or court interpretation; c) the law and implementation stay "constant" in the sense of following the same rules, but non-governmental factors change enough that the overall "effect" of the legal regime substantively changes. Learning mediates each of these potential changes: a) societal values shift, and presumably reelection seeking officials move along with them; b) lawmakers are not automatically knowledgeable about the world, but instead learn about new developments in implementation etc. over time; c) or they learn about new market developments etc. Perhaps most importantly, lawmakers may simply learn that the effects that they believed the laws would have when they passed them were not actually realized in practice, were in fact undesirable even though they had seemed to be good answers, or could only be realized by also producing unintended negative consequences. Values may not have changed, but beliefs about the linkage between a certain policy and its actual effects may change.

Given these observations, we can see that determining exactly what counts as dangerous erosion is a complicated process. But it is by no means simply exogenous. To return to the

specifics of the BHC Act, what had changed by 1956 was the idea that evasion of banking regulations by BHCs posed a serious risk to the regulatory framework. This impression was created by a unification of previously dissonant voices, including those of regulators. What led to an act of successful, if partial, maintenance was an emerging consensus over what was threatening erosion, and what was not. This process depended on the involved actors' interests but also on their learning about the practical consequences of the legal environment.

C. Maintaining Separation under the BHC, 1956-1970s

In 1965, the Supreme Court handed down another standing decision in *Whitney National Bank v. Saxon* (1965). The controversy in the case resulted from a complex interaction of the Bank Holding Company Act of 1956 and Louisiana state anti-branching law. A joint decision of the Comptroller in making Whitney a national bank and the Federal Reserve Board in granting BHC status was under review through a process specified in the BHC Act, while the case at hand short-circuited that process by enjoining the Comptroller without allowing the Fed's decision to be reviewed as stipulated in the act. Justice Clark and a Supreme Court majority ruled that this arrangement of allowing the Fed's judgment to be formed carefully and then allowing it to argue its case in Court was an important part of the BHC Act's design, crucial to preserving agency primacy over courts (at 420). Because the Fed had been the home of policy entrepreneurs instrumental to shaping the banking system and the holding company form, its opinions should be given special weight (at 421). For our purposes, the case shows that Congress consciously addressed the tradeoff between bureaucratic drift and powerful agencies, with the courts respecting their judgment (see Shepsle 1992). Douglas and Black filed dissents that worried about the consequences of depriving courts of jurisdiction while the Federal Reserve conducted

reviews, arguing that the majority's decision would allow the Comptroller to collude with banks, who would only have to stay out of courts in order to erode valid laws such as the Louisiana statute in question (at 430-2). In other words, Congress should not be allowed to undermine its own purposes by keeping questionable agency decisions out of court, concerns about agency authoritativeness notwithstanding. These justices apparently envisioned a proactive maintenance role for courts.

The major erosive challenges of the period were dictated by the compromise of the BHC Act, which had left many loopholes intentionally and also contained enough ambiguity to allow others to form. For example, in 1957 the Comptroller foreshadowed future erosion by allowing banks to profit from brokerage transactions they provided for their customers, whereas previously they had been barred from any profit, although the OCC still insisted that such services only be offered to existing customers rather than marketed to the public (Fed Banking L. Rep. (CCH) P 96,262 at 81,357). Incremental decisions of this type are far too numerous to list individually, but they represent the most common form of erosion.

In 1965, Congress gave serious consideration to closing the loopholes left by the 1956 Act. The bill originally introduced by House Banking Committee Chairman Wright Patman (D – TX) was an extremely narrow bill to repeal an exemption for trusts established by will, which had allowed the estate of Alfred duPont to control a miniature empire of banks and non-banks in Florida, all without regulation (CQ 1965, 856). But Rep. Charles E. Bennett (D – FL), encouraged by the Fed, offered a comprehensive amendment that would have repealed all of the most important exemptions, including that of one-bank BHCs. The broader maintenance bill passed the House 199-178 on the strength of Republican and Southern Democratic support (CQ 1965, 856). Patman opposed this broader bill, arguing that it would end all exemptions without

due consideration, and that each should be considered separately (CQ 1965, 857). Although the Fed was adamantly in favor of ending the one-bank exemption, doing so was strongly opposed by the IBAA, the Comptroller (who said “imaginary possibilities of abuse” were no reason for action and worried of Fed jurisdictional imperialism), and the ABA (CQ 1966, 764-5). The Senate Banking Committee proceeded to drop the one-bank exemption before passing the bill out of committee, with observers indicating that it could not have passed if the one-bank provision had been included (762, 766). The House assented to the Senate amendments by voice vote, and the bill was signed into law by a fairly uninterested President Johnson on July 1, 1966, having closed many important loopholes but left the single most important one untouched.

How should we explain this incomplete maintenance? The enacting coalitions of the Glass-Steagall and BHC Acts were apparently still committed to a separation of commercial and investment banking, but sought to pursue that goal through the path of least resistance. Where loophole-closing upkeep was likely to anger some constituency, the lawmakers weighed the political costs against the likely costs to the statute’s ability to fulfill its purpose. Where loopholes no longer had deep interest group support, they were shut.

After 1965, many BHCs took advantage of the one-bank loophole to escape Fed regulatory supervision.¹⁶ In 1965 there were 550 one-bank BHCs, by year-end 1968 691, and by February 1969 there would be 810, controlling 40% of all commercial bank deposits (CQ 1969, 942). President Nixon urged Congress to stop this “disturbing trend in the past year toward erosion of the traditional separation of powers between [banks and commerce].” The

¹⁶ CQ 1969, 941-2 provides a list of other loopholes being used. The desire to escape regulation leads to some fairly ingenious means of evasive action, some of which seem obvious in retrospect but many of which simply seem impossible to anticipate. An obvious one was the minimum of 25% ownership of a securities firm that triggered regulation. BHCs simply found ways to exert controlling interests with 24% of shares. This loophole was closed by the 1970 amendments by simply allowing the Fed to determine when a controlling interest was present (CQ 1970, 874).

Administration offered a bill, as did Wright Patman, who had now abandoned his defense of the one-bank loophole and indeed derided the Administration's bill for being too lax. Patman's bill would put all regulatory authority in the Fed, while the Administration's bill would share power between the Fed, OCC, and FDIC. The Fed, unsurprisingly, favored Patman's bill, but said it would support either because the need for regulation was so pressing. Chairman William McChesney Martin, Jr., furthermore, split with Patman over the question of how permitted activities should be defined. Patman's bill would require a "close relationship of the proposed activity to the business of the subsidiary banks," but Martin averred that the regulators would be in the best position to judge whether an activity was proper and thus preferred that the Fed should be left unmolested by constraining statutory language (CQ 1969, 942-4). That this matter was openly contested shows how explicitly Congress and the Fed considered the question of how erosion would be handled, with Congress advancing a role for the courts in limiting agency creativity, and the agency pushing back for its own independence.

Rep. William Widnall (R – NJ), the sponsor of the Administration's bill, protested giving the Fed complete control (CQ 1969, 944). This could be interpreted as a worry over bureaucratic drift, or simply an attempt to include the banks' champion, the OCC, in the ongoing process of navigating erosion and maintenance. Meanwhile, the ABA itself opposed the bill's inclusion of judicial review of bank regulatory agencies' decisions about permitted diversification activities, and argued that decisions should be made by a majority of the OCC, FDIC, and Fed. The IBAA was foursquare for the Patman bill (CQ 1969, 945).

The changes in positions since 1965 show both the importance of policy learning over time, and also the tendency of interests to shift their positions along with legislative currents. Once need for regulation of one-bank companies seemed overwhelming, the question for the

IBAA became how to make things worse for bigger competitors who would gain more competitive advantages if more activities were allowed. The most effective means of pursuing this course for the small bankers was to accept inclusion of one-bank holding companies into the regulatory framework, but subject their larger counterparts to Fed, rather than OCC or mixed, supervision. The big banks countered that “the agency having primary responsibility for the bank in question” should exercise authority—for them, this would mean the OCC (945). The OCC and FDIC supported the Administration bill, thereby promoting their own interests (945-6). The Chairman’s Fed-centric bill ultimately won out and was reported to the full House.¹⁷

The Senate began its hearings in May 1970, with Chairman John Sparkman (D – AL) working closely with the Nixon administration. Well-represented at the hearings were trade groups for data processing companies, public accountants, insurance agents, and travel agents, all of who protested banks’ incursions into their businesses (CQ 1970, 878).¹⁸ The Senate passed an amended version of Patman’s bill, giving the Fed the leading role. It did add in several exemptions, however, for BHCs whose total bank holdings were less than \$3 million, and for BHCs whose bank holdings were less than 25% of the company’s total net worth, or \$50 million, whichever was less. Perhaps more important was an amendment that exempted “traditional banking practices” from the prohibition on “tying”—making credit contingent on the use of a service (CQ 1970, 880). The ABA intensely lobbied House conferees to accept these bank-friendly Senate Amendments. Once again, loopholes that served well-positioned interests were included as long as they seemed not to threaten the overall efficacy of the law.

¹⁷ Two major changes, both against Patman’s desires, were adopted: a grandfather clause was added, and allowed activities were required to be “functionally related” to banking rather than having a “close relationship to the business of the subsidiary banks” (946). Both show worries about the costs that maintenance imposed on private interests for actions which, when taken, had been perfectly legal.

