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Abstract: The debate over modernizing the financial structure is raising questions about the merits of modernizing the financial regulatory structure. Regulatory structure is important because an almost unavoidable feature of our current system of government is that Congress assigns multiple goals that sometimes have conflicting policy implications to the regulatory agencies. The structure of the agencies is important to the resolution of these conflicts. Responsibility for two or more goals that have conflicting implications may be assigned to a single agency that is likely to resolve the conflict with a consistent set of policies based on the agency's priorities. Alternatively, the goals may be assigned to more than one agency, an action that often results in the conflicts being debated in the public arena but that may also result in the agencies' implementing inconsistent policies. This paper uses the problem of goal conflicts to provide a framework for evaluating alternative regulatory structures.

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Financial Regulatory Structure and the Resolution of Conflicting Goals

Larry D. Wall and Robert A. Eisenbeis

Most of the current debate about the future of the financial regulatory structure is being conducted by the regulatory agencies primarily because the scope of their authority and constituencies are at stake.[1] Many other parties interested in financial modernization tend to dismiss agency structure questions as being primarily regulatory turf issues. This paper argues that regulatory agency structure is not merely a turf issue because it affects how the often conflicting regulatory goals assigned by Congress to the agencies will be balanced and resolved, both within and across regulators. In the end, how this conflict is resolved often will have an important impact on social welfare.[2]

Questions about the structure of regulatory agencies and their responsibilities are not unique to financial services. A staff report of the U.S. Senate Committee on Governmental Affairs (1977, vol. 5, p. 5) notes that Congress tends to address problems in a piecemeal fashion and that the result is "imprecise (or actually duplicative and

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1 Financial services firms also have an important stake in the debate. However, agency structure is a second-order problem. For them, getting the "right" legislative goals enacted is the first-order problem. Moreover, some firms may also be careful about their public statements to avoid offending their existing regulator.

2 The importance of establishing goals for financial regulators is recognized by the Basle Committee on Banking Supervision (1997). The first sentence of the committee's first principle states, "An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations."

conflicting) statutory mandates."[3] The report continues (vol. 5, p. 5): "Where several agencies are involved in a particular regulatory function there is the possibility of omissions, inconsistencies and conflicting policy." This potential for conflicts has been recognized in the area of financial regulation. Horvitz (1983) points out that Congress has assigned multiple goals to the financial regulators and that oftentimes these goals have inconsistent implications for regulatory policy. He suggests that Congress often deliberately assigns these goals to different agencies. As a result, jurisdictional conflicts between the regulatory agencies over the form, substance, and implementation of regulations arise that are often a logical by-product of differences in their responsibilities. When conflicts arise from assignment of different and possibly conflicting goals to different agencies, in many cases they can be resolved in a consistent fashion in the public arena only by congressional action or compromise between the agencies. This process is termed **external conflict resolution**.[4] Horvitz notes that the publicity associated with

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[3]. This paper focuses on the United States largely because of differences in elected officials' ability to respond to goal conflicts operating under the U.S. Constitution versus governments operating in a parliamentary system where the finance minister is generally a member of the majority group in the legislature. For an international comparison of regulatory structures, see Barth, Nolle, and Rice (1997).

[4]. Each of the agencies has goal conflicts with the other agencies. The Securities and Exchange Commission (SEC) and bank regulators have recently clashed over bank loan loss accounting. The SEC is pushing banking organizations to use less discretion in setting loan loss reserves in order to reduce alleged income smoothing. The bank regulatory agencies are pushing banks to use their discretion to conservatively value the loans on their books in order for the banks to build a larger cushion to absorb future loan losses. The Commodities Futures Trading Commission (CFTC) also has clashed with all of the other financial regulatory agencies. The CFTC has suggested that parts or all of the market in over-the-counter (OTC) derivatives should be under CFTC regulation. The SEC and bank regulators have argued that even discussing CFTC jurisdiction over OTC derivatives may damage that market.

these conflicts may be reduced or eliminated by assigning the conflicting goals to a single agency that may then resolve these internally. However, he points out that assigning the conflict to a single agency does not eliminate the conflict but merely allows it to be resolved within that agency according to that agency's objectives and priorities. Since most agencies have both primary and secondary missions and constituencies, they will tend to align their solutions to conflicts according to the primacy of their objectives. We shall call this process **internal conflict resolution**.[5]