¹⁸ In part because of the Glass-Steagall and Bank Holding Company Acts, banks were prohibited from insurance activities, and the erosion and maintenance of this separation became increasingly intertwined with the question of the separation between commercial and investment banking.

The conference report mostly retained the Senate's amendments, and the bill became law near the end of 1970. Importantly, there were some disputes between the House and Senate on how the act's language would operate, and so for all practical purposes the Fed was left to exercise its own discretion to determine what "public benefits" would mean in practice, as future courts would be unable to discern a clear congressional intent capable of trumping reasonable bureaucratic interpretations. Also, although Congress had considered including a "laundry list" of prohibited activities, in the end they favored Fed discretion (Jessee and Seelig, 30-33).

How do the theories do in explaining this round of erosion and maintenance? Baumgartner and Jones's theory does seem to have some power this time, as after the BHC Act of 1956 the issue fell off of the agenda only to return when the problem became large enough. Krehbiel's *Pivotal Politics* model might again be useful if supplemented with a sophisticated understanding of what it means to have a moving status quo. In this case, the status quo seems to have moved both because of change in the usage of the one-bank holding company form and in the perception of policy-makers as to the workability of that arrangement. Kingdon's framework can once again be useful if we look to the alignment of interests, but again serves more to describe than explain. The theory of maintenance and erosion explains lawmakers' changed positions more effectively by focusing on the intended ends of their action: maintaining Glass-Steagall separation effectively at the least possible political cost.

The next major developments for Glass-Steagall and the BHC Act came in court. By far the most important standing decision was handed down by Justice Douglas for a unanimous court in *Association of Data Processing Service Organizations v. Camp* (1970). In this case, data processing companies challenged a ruling by the Comptroller allowing American National Bank & Trust Company to offer data processing services to other banks and customers (at 151).

The petitioners contended that this went beyond the powers given to the Comptroller in the National Bank Act, and claimed standing because they were damaged by the competition from banks thus allowed.¹⁹ Although acknowledging traditional concerns about restricting standing to “cases and controversies,” the Court found that aggrieved competitors were entitled to standing to challenge agency decisions granting new bank powers in spite of the lack of explicit provision by the statute for such standing (at 156-7). While this case was not directly about Glass-Steagall or the BHC Act, it had momentous implications for the administration of those two acts. Thenceforth, the chief opponents of new powers for banks would be able to bring legal challenges, an opportunity they would not waste.

This involvement became consequential with *Investment Company Institute v. Camp* (1971). The ICI, which is a securities firm trade group, alleged that the Comptroller’s decision to allow banks to offer their customers “investment funds” violated the Glass-Steagall Act’s prohibition of securities activities for banks. The District Court found a violation by the Comptroller, but the Court of Appeals reversed, deferring to the Comptroller’s interpretation of the act. Justice Stewart, writing for the Court’s majority, wrote enthusiastically of the need for deference, but then found that, whatever the Comptroller might say, the investment funds in question were so nearly indistinguishable from mutual funds as to represent violations of the Glass-Steagall Act (at 625-7). Important to the decision was the fact that the Comptroller had offered little rationale for its holding, and the “post hoc rationalizations” offered by the agency’s appellate counsel were judged to be too late to affect the court’s reasoning (at 628). The decision delved far into Glass-Steagall’s legislative history to satisfy itself that mutual fund activity was

¹⁹ The relationship between cases that challenge the Comptroller on grounds of exceeding the powers given to him by the National Bank Act are not precise legal equivalents to cases challenging the Comptroller for violating the provisions of Glass-Steagall. Nevertheless, legal developments affecting one of these questions are closely linked to each other, and each type cites the other for precedent.

indeed meant to be prohibited (at 631-3). Having done this, Justice Stewart concluded that the narrow reading of the term “securities” given by the Comptroller would effectively vitiate Congress’s will, and so was clearly impermissible (at 634-6). Justice Harlan dissented, and would have denied standing to ICI (at 641-2). Justice Blackmun also dissented, complaining that the majority’s opinion was “based more on what is...desirable national banking policy than on what is a necessary judicial construction of the Glass-Steagall Act of almost four decades ago...Policy considerations are for the Congress and not for this Court” (at 642-3). In other words, Blackmun argued that the default interpretation should be permissive so as to minimize the statute’s invasiveness without further congressional guidance.

The Court’s dilemma in statutory interpretation is quite clear here: should it engage in an attempt to understand the “true” purposes of the statute, and then attempt maintenance of the law’s “spirit” even when the text is lacking, or should it limit itself to the plain meaning of the text? The first path sounds more attractive in many ways, but it is fraught with difficulties. As so much of social choice theory has shown, speaking of a coherent aggregate will of a multi-member body is often incorrect, and even when a statute attempts to articulate its own purpose (for instance through a preamble), the situation may not be simple.²⁰ Jonathan Macey (1984) discussed *ICI v. Camp* in this light, and concluded that the Court was twisting itself into knots because giving force to the act’s language and thereby frustrating consumers who would benefit from wider bank powers would have the practical effect of undermining the act’s stated intentions, which were to promote the public’s interest. Therefore while the majority’s *Camp* opinion reflected the court’s fine motivations in maintaining the act’s practical policy goals, the statutory scheme was destined to collapse under the weight of its own internal contradictions.

²⁰ Farber and Frickey (1991) present a good discussion of these issues. They ultimately recommend using legislative intent as a non-binding guide.

Macey argues that all special-interest legislation is likely to create similar paroxysms, but the theory of erosion and maintenance suggests that it is not the special-interest nature of laws that requires maintenance over time, but rather statutory complexity allowing private actors room to maneuver themselves into technical compliance and practical evasion.

D. A Change in Commitments: 1970s to 1980s

After Congress had taken so much care in 1970 to give administrative responsibility to the Fed rather than dividing it among the three banking agencies, presumably hoping to keep implementation fairly strict, it may have come as a surprise that the Fed from 1970-1974 turned out to be fairly lenient in allowing non-bank activities, and the BHC became far and away the dominant corporate form for banks during the period (Jessee and Seelig, 34). In 1972 the Board amended the regulations governing which actions were “closely related to banking,” therefore enlarging the permissible scope of activities for BHCs (*Bd. Of Governors v. ICI*, 1981, at 48). Only in 1974, with an economic downturn, did the Fed return to its conservative side, adopting a “go slow” policy and multiplying its denials of applications for new activities (Jessee and Seelig, 39). Meanwhile, the Comptroller continued to facilitate slow but steady erosion, in 1974 interpreting Glass-Steagall to let banks advertise computer-assisted stock purchasing services, although they could still only be offered to those with checking accounts at the bank (Fed. Banking L. Rep. (CCH) P 96,272 at 81,353).

By this time, three decades after the passage of Glass-Steagall, we can see that the belief in the Act’s basic principles had flagged among regulators. The more recent BHC Act and the amendments to it represented a strong remaining congressional commitment to keep the burden of regulation consistent for all types of important banking institutions, but may not have reflected

a deeper reaffirmation of the fundamental principle of separating commercial and investment banking. Without such a commitment, the die was cast for erosion of the strict separation between types of banking activity. This does not mean that maintenance was completely irrelevant, however. Regulators continued to value their ability to steadily guide the incremental development of bank powers in what they considered to be a safe and rational manner, and as the legal environment shifted in coming years, they would need to actively seek maintenance in order to meaningfully retain this power. Since this goal differed from that of the statute's original architects, one might also call this policy repurposing.²¹

During these years, legislative inaction may have begun to represent ambivalence about the continuing value of Glass-Steagall. Certain types of erosion—presumably those directly provoking important constituents—were still capable of arousing congressional ire, but maintenance in the form of legislation never came through. For example, in 1980, the House passed a bill to restrict BHCs from acting as insurance agents, but the Senate never took action (CQ 1999, 5-26). Signs were soon emerging that Congress was considering abandoning the project of maintenance and turning toward large-scale “reform” of the act, which would mean abandoning some of the central provisions. In 1983, Ronald Reagan proposed Glass-Steagall reform, including allowing banks to conduct real estate operations, but neither the House nor the Senate acted (CQ 1999, 5-27). In 1984, the House considered legislation that would have closed remaining loopholes in the 1956 legislation. Working at cross-purposes, the Senate passed

²¹ Importantly, policymakers did remain committed to the idea that there should be a separation between banking and commerce. See Figure 1 appended to end of text. Representative Jim Leach (R – IA), the single most important advocate of Glass-Steagall reform in the 1990s and one third of the namesake for the Gramm-Leach-Bliley Act, cites the preservation of the separation between banking and commerce as one of the motives for the reform that removed the separation between commercial and investment banks (Leach 2008).

legislation to allow BHCs to form subsidiaries which dealt in mortgage-backed securities and municipal bonds (CQ 1999, 5-27).²²

Regulatory erosion had continued amidst this indecision. For example, in 1982 the Comptroller abandoned all limitations to banks marketing of brokerage services, allowing national banks to operate subsidiaries offering discount brokerage services to the public at large from any of the bank's branches (Fed Banking L. Rep. (CCH) P 99,284 at 86,255). In 1984 the Fed allowed bank subsidiaries to market and underwrite all types of government securities (70 Fed Res. Bull. 661, Aug. 1984); in 1986 to provide full brokerage services, which it deemed sufficiently similar to services already allowed (72 Fed. Res. Bull. 584, Aug. 1986); in 1987 commercial paper dealing powers for BHC affiliates (73 Fed. Res. Bull. 473, Jun. 1987); subsidiary revenue-bond and mortgage-backed interest powers (73 Fed. Res. Bull. 607, Jul. 1987); and the list could be continued.

A fascinating wrinkle in these Board of Governors decisions was that several were decided 5-2, including a rare dissent from the Chairman, Paul Volcker. In this case, Volcker objected not on the merits of the policy choice but on the legal ability of the Fed to approve the changes under existing law. Volcker wrote: "As the Board as a whole has repeatedly urged, the plain and desirable remedy to this legal and substantive morass is a fresh congressional mandate" (73 Fed. Res. Bull. 473, at 506, Jun. 1987). Volcker and other Fed governors also testified in numerous congressional committees throughout the early 1980s, practically begging legislators to take up the task of reform. Central to these pleas was the argument that the Fed was incapable of doing the right kinds of legislative maintenance, which required new statutory language. As it

²² Many readers may want to interpret the loss of interest in Glass-Steagall as being part of the broader trend toward deregulation in the late 1970s and 1980s, and certainly the philosophical shift was relevant (for a description of the shift, see Derthick and Quirk 1985). But it should be noted that regulated interests were not asking to be unfettered so much as they were asking for flexible regulation by expert bureaucrats rather than inflexible regulation by an anachronistic statute that was probably misguided from the time of its adoption.

was, the Fed could only provide a series of patchwork fixes that relied on whatever legal forms could be devised consistent with the law's language.

With regulators having largely abandoned maintenance of the original goal of total separation, and Congress having become somewhat ambivalent about the importance of maintaining the wall, the task of maintenance in the 1980s fell mostly to the courts. But whereas in 1971 the Supreme Court had given a broad reading of the statutory language, in the 1980s the courts were mostly unwilling to do so. If we suppose, as is sensible, that they had no special policy preference in favor of preserving Glass-Steagall, then their commitment to maintenance derived only from their generic desire to see statutory language be treated as meaningful. In other words, the court's interest was basically that erosion take place through means that clearly respected statutory language rather than simply flouting the force of the laws.

In *Board of Governors v. ICI* (1981), the Supreme Court handed down its first pro-erosion decision concerning Glass-Steagall. At issue was the Board's determination that banks could affiliate with closed-end investment companies²³, which Justice Stevens, writing for the Court, said was entitled to "the greatest deference" (at 56). The opinion relied heavily on the fact that affiliates, rather than banks themselves,²⁴ would be involved in closed-end investment operations (which the court admitted was "securities" activity), as well as the fact that here, unlike in *ICI v. Camp*, the Comptroller offered an extensive, convincing opinion (at 68).

Continuing the trend toward deference, the D.C. Circuit Court ruled in favor of the Fed's decision to allow a state member-bank to deal commercial paper in *A.G. Becker Inc. v. Board of Governors* (1982). The Fed had determined that commercial paper (short-term corporate bonds),

²³ Whereas a mutual fund, which continuously sells shares throughout its existence, is designated as an "open-end" investment company, a "closed-end" investment company does not generally sell shares after its initial organization or redeem its shares on a regular basis (at 51).

²⁴ See Figure 2, appended to the text, for clarification.

was not a “security” within the meaning of the Glass-Steagall Act, since it functioned very much like a loan (at 139). Commercial paper’s treatment was a hugely consequential issue, as over the course of the 1970s the instrument had mushroomed in importance and provided a cheap means for corporations to raise funds. On the deposit side, banks had lost a great deal of business to money market mutual funds, another product offered by securities firms that had been all-but nonexistent several decades before. As a result, banks were losing customers to Wall Street—a phenomenon called “disintermediation” (CQ 1988, 230; Chernow 1997). This particular form of erosion made the regulatory system for banking doubly deficient: first, it was increasingly incomplete in its coverage; second, it was now subjecting its constituents, the banks themselves, to ever-widening competitive disadvantages, a development that may have pleased the securities industry, but certainly not the banking regulators themselves.

Showing sympathy for a regulator trying to make the best of this situation, the two-judge majority on the court of appeals panel emphasized the deference due to the Fed’s opinion because of the agency’s “scope of authority..., expert knowledge of commercial banking,” the lack of a precise definition in the statute (“we cannot assume that Congress intended the term to comprise a set of rigid and unchanging categories”), and the thoroughness and validity of its reasoning (at 140-1). The court endorsed the Fed’s functional analysis of commercial loans, agreeing that commercial paper was more like normal bank lending than securities speculation (at 149). There was a vigorous dissent arguing that the majority’s holding was inconsistent with *ICI v. Camp* and contrary to the simple language of the Glass-Steagall Act (at 152).

Deference to Fed power also carried the day in *SIA v. Board of Governors* (1983), in which a Second Circuit panel held that the Fed’s decision to allow a merger between Bank of

America and discount brokerage Charles Schwab did not violate Glass-Steagall or the BHC Act. This was upheld by the Supreme Court in 1984.

The overall trend toward deference was reinforced by *Chevron, U.S.A. v. Natural Resources Defense Council* (June 1984), a case involving EPA regulation of stationary source pollution. Justice Stevens, writing for a unanimous Court, set out a two-pronged test for agency deference that was fated to become canonical: first, if the intent of Congress is clear in the statute's language, this is always definitive for courts; second, if ambiguity exists, an agency's reasonable and permissible constructions of the statute deserve deference (at 842-3). *Chevron* was a part of a long-term shift toward deference for agencies, but its independent causal influence should not be underestimated in sorting out the banking laws in the years to come.

When regulators became too aggressive and appeared to simply ignore the statute's plain meaning, however, courts were still willing to take a stand. A string of cases in the years after *Chevron* probed the limits of deference. Two different strands of cases are particularly important. The first had to do with the Federal Reserve's ability to define what constituted a bank for the purposes of the BHC Act. The second returns to the issue of corporate paper debated in *A.G. Becker*, discussed above.

In *First Bancorp. v. Board of Governors* (February 1984 – decided before *Chevron*), the Tenth Circuit showed that deference was not absolute, and in this case that meant that erosion once assented to could not be reversed at the whim of later regulators acting without providing extended justification. In 1979 the Fed had unconditionally approved the application of First Bancorp, a BHC, to acquire an industrial loan company (ILC)—one species of “non-bank bank,” a bank-like creature that nevertheless was unregulated as a bank. In 1981, that ILC began to offer negotiable orders of withdrawal (NOW) accounts, which function like savings accounts but

do not legally obligate the banker to return deposits on demand (i.e. without delay). In 1981 First Bancorp applied to acquire another ILC that would offer NOW accounts, but this time the Fed agreed to the acquisition only if it was agreed that the bank should not offer *both* commercial loans and NOW accounts, as doing so would make it a bank²⁵. In addition, the Fed also ordered First Bancorp's first ILC to cease offering either commercial loans or NOW accounts (at 435). At issue here was whether the act's definition of a bank, which required that depositors have a "legal right withdraw on demand," was to be read narrowly, or, as the Fed preferred, functionally. The three-judge panel unanimously found that the Fed's new reading was inconsistent with the statutory language, which unambiguously defined what was to be considered a bank (at 436). The Board's pleas for deference were rejected because the court found that "the Board's order is an attempt to construct policy by adjudication" (at 438). By making a change in this way, the Board evaded the notice and comment requirements that general policy changes are subject to under the APA, and was thus beyond its authority.

Following on directly to this case was *Dimension Financial v. Board of Governors* (September 1984). This case, also in the 10th circuit before two of the same judges as in *First Bancorp.*, was to review official Federal Reserve changes in the definition of bank, which affected both the NOW accounts already decided and the definition of commercial loans. The Fed, in promulgating the new definition, now offered extensive reasons for its change in policy. Nonbank banks were said to enjoy an unfair competitive advantage by escaping Fed regulation (*Bd. Of Governors v. Dimension Financial*, at 367). In reviewing the Board's change in the definition of commercial loans, the once-again unanimous three-judge panel declared that since 1970 "commercial loan" had undergone no changes in common usage, congressional directive,

²⁵ This was problematic because the current application to acquire it was under a section of the BHC Act providing for acquisition of nonbanks.

or regulatory usage other than the Fed’s new regulation. It then chastised the Fed for making changes “with no reference to the actual meaning,” but rather “purely...to stop changes in the business of providing financial services—thus to bring a large number of additional enterprises under its jurisdiction.” “It was a device to freeze the changes in the business of financial services until the Board could persuade Congress to act” (at 1405). These changes, importantly, were not supported by the FDIC or OCC, or even by all of the regional Fed Banks (at 1408, 1410). The court reasoned that the institutions the Fed now sought to target had perfectly legally exploited “permitted exceptions”—intentional loopholes—and could not now suddenly be treated as if they had impermissibly evaded the act, and was emphatic that if anyone was going to fix this “problem, if it is that,” it would have to be Congress (at 1407). To support this position, it cited examples of Congress performing statutory maintenance on the BHC Act in the past, thereby showing that Congress was perfectly capable of acting (at 1407-8).