While the concerns about financial regulatory structure noted by Horvitz have long existed, the problem has become more acute in recent years. Financial firms have used advances in information processing and financial technology to exploit legal loopholes and to offer ever more products that are functionally equivalent to those offered by differently regulated financial services firms.[6] The result has been that competing institutions offering essentially identical products are subject to different rules, regulations, and regulatory burdens that differentially impact firms' profits and competitiveness in markets. To exploit these differences, institutions have engaged in regulatory arbitrage, seeking the most

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[5] Each of the agencies has important potential conflicts that it resolves internally. The SEC is charged with protecting small investors, but it must also be concerned with the efficiency of the domestic securities market. The CFTC promotes liquidity in futures markets, which may imply setting rules that enhance the profitability of the "locals" that provide liquidity. Yet the CFTC seeks to promote fair and transparent price setting, which may reduce the locals' profitability. Bank regulators may face the conflict between safety and soundness and CRA.

[6] For example, see Greenspan (1995).

favorable regulatory climate for the products they offer.[7] As a consequence, policies adopted by one regulator intended to achieve a specific public policy goal often have the unintended consequence of shifting market share to financial services firms regulated by another agency with different goals. The range of policy goals subject to regulatory arbitrage includes consumer protection (for both retail and wholesale customers), community development, market transparency, safety and soundness, limiting the safety net, reducing systemic risk, and increased competition. The problems associated with regulatory arbitrage are almost certain to increase whenever financial modernization legislation is passed to lower the legal barriers separating different types of financial services firms.

This paper examines four aspects of goal conflicts and regulatory structure. The first section analyzes the optimal resolution of conflicts in policy goals, assuming that both Congress and the government regulatory agencies sole objective is maximizing social welfare. This section argues that regulatory agencies may be better at identifying the most efficient set of policies but that Congress may be better at identifying the social welfare function. The second section recognizes that voters may not share identical interests and that one function Congress performs is to act as an agent for the voters in setting social policy and resolving conflicts. The public debate creates an environment in which revealed preferences help define the social welfare function or at least to identify preferred policies. This section also argues that Congress may not always be able to resolve goal conflicts in

[7] Examples of such products include commercial paper, which substitutes for bank loans to large corporations; direct loans by the securities firm to small businesses, which compete with comparable bank loans; and money market mutual funds, which provide many of the transactions services of bank transactions accounts.

a timely manner. Because of this, it may be rational to delegate the resolution of goal conflicts to regulatory agencies when immediate resolution through the legislative process would be too difficult. The third section considers the advantages and disadvantages of external conflict resolution relative to internal conflict resolution. The fourth section considers a variety of regulatory structures that seek to obtain the best of external and internal resolution. The analysis in this section shows that variations in regulatory structure can mitigate some of the disadvantages associated with both internal and external resolution. The conclusion draws on the rest of the paper to suggest a framework for working through questions of regulatory agency structure.

Our paper is related to but somewhat different from another paper, Kane (1999). Kane addresses the important question of how to control authorities that are using their power to transfer wealth from the taxpayers to themselves and their regulatees. While parts of our paper touch on this issue, our main focus is the impact of regulatory structure on the choice of priorities among conflicting public policy goals.

Our purpose in focusing on goal conflicts is not to provide the “best” solution to the goal conflict resolution, and, indeed, we do not find any single “best” solution. Instead, the aim is to elevate the debate over regulatory agency structure by recognizing that regulatory agency structure is important to how goal conflicts are resolved. We hope to provide a common framework through which many of the problems of agency structure may be analyzed and that such a framework may help in discussing the merits of alternative restructuring proposals.

1 An example of optimal resolution of policy conflicts

Optimal resolution of conflicting policy goals requires both the identification of the socially optimal set of policies and the implementation of those policies in a timely manner. To do this, policymakers must have information on the trade-offs between the policy goals and society's preferences for those trade-offs. This section provides a formal framework using a simple example to identify efficient combinations of policies and the social welfare function to be used to select a particular set of policies.[8] This requires that the policymaker understand the implications of each regulatory policy for achieving policy goals and society's preferences for combinations of different policies. It then must pick the optimum set of policy goals and the regulatory policies to achieve them. The example provides a basis for comparing the relative advantages of a regulatory agency and Congress in resolving conflicting goals under the assumption that both are solely motivated by a desire to maximize social welfare.