Just over a year later Chief Justice Burger and a unanimous Supreme Court affirmed, in *Board of Governors v. Dimension Financial Corporation* (January 1986). Following the lower court’s logic closely, Burger emphasized that Congress could act if it was distressed by the growth in nonbank bank holdings by BHCs (at 365). The Court ruled that *Chevron*’s first prong applied here, since the statutory language creating the loophole was unambiguous, and therefore did not give the Federal Reserve the discretion to close it at will (at 368). The Board, in its current anti-erosion manifestation, attempted to support its position by arguing that “a statute must be read with a view to the ‘policy of the legislation as a whole’ and cannot be read to negate the plain purpose of the legislation” (at 373). The Court, however, declined to entertain this logic, insisting that imperfections in the statute were Congress’s alone to fix (at 374).

At stake in the *Dimension* cases was whether Congress would be able to write effective loopholes. If the courts had assented to the Fed's policy changes, they would effectively have been saying that the banking agencies had unlimited scope in deciding how and when to perform maintenance on statutes, and would therefore have deprived Congress of ultimate authority to shape the functioning of particular statutes. As with Justice Blackmun's *ICI v. Camp* dissent, what is notable is the reliance on Congress's ability to act over long expanses of time to maintain statutes. Given the theory of erosion and maintenance, the court's belief is problematic. As we have seen and will see again, while it may be formally correct to say that Congress may clarify its aims at any time, it is often politically untrue. Even accepting this, however, courts are left to choose between the unattractive alternatives of facilitating regulatory evasion through pro forma compliance or acting as on-the-fly authors of amendments.

The second strand of cases, which began in 1982 with the D.C. Circuit's *A.G. Becker* decision, temporally overlaps with the first. In June 1984²⁶, the Supreme Court overturned the D.C. Circuit. Justice Blackmun, writing for the majority, insisted that commercial paper "falls within the plain language of the act," and therefore should be treated as a security for the law's purposes (at 140-1). The Fed's functional analysis was deemed illegitimate, as it required disregarding the statutory language (at 141-2). The Court cited its *ICI v. Camp* decision in support of various parts of its logic (at 144, 145), which is especially ironic since the majority in that case (which did not include Justice Blackmun) had embraced a functional reading of Glass-Steagall in contrast to the Comptroller's narrow, erosion-enabling reading. This case shares with *Board of Governors v. Dimension Financial*, to be decided nineteen months later, an insistence that the Fed is not allowed to treat itself as ultimate arbiter of how to "make the statute as a

²⁶ This case is now technically known as *SIA v. Board of Governors*, but is universally referred to as *Becker* in other court cases and in the literature

whole work,” or what the “real spirit of the law” is. Instead, Congress must be the one to navigate the course of erosion and maintenance, and if it chooses a course of inaction, that constitutes an “adherence” to previous statutory language (*Becker*, at 153). This logic would suggest that *ICI v. Camp* was decided wrongly, as Justice Blackmun originally argued. In *Becker*, Justice O’Connor, joined by Justices Brennan and Stevens, wrote in dissent. Because there was no explicit definition of securities provided, they would have deferred to the Board’s determinations on grounds of expertise, in line with *Chevron* (handed down just three days earlier). This *Chevron* reasoning would ultimately prove victorious.

In the wake of *Becker*, two district courts attempted to figure out what to do with the Comptroller’s decision to allow banks to establish individual retirement accounts (IRAs). *ICI v. Conover* (N.D. Cal., August 1984) aligned with *Becker*, arguing that the Comptroller was charged with administering unchanging statutory language, not with creating its own discretionary law (at 854). This was to be the high-water mark of for *Becker*, as in a parallel action, also called *ICI v. Conover* (D.D.C., November 1984), the ruling instead followed *Chevron* in finding the Comptroller’s IRA decision worthy of deference. The same result obtained in another nearly identical action, *ICI v. Clarke* (D.Conn., January 1986). The Second Circuit was the first Court of Appeals to take up the matter, and in a quick *per curiam* opinion affirmed the deferential result in May, 1986. Judge Kenneth Starr, writing for a unanimous D.C. Circuit Court of Appeals panel including then-Judge Scalia, affirmed the D.C. District Court ruling in May, 1986. Noting the extensive justification provided by the Comptroller in making his ruling, the court was able to distinguish *Camp*, at which point it could rely on *Chevron* deference. Since the statutory language and legislative history were ambiguous (although they were no different than in 1971), reasonable constructions by the responsible agency must be

accepted by courts (at 933-935). Rather than seeing statutory deficiencies as being Congress's to correct, Starr wrote that "Congress has charged the Comptroller with making" complex economic judgments "in the first instance," and that it was none of the courts' business to interfere with that delegation (at 938). The outlying Northern District of California decision was then overturned by the Ninth Circuit in June 1986 in *ICI v. Clarke*, which declared that "whether [the Comptroller] performs his task wisely is not for us to decide" (Judge Reinhardt at 222). The Supreme Court then denied certiorari in November 1986.

Finally, to cap this strand of cases, the D.C. Circuit took up another case called *SIA v. Board of Governors* (December 1986). A unanimous three judge panel joined Judge Bork in challenging *Becker* head-on, ruling to uphold a Fed commercial paper ruling made on remand after *Becker* that justified approval through another section of the Glass-Steagall Act and thus circumvented the Supreme Court's complaints (at 1055). Relying on the fact that the Board now had "comprehensively addressed the language, history and purposes of the Act," the court found the action cleared *Chevron*'s first prong and was clearly reasonable enough to satisfy the second. The Board was well within the bounds of statutory language and the underlying concerns of the statute, as it demonstrated through various precautions and promises extracted from the bank in question (at 1067). Once again, this time perhaps more surprisingly, the Supreme Court denied cert in June 1987.

What should we make of the Supreme Court's silence as its own precedents were distinguished into oblivion? This was a quiet but wholly effective for the Court to allow *Chevron* deference to become the controlling rule in banking regulation without ever having to suffer the embarrassment of directly reversing its own decisions. Because of the almost inexhaustible nuances of the policies involved, regulators and those that they regulated could

respect the Court's precedents in name without having to worry too much about their effects. As long as the courts were unwilling to oppose the regulators consistently, in many cases, over a long period of time, the regulators would have their way in dictating the course of erosion.

In November 1986, the D.C. Circuit dealt with some of the fallout from giving the banking regulators their way in *American Bankers Association v. SEC*. In the wake of the commercial paper holdings, the SEC asserted its right to regulate banks as broker-dealers of securities, and it convinced a D.C. District Court of its position. With surprising directness Judge Wald, writing for a unanimous three-judge panel, stated that “the original administrative construction of the Glass-Steagall Act has been dismantled piecemeal over the last fifty years” (at 741). The court understood the SEC's position to rest on the idea “that regulatory authority should be divided among government agencies according to the different financial functions performed by the regulated entity, and not according to the species of financial institution it is” (at 742). This functional approach to regulation was advocated by the Fed, as well. But this functionalism was *not* provided for by the Glass-Steagall Act or the Securities Exchange Act of 1934, and the SEC was not entitled to expand its own jurisdiction simply because there might be good policy reasons to do so (at 743). Judge Wald sympathized with the SEC's argument from functional need, but believed it “raise[d] basic issues about the role of courts in construing legislation” (at 748). She asserted that “it is not the job of courts to play the game of ‘what if’ in predicting hypothetical congressional reactions to hypothetical circumstances,” especially when the statutory language itself is fairly clear (at 749). Showing worries for courts' capacities, Wald wrote that doing so “would embroil courts in constant controversies as to whether the context that had changed was really relevant” (at 754).

What can we say theoretically about this string of judicial opinions respecting the erosion and maintenance of the Glass-Steagall Act? Clearly it would be unfair to expect theories of legislative action to account for these, but it is worth noting the interconnectedness of the judicial proceedings and Congress's actions—or inactions. Policy was effectively changing without legislative actions, and it was doing so in ways that are difficult to describe in terms of an ideological spectrum. Instead, in a pattern familiar to the American Political Development literature (e.g. Frymer 2008), this process of bending but not breaking statutory language produced policy outcomes that were not a weighted average of any actor's choices. The eroded and shabbily maintained state of the law itself became a problem for Congress to cope with.

Erosion continued with regulator encouragement now, as the FDIC granted the state banks over which it has regulatory jurisdiction the ability to have securities affiliates. This decision, challenged in *ICI v. FDIC* (April 1987), was upheld by the D.C. Circuit. A *per curiam* opinion by Judges Starr, Silberman, and Wright leaned heavily on *Chevron* and found that the Glass-Steagall Act's language clearly gave regulators latitude to allow non-member banks the ability to affiliate with securities firms, and therefore first prong analysis was all that was necessary to decide the question (at 1546).

E. Waiting for Good-Enough: 1980s to 1999

With so many holes in the floodwall and so much water over the dam, one might think that Congress would feel compelled to assert its primacy by at least determining the course of erosion. At this point in the story, it must be admitted that the theory of maintenance and erosion and the other theories discussed will all have a difficult time making much sense of the delays in Congress's Glass-Steagall reform that will characterize the final period. Ideological conflict or

gridlock intervals seem to be poor descriptors, and a lack of attention was clearly not an issue. Perhaps Kingdon's willingness to use the (rather mystical) explanation of the "political stream" not coming around is the best we can do. The theory of erosion and maintenance does add to this in part by drawing our attention to the ability of interest groups to block changes adverse to their interests, and certainly the securities industry's intransigence would play a large role in stalling change, but this should not be taken as the whole story.

In 1987 Congress did perform one important piece of maintenance by attaching a provision to bring nonbank banks under the BHC regulatory framework to the Competitive Equality Banking Act of 1987, which was mainly targeted at recapitalizing FSLIC (the savings and loan equivalent to the FDIC). This provision was championed by Democrats, and survived an attempt by Jake Garn (R – UT) to remove it from the bill (amendment defeated 35-54) (CQ 1987, 632). Showing that the Congress was intended to perform broader maintenance, the Act also imposed a one-year moratorium on regulatory approval of BHC applications to engage in real estate, insurance, or securities underwriting activities.

In 1988 the Senate turned to the larger deficiencies of the regulatory regime. There was a feeling of some urgency to redefine bank powers because of recognition that the Fed and other bank regulators, with legal approval from federal courts, "would continue a pattern of chipping away piecemeal at Glass-Steagall prohibitions" (CQ 1988, 230). The moratorium had attempted to "put a brake" on this pattern while Congress assembled new legislation. The bipartisan Proxmire-Garn bill, named for Banking Committee Chairman Proxmire (D – WI) and Ranking

Member Garn, was negotiated behind closed doors, giving the senators the chance to hash out thorny issues away from lobbyists' scrutiny (CQ 1988, 231).²⁷

The bill would have allowed banks to market securities, but only through separate affiliates owned by BHCs, and thus under Fed regulation. It would have also included certain "fire walls" to prohibit risky arrangements. For insurance activities, banks would be strictly limited geographically and in which lines they could write, which most observers thought was very favorable to the insurance companies (and attributable to their congressional champion, Sen. Christopher Dodd, D – CT) (CQ 1988, 231). The bill was reported out of committee 18-2, and passed virtually unchanged on the Senate Floor, 94-2. The ABA and insurance industry both supported the bill as a fair compromise, although the IBAA stood in opposition because it feared industry consolidation as a consequence (CQ 1988, 232).

When the House Banking Committee subsequently considered its own bill, it divided along party lines. Chairman Fernand St. Germain included strict consumer protections, leading the ABA to condemn the bill as needlessly partisan. The bill that finally came out of committee pleased few legislators or groups other than St. Germain himself (CQ 1988, 236). What especially rankled bankers was the proposal to stiffen the Community Reinvestment Act (CQ 1988, 237). The actual substance of Glass-Steagall reform was not politically divisive, but it was bundled with a far more controversial provision that induced gridlock. The situation was further complicated when John Dingell (D – MI), a champion of the securities industry, led his House Energy and Commerce Committee to report a version of the bill with much sharper limits on permitted activities for bank affiliates (CQ 1988, 241). When Speaker Jim Wright failed to negotiate a compromise, the session ended without further House action.

²⁷ The use of such unorthodox drafting techniques may be crucial to Congress's ability to perform maintenance activities against the wishes of interest group constituents. This dynamic deserves further attention. See Arnold (1990) for a discussion of related issues.

At this point, new Fed Chairman Alan Greenspan wrote and repeatedly testified to urge action, which many members took as a signal that the Fed would act on its own if Congress would not. The outgoing Proxmire (who was headed to retirement and had just been deprived of a career-capping achievement) thought that the Fed should step in, but St. Germain was emphatic that he would not be dictated to by the Fed, saying he would feel free to overturn Fed actions—a hollow threat, since what the Fed was demanding *was* congressional action (CQ 1988, 241).

With the fallout from the Savings and Loan crisis dominating the Banking Committees' attention in the years to come, St. Germain never had a chance to follow up on his promise. In the giant banking bill of 1989, FIRREA, banking powers went unaddressed except to empower banks to acquire distressed thrifts and thus help to alleviate the stress in that industry (CQ 1989, 122). Erosion by the Fed and OCC continued. For example, in November 1989 the Fed allowed banks to derive as much as 10% (up from 5%) of their revenue from securities underwriting and dealing activities (75 Fed. Res. Bull. 751, Nov. 1989).

In 1991, at the urging of President Bush, Congress took up Glass-Steagall reform again alongside an overhaul of the nation's acutely distressed deposit insurance system. The Administration's comprehensive plan was cheered by large banks and even cautiously supported by the securities industry, which was actually becoming sympathetic to reform as the loosening of banking restrictions by regulators had allowed banks to make inroads into securities, but offered no compensatory benefits to securities firms wishing to affiliate with banks.²⁸ A reform would be useful to them only if it enabled banks to affiliate with non-bank commercial enterprises, however, since many already held non-financial subsidiaries (CQ 1991, 76).

28 This reversal of the securities industry's position nicely illustrates the opportunistic orientation of interest groups toward erosion or maintenance. This dynamic closely parallels what Hammond and Knott (1988) describe (with a metaphor contrary to this paper's) as the "deregulatory snowball". When the status quo of regulation is sufficiently disrupted, i.e. eroded, those who found themselves as beneficiaries of regulation in the past may now find themselves receiving the short end of the stick and call for the abandonment of regulation altogether.

The plan was opposed by smaller banks and the insurance industry, and at critical moments the administration failed to energetically push it through congressional obstacles (CQ 1991, 76, 78). Although the House Banking Committee passed a broad bill that resisted most attacks, including Jim Leach's (R – IA) amendment to delete the part of the bill that would allow affiliations between banks and commerce (CQ 1991, 84), it had to face the demands of four other committees hoping to take a crack at it. At this point, lobbyists including for the IBAA, consumer advocates, and insurance agents went to work in hopes of narrowing the bill.

Just as in 1988, House Commerce and Energy Committee Chairman Dingell turned out to be the biggest obstacle to banking reform, and would eventually force the House to consider only a very narrow deposit-insurance-reform bill. His committee passed a narrow bill, and he then allied with the disenchanted Chair of the House Banking Committee, Henry Gonzalez (D – TX), who was more determined to replenish the bank insurance fund than he was to take on Glass-Steagall. Gonzalez agreed to substitute the Commerce Committee's title on bank affiliations for his own committee's, thus cutting the legs out of larger reform (CQ 1991, 89). After broader bills were voted down, a narrowly tailored deposit insurance bill passed 344-84 (CQ 1991, 91). A similar story played itself out in the Senate, where Glass-Steagall was thrown overboard in order to secure a narrow consensus. While some hoped to revisit wider reforms, few "had the stomach for reopening the battle wounds they received during 1991" (CQ 1991, 96).

In 1994 Congress addressed itself to the interstate banking question, which parallels the Glass-Steagall story in many ways. While comprehensive reform was shelved for a time for Glass-Steagall, the Riegle-Neal Act showed that Congress was capable of performing maintenance by altering long-standing banking regulation.

After the Republican takeover of 1994, many thought that prospects for bank-friendly reform from Congress looked bright, but the interest group landscape was mostly unchanged, and insurance agents especially remained implacable foes of any bill that would expand banks' insurance powers (CQ 1995, 2-78). Meanwhile, the changes made by regulators actually lessened the urgency felt by many banks, who been allowed to do much of what they wanted without any changes in the underlying statutes (CQ 1995, 2-79). Some members of Congress, including Jim Leach, were still determined to try to "bridge the gap between law and reality," bringing Congress up to speed with the changes made by regulators and courts (CQ 1995, 2-78). What banks were enthusiastic for was "regulatory relief," meaning the cutting away of red tape from consumer protection laws, which the House leadership planned to bring to the floor in tandem with Glass-Steagall reform (CQ 1995, 2-79). The Clinton administration gave lukewarm support to expanding bank powers, and in the Senate Banking Committee Chairman Alphonse D'Amato (R – NY) was sympathetic but skeptical that passage could be obtained; he promised to deliver Senate action if and only if the House first passed a bill (CQ 1997, 2-75).

The House Banking Committee passed now-Chairman Leach's Glass-Steagall bill easily, 38-6, quickly drawing stiff opposition of the insurance industry. Richard Baker (R – LA) proposed a potential compromise allowing bank holding companies to market insurance only by acquiring insurance affiliates purchased from existing agencies but then explicitly preventing the Comptroller from expanding powers further, but this failed to take off. Commerce Committee Chairman Thomas Bliley (R – VA) also tried to introduce insurance powers, but was compelled to drop the idea after meeting withering insurance industry opposition (CQ 1995, 2-80).

Hoping to shepherd reform through difficult terrain, the House leadership now married the bill to the regulatory relief bill, along with a permanent moratorium on OCC expansion of

bank powers. This last provision, which would prevent a future run of erosion directed by the banks' favored regulator, disappointed the ABA, which turned against the entire package (CQ 1995, 2-80). It could do this because it expected the Supreme Court to validate significant insurance powers given to banks by the OCC in the upcoming case, *Barnett Bank v. Nelson* (1996) (CQ 1995, 2-84). This maneuvering in light of judicial developments shows that when interest groups think of erosion and maintenance, they do in the context of the policy that is likely to emerge from the whole process involving all branches of government. The specific content of statutes is only a means to this ultimate end.