1.1 The efficient set of regulatory policies

To begin with, suppose we are concerned with the protection of the rights of investors, as was the case recently when the SEC forced a restatement and reduction in the loan loss reserves of SunTrust Banks, and achieving bank safety and soundness. At issue is the right of investors to know about the financial condition and earnings performance of the banking organizations in which they invest against the likelihood that reducing an institution's capital through such a restatement may increase its risk and lower the capital cushion to avoid losses. The conflict between the interests of shareholders and regulators, who prefer higher to lower capital ratios, should be clear. To put this issues in

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8 The question of how these regulatory goals are established or how they may conflict is important but outside the scope of this paper. For a discussion of the setting of goals see Becker (1983) and Tomain and Shapiro (1997, 385-96) and the cites therein.

a more formal context, assume that the social welfare function contains three arguments: (1) the expected number of bank failures, (2) reliable information on bank earnings, and (3) the net subsidy to banks or tax imposed on banks to reduce failures and to ensure proper financial disclosure. The principal tool available to banking supervisors for reducing bank failures is to require banks to hold additional equity capital in relationship to their risk exposure. Banks may be required to provide more accurate information about their earnings, but this information may be costly to produce and, as in the SunTrust case, have the effect of reducing required capital levels. The costs to banks of having their capital and information regulated constitute a type of tax that may be partially or fully offset by a government subsidy.

For any given regulatory measure of bank risk, the reduction in the probability that a bank will fail is a convex function of the required level of capital and of the net subsidy. Similarly, the principal tool of the SEC to enhance disclosure is the requirement that accounting conventions be modified to restate the loan loss account, thereby increasing bank earnings and lowering its reported capital. The trade-off between increased disclosure (and the associated compliance costs) and bank safety is a convex function between bank capital and reported earnings.

There is no conflict between reducing expected failures and increasing reported earnings if regulatory agencies can offset the reductions in bank safety through subsidies. However, the two goals are in conflict, as is illustrated in Figure 1, showing the trade-off curve between the interests of shareholders and the safety and soundness objectives for any fixed level of tax or subsidy. The efficient frontier gives the largest possible reduction in the risk of failure for any given level of disclosure. On this frontier, the regulators are assumed to be using a risk measure for capital adequacy purposes that does not distort banks' portfolio investment and are requiring banks to use the most appropriate accounting methods for disclosing earnings. The efficient frontier is concave to the origin because increases in capital yield diminishing marginal reductions in expected bank failures and reductions in reported earnings to shareholders. The shaded area inside the efficient frontier represent the set of feasible but inefficient policies. These points arise because the regulators have imposed an inefficient combination of capital and disclosure rules.

One problem in determining the socially optimal combination of disclosure and capital adequacy policies is identifying the efficient set of policies and the impact of the policies on bank failure reduction and disclosure. This problem arises because we cannot directly observe societies' preferences and can only approximate the trade-offs between risk and disclosure. Two different sets of possible efficient policies are shown as Efficient Frontiers 1 and 2 in Figure 2. Determining which frontier better represents the feasible set of trade-offs is further complicated because the efficient set of policies and the frontier will depend upon how banks respond to different regulations once they are in place. It is not feasible to ask the affected parties who have the incentive to misstate the costs and hence give biased estimates of the trade-offs. Banks, for example, have an incentive to overestimate the expected costs and underestimate the benefits in order to minimize the costs imposed by regulation. Similarly, attempting to assess the collective value of alternative disclosure policies to all possible investors would be infeasible. Asking consumers or representative investors would also likely be unreliable since they would have an incentive to underestimate the costs and overestimate the benefits.