Going against their leadership and Leach, Banking Committee members voted against insurance powers for banks, disrupting the nascent compromise and effectively dooming the bill. Insurance companies now disliked its empowerment of banks, banks disliked its OCC moratorium, and the Clinton administration and Democrats had never much liked extensive regulatory relief. Leach's extensive efforts to restore the compromise came to naught. Said House Majority Whip Tom DeLay (R – TX), "We are not interested in a bill this year if it is controversial and we have to pick between our friends" (CQ 1995, 2-84). This statement is remarkable in its openness about shaping policy choices to interest group demands, but probably does not reflect an extraordinary thought process for congressional leaders. After all, cleaning up the banking system would yield few electoral rewards compared to other policy opportunities.

Two important Supreme Court cases deciding banks' insurance powers were handed down in the mid-1990s, justifying banks' faith in the courts. In the first, *Nationsbank v. Variable Annuity Life Insurance Co. (VALIC)* (January 1995), the Court was asked to consider a 5th Circuit decision invalidating a Comptroller decision to allow banks to sell annuities. VALIC, an insurance company, contended that this power invalidly exceeded the powers granted to national

banks by the National Bank Act. Justice Ginsburg wrote for a unanimous Court that a failure to specifically enumerate a certain power within the statute did not preclude the Comptroller from authorizing it on functional grounds, and that the Comptroller's decision was therefore deserving of *Chevron* deference (at 262). This represents a clear departure from the mid-1980s Supreme Court's aversion to functionalist logic, and shows just how definitive *Chevron* had become.

The second case was the aforementioned *Barnett Bank v. Nelson* (March 1996). At issue was whether Florida could forbid national banks from selling insurance in small towns, in spite of a 1916 law that expressly granted banks the power to sell insurance in towns with less than 5,000 people. This case was quite complex because of the McCarran-Ferguson Act of 1945, which creates a reverse-preemption rule for insurance, so that state law is presumed to govern on all issues except those on which the Congress speaks directly (at 29). The legal analysis is irrelevant here, but the result is not. Justice Breyer, writing for a unanimous Supreme Court, ruled that national banks were indeed entitled to sell insurance in small towns, and any state laws to the contrary were preempted. The aggregate effect of this ruling was to allow banks to greatly expand their insurance operations, and thus further weaken their demands for legislation that would have delivered the same result.

Back in the legislative arena, in 1996 Chairman Leach continued to press for Glass-Steagall reform, in the process holding up regulatory relief and a recapitalization of the Savings Association Insurance Fund (SAIF) (by means of combining it with the Bank Insurance Fund – BIF) that had become a priority for the Clinton administration.²⁹ Because the plan would raise insurance premiums for banks, however, “the deposit insurance plan was a piece of legislation in search of a vehicle to help carry it past its opponents and over procedural hurdles” (CQ 1996, 2-

²⁹ Another interesting case of bundling, the Clinton administration had negotiated with House leadership to include the SAIF plan in the 1995 budget-reconciliation act in order to give it “political and procedural cover” (CQ 1996, 2-43). However, the bill as a whole then became unacceptable to Clinton, who vetoed it.

44). As negotiations dragged on without bearing fruit, Leach agreed to offer a bill combining only regulatory relief with the BIF-SAIF plan, but it included a provision subjecting banks marketing insurance to comply with state licensing requirements, which banks saw as undercutting their gains from regulators and courts and therefore opposed (CQ 1996, 2-45, 2-54). The status quo was now newly favorable to banks after the Supreme Court decided *Barnett Bank v. Nelson*, and they could therefore afford to reject bills they felt ambivalent about and wait to support a bill that would suit their interests exactly (CQ 1996, 2-52; McConnell 1996). Ultimately, the Clinton administration spun off the BIF-SAIF and included it in an end-of-year omnibus appropriations bill, and Leach's bill had no hope of reaching the floor (CQ 1996, 2-46). Leach's strenuous efforts to revive a Glass-Steagall ultimately sagged without enthusiastic support from congressional leadership or the Clinton Administration (CQ 1996, 2-53).

Leadership now hoped to pass a regulatory relief bill on its own, and after surviving a vicious brawl between banking and insurance interests over the licensing question (which was excluded in the end), a bill capable of winning passage emerged. Notably, it contained one provision designed to close the gap between Glass-Steagall law and practice. Well-capitalized BHCs seeking to expand into non-banking activities previously approved by the Federal Reserve had previously had to apply and wait for Fed Board approval, which took 60 to 90 days. The new law allowed them to proceed without Fed approval, requiring only that they notified the Fed within 10 days of commencing the new activity (CQ 1996, 2-49). In other words, the provision officially sanctioned bureaucratic erosion in the absence of more sweeping reform.

After these failures to pass Glass-Steagall reform, the Fed soon acted on its own volition to allow BHCs to expand securities operations in affiliates, changing the cap on affiliate security revenue from 10 to 25. Similarly, the OCC now allowed bank subsidiaries to perform activities

previously restricted to affiliates (CQ 1996, 2-54). These changes meant that the legislative status quo now advantaged commercial banks at the expense of the securities and insurance industries. Glass-Steagall reform would now become a priority for these industries, who found that banks were restricted from entering their industries only where the original statute was crystal-clear, while they were still barred from engaging in banking activities (CQ 1997, 2-74).

In 1997 legislative efforts resumed yet again. Chairman Leach hoped to pass some sort of reform law to provide maintenance for the now woefully fragmented regulatory edifice, rather than simply to bring erosion to its logical end. Reform would provide an “equalitarian” regulatory framework where an incoherent, bank-heavy system was developing (Leach 2008). Early in the year, a merger between Bankers Trust and the brokerage Alex. Brown had been approved, representing the biggest and most blatant breach of Glass-Steagall to that point (CQ 1997, 2-75). At a panel in May, former Fed Chairman Volcker told Congress that legislation was overdue, as the resolution being provided by courts and regulators was both uncertain and inadequate in many ways (CQ 1997, 2-75). Members of Congress other than Leach began to feel jealous of their own eroded prerogative, as well. Conference Chairman John Boehner (R – OH) declared, “Congress wants to preserve our right to write laws, which frankly has been overshadowed by the OCC and other regulators” (CQ 1997, 2-75).

Leach’s Banking Committee barely passed a bill, 28-26. One of the “yea” votes was Leach’s, and he expected not to support the bill on the floor because of amendments added against his wishes including one to allow a mixing of banking and commerce (CQ 1997, 2-75). The Commerce Committee reported a version of the bill somewhat more favorable to insurance and securities interests. The leadership, especially Boehner, then tried to broker a compromise in

private to avoid a floor-fight among co-partisans. Such a compromise did not emerge before the end of the session, however (CQ 1997, 2-79).

A deal was finally announced in March 1998, and the bill was introduced on the House Floor with strong leadership support. The bill would create a new legal form, the Financial Holding Company, which could offer banking, insurance, and securities underwriting and marketing. This would thus allow banking companies to buy brokers or insurance companies (already happening), as well as enabling purchases in the other direction (CQ 1998, 5-5). Although consumer advocates expressed unease, the bigger problem was that the ABA now deemed the compromise unpalatable and announced its opposition (CQ 1998, 5-7). Without this key support, leadership attempted to get things moving by attaching what it thought was a popular credit-union support bill, but to their surprise found that this actually made things worse, not better, and were forced to withdraw the bill for further alterations (CQ 1998, 5-7). Leach sought to lure banks back to the table by including a provision to allow limited securities powers to bank subsidiaries (rather than BHC affiliate companies), and hoped to gain Democratic support by tying in an extension of the Community Reinvestment Act (CQ 1998, 5-8).

At this point the landscape was changed in part by the announcement on April 6, 1998, of the merger of Citicorp and Traveler's Group, at that point the biggest stock swap in history. The market greeted the news of the intended merger with enthusiasm, as both companies' shares surged, even though Federal Reserve approval was required and current law would require the merged company to divest itself of insurance and underwriting activities (which accounted for about half of Travelers' revenue) (CQ 1998, 5-9).³⁰ With more pressure on Congress than ever before, the reform bill was reintroduced in May. At this point, Leach successfully passed an

³⁰ The Fed would approve the merger, giving a five year window for divestment, and there was a strong sense that Congress would act before that date came to pass (CQ 1999, 5-23).

amendment stripping the provisions that would allow the mixing of banking and commerce, 229-193 (CQ 1998, 5-11), and the final bill won passage 214-213 after many favors were called in, with Republicans giving about 2-1 support and Democrats opposing by about the same ratio.

Senate Banking Chairman D'Amato had recently said he would take up a bill only if it passed the House with broad, bipartisan support, but he agreed to try to get a bill through the Senate (CQ 1998, 5-10). This attempt soon became tangled in the Senate Banking Committee because of Senator Phil Gramm (R – TX), whose unwavering opposition to the Community Reinvestment Act (CRA) motivated him to halt the bill (CQ 1998, 5-12).³¹ Meanwhile, Treasury Secretary Robert Rubin also declared that the bill would be vetoed by President Clinton if it invested supervisory powers wholly in the Fed rather than the Treasury Department—indicating what some called a “turf war” (CQ 1998, 5-14). Despite the remarkable breadth of the interests favoring compromise, 1998 ended without a bill passing the Senate floor.

In 1999, Congress picked up where it left off, with Gramm now Chairman of the Senate Banking Committee after D'Amato's defeat in the November elections. The turf issue was active again, with Alan Greenspan arguing that non-banking activities should be held in holding companies' separate affiliates, while Rubin was equally adamant that banks should be allowed to embed these services in subsidiaries of banks themselves (CQ 1999, 5-5). Leach's House bill favored the Fed, while Gramm's Senate version would allow subsidiaries for banks with assets less than \$1 billion. Unsurprisingly, Gramm once again came out guns blazing against the CRA, and despite drawing veto threats provisions taking aim at the CRA were still included when the bill was sent to the floor (CQ 1999, 5-6). Leach's committee made some concessions to the Administration on structure and the CRA, and was able to report out its bill with a stunning 51-8

³¹ It should be noted that Gramm's intense opposition to the CRA appeared to be ideological rather than interest-group-driven. The ABA's representative said that banks did not feel particularly strongly on the issue (CQ 1999, 5-10).

vote in favor (CQ 1999, 5-7). On May 6 Gramm's bill, complete with its controversial provisions, passed the Senate floor with a party-line vote, 55-44 (CQ 1999, 5-9). In the House Commerce Committee's deliberations, privacy protections for consumers and questions about unitary thrifts inspired controversy, but compromises emerged (CQ 1999, 5-11, 5-12). The House leadership, including Speaker Dennis Hastert (R – IL), then guided the merger of the Banking and Commerce efforts, mostly favoring Leach's Banking Committee (CQ 1999, 5-13). Although there were fierce floor battles over peripheral issues, the bill won the administration's backing and strong bipartisan support, passing 343-86 on July 1 (CQ 1999, 5-15).

The conference committee that convened in late September was unable to work through difficult issues, and turned to backroom negotiations. At this point, interest group lobbyists were turned up the heat to make sure their favored provisions survived, with contributions having soared in the first half of 1999 (CQ 1999, 5-22). On October 14, the Fed and Treasury announced a truce in their turf war, agreeing on a structure that gave the Treasury much of what it wanted in terms of subsidiary powers (CQ 1999, 5-25). Negotiations and amendments, now public again, dragged on until culminating in a session lasting until 2 AM on October 22 that produced a final deal (CQ 1999, 5-26). The CRA had caused the most trouble, with Gramm doggedly holding out until he won concessions. On November 4, the House passed the bill 363-57 and the Senate 90-8, and a week later President Clinton signed into law the Financial Services Modernization Act, better known as Gramm-Leach-Bliley (CQ 1999, 5-31).³²

³² The law is extraordinarily complex, but two small provisions deserve mention here. One is that the law codified the preemption standard enunciated by the Supreme Court in *Barnett Bank v. Nelson* (CQ 1999, 5-35). The second is that the Act allowed banks to enter real estate brokerage activities if the Treasury Department passed a rule to that effect (CQ 2002, 2-36). A Treasury Department Spending bill in 2002 contained a real-estate backed provision imposing a one-year waiting period before such a Treasury proposal could be finalized (CQ 2002, 2-36). The following year, the same provision was attached again to Treasury appropriations (CQ 2003, 2-78), and the process was repeated again in 2004 (CQ 2004, 2-44). Finally, in 2006, the ban was made permanent by voice vote (2006, 2-42). This episode may invite further study.

Gramm-Leach-Bliley is nearly universally regarded simply as a repeal of Glass-Steagall, and understandably so. Representative Leach's office held a wake for the law, which featured a cake frosted with "Glass-Steagall, R.I.P., 1933-1999" (American Banker 1999). As we have seen, while this is correct in some sense, "repeal" had mostly been accomplished by a long process of erosion. Representative Leach thought of the act as "precompetitive, but not anti-regulatory" reform (Leach 2008). Given the right perspective, GLB was an important piece of maintenance that restored legal order to financial regulation. Although the tumultuous political battles leading to its final passage were complicated enough to defy clean theoretical classification, the theory of maintenance and erosion makes more sense of the final result than any of the alternatives theories considered.

III. Conclusions

A. *Erosion, Maintenance, and the Electoral Connection*

Electoral politics seems to have played almost no roll in the preceding narrative. This is no mistake. When the banking system is functioning without incident, the general public is all-but-completely oblivious to the subject of banking regulation.³³ Moreover, it is hard to imagine that most people possess even latent preferences about complex decisions of regulatory policy. They are simply too heavy to be turned into political footballs.³⁴ That said, banking crises do affect the public with startling directness, and lead people to demand actions that will minimize their damage and prevent future recurrences. As already discussed, public attention played an

³³ Greider (1987) argues that the general public was much more engaged with issues of banking and monetary policy before the creation of the Federal Reserve, and so the analysis here might not apply to 19th century issues of banking regulation (of which there were many). Then again, there were also many more banking crises then.

³⁴ As evidence, John McCain's attempt to portray Democrats as having been too soft on Fannie Mae and Freddie Mac, which is a much simpler issue than most in banking policy, seems to gain little traction with the general public in the 2008 election.

important role in the formation of policy in 1933. It is doing so again in 2008 and 2009, although it is difficult to make out the exact direction of influence as of yet. (Regulators whose distinguished academic careers centered on the causes of the Great Depression may actually be more prone to radical action than even the alarmed general public.) But in the 75 intervening years, the public can be said to have played a very small role. Their latent hatred of banking crises may have lurked deep in legislators' minds, but that is about all.³⁵

With such an uninterested public, what exactly are Congress's interests in the banking system? To answer this question, we must first ask what interest individual legislators might have in banking policy.

As noted above, electoral positioning will provide little reason for congressmen to take positions one way or another. Incumbents may nevertheless be able to use the issue to improve their political fortunes through position-taking pleasing to wealthy special interests available as potential campaign contributors. As will be discussed momentarily, there is a multiplicity of such interests pointing in different directions, and so lobbyist pressure will not act as a force for congressional uniformity. Instead, we see Congress fragmented along interest group lines.

If we move away from the electoral connection³⁶, individual members of Congress may genuinely hope to construct a system of banking regulation conducive to the benefit of the general public (even if this is a relatively low priority). Even if there is a consensus on the importance of this goal, understanding enough about policy to know what changes to support is still a monumental task. While specialized committee staffers undoubtedly provide some

³⁵ One might argue that voters influence banking policy indirectly by supporting either pro-regulatory Democrats or anti-regulatory Republicans. It is difficult to see how this ultimately matters very much, though. As noted, there was no real push for "free-market" solutions in banking, and the interest-group considerations that undoubtedly do influence policy making tend to be cross-partisan. It is hard to imagine that the Senator from Connecticut would fail to be a strong advocate for insurance companies regardless of his party.

³⁶ We might follow Fenno (1973) in assuming that members pursue three goals simultaneously: reelection, influence within their legislative chamber, and good public policy. In the context of banking, the second of these goals will mean chairing a relevant committee or being recognized as an important constituency's "point man."

information apposite to this purpose, most information is received directly from the regulated interests or the banking regulators themselves. This may be supplemented by non-governmental experts, including academic economists. Finally, while it is rare, some members of Congress may derive preferences about banking policy from their own broader ideologies, especially pro-market ones.³⁷

How do these individual legislators' preferences coalesce into a single congressional stance? The realistic answer is that, mostly, they do not. As the extraordinarily conflicted political struggles of the 1980s and 1990s showed, the complexity and number of issues involved are likely to make it quite difficult to distill just one bill acceptable to a majority without prying the interest of congressional leaders away from other more electorally salient issues. In the context of a crisis, this will be easy. It will probably also be relatively unproblematic to pass legislative maintenance bills if a law's enacting coalition is still present. But in the absence of either of these conditions, a conflicted Congress is likely to remain uninvolved.

The other way we might expect Congress to affect policy outcomes is through oversight, which has also been ignored throughout this narrative. This is not because there were no congressional interest or committee hearings, but rather because they seem to have had almost no effect. As an article in the *American Banker* put it, bureaucrats might find themselves subject to a "tongue-lashing," but if there was no real chance of a legislative follow-up, this could be shrugged off with relative impunity. Representative Jim Leach could thunder against the Comptroller's abrogation of Congress's constitutional authority, but with every bill becoming tangled in the interest-group morass, this amounted to rhetoric (Seiberg 1998).

³⁷ This may not seem so rare to some readers, but what it means is that a member of Congress would be willing to push free market principles in issue areas where the regulated entities themselves are uninterested in doing so. Obviously, regulated interests themselves may advance their arguments in ideological form, and it may be in this form in which they are absorbed by legislators.

B. Erosion and Maintenance as Functions of Statutory Interpretation

Many political scientists assume that judges have well-defined policy preferences and reach decisions which promote these. Whatever the plausibility of this hypothesis in the realm of hot-button political issues such as civil liberties, it is hard to discern any appreciable effect that individual judges' specific policy preferences may have had in the realm of Glass-Steagall. Instead, judges' overarching concerns dictate their stance toward erosion and maintenance.

First, judges have an institutional interest in defining the scope of their own jurisdiction. On the one hand, they must jealously defend their ability to weigh in from bureaucrats who would just as soon not have their decisions subjected to second-guessing by non-experts. On the other hand, they do not want to create a situation in which courts are the go-to arbitrator for every conflict between regulators and those regulated, because doing so would swamp judicial capacity.

Second, judges desire to faithfully uphold the plain meaning of statutory language as well as upholding Congress's underlying intent.³⁸ They may want to do this out of fear of congressional retribution (Clark 2008), or for what amount to capacity concerns (many judges do not *want* to act as ad hoc legislators), or for the "proper" reason instilled by law schools, which is that in the separation of powers the judicial role is one of interpretation. At least in the court cases considered in the history of Glass-Steagall, it requires an exquisitely refined sense of cynicism about courts to believe that the courts are uninterested in being faithful to Congress's

³⁸ The argument that "legislative intent" is an oxymoron, advanced by Shepsle (1992b), is one that courts clearly ignore, regardless of its merit. Also mostly ignored is the possibility that Congress would provide a disingenuous intent to mask its true motivation of delivering benefits to an interest group (as Stigler 1971 supposes is self-evident).

intent or the meaning of its plain language—although, as we saw, figuring out exactly what that entailed was far from easy or uncontroversial.³⁹

Finally, deference to policy actors with greater expertise, including Congress, is an important norm for unelected, non-expert judges. This may be especially true since *Chevron*. Because judges recognize the informational advantages possessed by bureaucrats, they may see deference as the best way to secure good policy, and in any case may not feel that they ultimately have another choice that does not entail constant judicial involvement in bureaucratic affairs.

Judges are put in a difficult situation when the law’s intent—its “spirit”—is in conflict with a straightforward reading of its language, as will often be the case once erosion has begun. Just as troublesome is when what seems to be the “straightforward reading” is rejected by regulators who spend their careers immersed in the details of a law’s operation—as will happen when regulators become sympathetic to erosion. Here judges may be strongly inclined to give force to the language. This is because Congress always retains the power to amend legislation, whereas this power will itself be undermined if courts allow themselves to decide how statutes should operate even where there is no clear language to determine this. The problem posed here will be of central importance for any court facing challenges to perfectly legal policy erosion. Furthermore, if judges do adhere to plain language, they will provide a means for which Congress to overcome at least in part the dangers of bureaucratic drift.⁴⁰

³⁹ The cynicism must be court-specific, as the argument made in Landes and Posner (1975) supposes that an independent judiciary that will faithfully interpret statutory language will be extremely valuable even to a Stiglerian legislature hoping only to peddle the fruits of legislation to the highest bidding interest group. This is because Congress can credibly offer a more durable bargain if it cannot simply be reversed by judges who dislike that bargain. (Of course, one might wonder why courts would willingly make themselves a party to such bargains...)

⁴⁰ This logic closely tracks the arguments made in the constitutional realm by Whittington (1999).

C. Restating the Theory of Policy Maintenance and Policy Erosion

The purpose of this paper has been to show the importance of the dynamic of policy maintenance and policy erosion to understanding the actions of legislators, judges, and bureaucrats. While further research is clearly necessary to attain a full understanding of the dynamics of policy erosion and policy change, the case of Glass-Steagall illustrated several key characteristics. Policy maintenance is likely to be undertaken for its own sake only if a statute's enacting coalition remains a majority. Bureaucratic agencies and courts may also engage in maintenance, however, if their larger purposes allow or require it.

We have also seen the complex interplay of the branches in negotiating erosion and maintenance. Individual congressmen may be dutifully committed to one interest or another, but (especially as the passage of the act becomes increasingly distant in time) the Congress as a whole is likely to be torn by opposing interests and thus offer only unsure maintenance. Whether it will become more unsure over time, as it did in the case of Glass-Steagall, will depend on the particular configuration of interests. As a result of Congress's inconstancy, the dominant determinant of erosion is likely to be bureaucratic disposition toward the act. A combination of regulated private actors and sympathetic regulators seeking erosion may therefore be only as constrained as the courts decide based on a statute's original language and structure. And in an era of *Chevron* deference and increasing executive power, the effect of this constraint may be quite small.

Because erosion should be a "known unknown" when Congress enacts legislation, it must confront the question of how it can achieve policy goals using means minimally susceptible to erosion if it is interested the long term. But if we are all dead in the long-run, congressmen are out of office even faster than that. Studying when congress chooses to take such concerns

seriously, and how they choose between legislative forms when they do so, remains a promising avenue for future research.

D. Erosion and the Financial Crisis of 2008

To end this paper, we will return to the question posed at the opening. What exactly was President-elect Obama talking about when he chastised the Bush administration for its deregulatory excesses?

For his part, former Banking Committee Chairman Jim Leach thinks that while Obama's language may have been imprecise, he may have actually understated his case against an administration uninterested in using many of the tools granted to it under the existing regulatory framework (Leach 2008). Many in the media have cited a 2004 change in SEC net capital rules which allowed Bear Stearns and Lehman Brothers to reach leverage ratios as high as 30 by the time they failed in 2008. The common interpretation of this, which is that valid regulations were ignored by a captured regulator, could certainly be interpreted as erosion. This is not the whole story, however; indeed, the regulatory changes were dictated by the adoption of the Basel II banking standards, an international accord meant to stabilize the international financial system, which allowed investment banks so much leverage as a result of its mathematical models for risk calculation (Calomiris 2008). This seems to have been a case of an attempt at maintenance on one dimension unintentionally, and disastrously, causing erosion on another.

The SEC's capital standards rule is not the only suspect, however, and in another case we see a clear example of the regulatory system as a whole experiencing erosion on a massive scale. This is in the rise of credit default swaps (CDS), a derivative whose value rises with a company's risk of default and thus potentially provides a form of insurance. Derivatives, like bank holding

companies so many decades before, fell through the cracks of the regulatory system, and as their importance shot up after 2000 they remained unregulated. In hindsight, this clearly represented a huge failure in maintenance of the financial system, which is at this point so interconnected that an erosion of one piece of the figurative dike seems to have released a torrent. Who is to blame for this failure is open to debate. Certainly Congress did little, but with an issue this complicated and new, we might well believe that only expert regulators could have offered effective maintenance if it was to occur. There are good reasons to think that various regulators with powers to supervise insurance companies (such as AIG), investment banks, and financial holding companies had the power to give some structure to derivative markets all along (Leach 2008).⁴¹ Looking forward, Congressman Leach points out, we should also be looking to designate a primary regulator responsible for ensuring that no product slips through the regulatory cracks (Leach 2008b). In other words, 2008 has vividly animated the potential consequences of policy erosion and the importance of policy maintenance, and we must seek out ways to have less of the former and more of the latter in the future. As we are seeing now, doing otherwise is to risk being lost in the flood.

⁴¹ An example of this offered by Leach is a clearinghouse for CDS, which would have normalized the functioning of these exotic instruments and greatly reduced their potential risks in the event of a downturn. See Landler (2008); Leach (2008b).

Figure 1

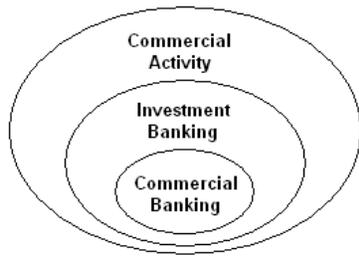


Figure 2



Chronological Listing of Cited Cases

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Whitney National Bank v. Saxon, 379 U.S. 411 (1965)
Association of Data Processing Service Organizations v. Camp, 397 U.S. 150 (1970)
Investment Company Institute v. Camp, 401 U.S. 617 (1971)
New York Stock Exchange v. Bloom, 562 F.2d 736 (1977)
Board of Governors v. ICI, 455 U.S. 551 (1981)
A.G. Becker Inc. v. Board of Governors, 693 F.2d 136 (1982).
First Bancorp. v. Board of Governors, 728 F.2d 434 (1984)
Chevron, U.S.A. v. Natural Resources Defense Council, 467 U.S. 837 (1984)
SIA v. Board of Governors (known as *Becker*), 468 U.S. 137 (1984)
Dimension Financial Corporation v. Board of Governors, 744 F.2d 1402 (1984)
ICI v. Conover, 593 F.Supp 846 (N.D.Cal., 1984)
ICI v. Conover, 596 F.Supp 1496 (D.D.C., 1984)
ICI v. Clarke, 630 F.Supp 593 (D.Conn., 1986)
Board of Governors v. Dimension Financial Corporation, 474 U.S. 361 (1986)
ICI v. Clarke, 789 F.2d 175 (CA2, 1986)
ICI v. Conover, 790 F.2d 925 (CA DC, 1986)
ICI v. Clarke, 793 F.2d 220 (CA9, 1986)
Cert Denied, 479 U.S. 939 (1986)
American Bankers Association v. SEC, 804 F.2d 739 (CA DC, 1986).
SIA v. Board of Governors, 807 F.2d 1052 (CA DC, 1986)
Cert Denied, 483 U.S. 1005 (1987)
ICI v. FDIC, 815 F.2d 1540 (CA DC, 1987)
Nationsbank v. VALIC, 513 U.S. 251 (1995)
Barnett Bank v. Nelson, 517 U.S. 25 (1996)

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70 Fed Res. Bull. 661, Aug. 1984

72 Fed. Res. Bull. 584, Aug. 1986

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