1.2 Social preferences

Selection of the best combination of policies depends on social preferences and requires a measure of social welfare that is aggregated across all of the individuals in society. A number of issues exist in making such an aggregation, and Arrow's (1963) impossibility theorem suggests that no policy may exist that satisfies a seemingly reasonable set of criteria. In order to simplify, the discussion of Arrow's theorem is ignored. A social welfare function is assumed to exist with the following attributes: (1) any point on the interior of the efficient frontier is dominated by one or more points on the frontier, and (2) some subset of the frontier dominates all other points on the frontier.[9]

Given a well-defined social welfare function, the problem of identifying the optimal policy involves calculating the social welfare at each point on the efficient frontier and choosing the point that yields the highest welfare. When only two goals are in conflict the solution may be illustrated graphically as in Figure 3, which continues the example from the prior subsection. Once again the efficient frontier is represented as a convex curve. Suppose that social welfare is represented by the series of four concave indifference curves label A'_1, A'_2, A'_3, and A'_4, each forming a continuum of policy outcomes to which society would be indifferent on any one curve. Total social welfare is maximized by choosing a point on the curves that lie to the northeast part of the diagram. Social welfare would be higher on indifference curve A'_1 than on indifference curves A'_2, A'_3, or A'_4. However, no point on curve A'_1 is feasible because it lies outside the efficient frontier. Indifference curve A'_2 touches the efficient frontier at a single point whereas indifference

9 That is, Congress can agree that some policies are more desirable than other policies even if Congress cannot agree on a unique optimal policy.

curves A'_3, or A'_4 pass through the interior of the set of efficient policies. The point where curve A'_2 touches the efficient frontier of policies represents a feasible alternative that is superior to any point on curve A'_3, or A'_4.

The optimal set of policies for achieving the goals of bank failure reduction and investor protection depends on this social welfare function, and its slope defines the elasticity of substitution between policies. For example, Figure 3 shows the optimal policies both under social welfare preferences A' and under social welfare function B' (curves B'_1, B'_2, and B'_3). The points at which the two sets of curves touch the efficient set of regulatory outcomes differ, implying different sets of policies.

Because the social welfare function depends on preferences of the members of society, its parameters are unlikely to be known with certainty. While specialists in a regulatory agency may be able to estimate the outcomes associated with different policies, the social welfare function will generally not be subject to similar estimation. Nevertheless, the concept of revealed preference can often be relied upon to help make that determination.

1.3 Optimal structure for resolving conflicting policies

If both Congress and the government agency's sole objective were to maximize social welfare, then the only problem in picking the optimal policy would be identifying the policy that maximizes welfare. However, a presumption of our representative democracy is that the elected members of Congress are better able to listen to special interests and then evaluate the revealed preferences for different policy outcomes than is a bureaucratic agency, which often has a narrower set of goals and priorities. One way of thinking about this is that Congress is explicitly structured so as to reflect society's views and that its processes are likely to reveal society's preferences.

One way of combining the institutional expertise of professional regulatory agencies with that of the Congress would be for Congress to set the optimal policy, taking input from government agencies about the expected outcomes of different policies. A limitation of this approach is that the efficient frontier may be time or state dependent. Congress then has two costly choices and one feasible choice. One costly choice would be to write legislation that covers all contingencies—a task that would generally be prohibitively costly and difficult, and another would be to plan to regularly write new legislation to cover changing circumstances. Alternatively, Congress could delegate the decision-making power to a government agency and instruct the agency to evaluate different policies according to a congressionally mandated set of social criteria. Because of limitations on Congress, the most efficient method may be for Congress to determine the social welfare function and to delegate the problem of identifying the best policy to a government agency.[10] This issue is explored in the following section.

1.4 Limitations on congressional resolution of policy conflicts

Individual members of Congress are elected to serve their constituencies. However, once a member is elected, voters cannot directly control their member's actions. In this situation the members of Congress are acting as the voters' agents. As agents, members of Congress are in a position similar to corporate executives. Acting as agents

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10 An example of such a time and state dependency is the determination of which activities are closely related to banking, a set that has been growing with technological developments. In this case Congress explicitly delegated the determination of acceptable holding company activities to the Federal Reserve subject to a concise set of criteria.

for their shareholders, they also have incentives to expropriate wealth by engaging in perquisite consumption and attempting to keep their jobs (or in the case of Congress, to get re-elected.)[11]

Analysis of agency issues in corporate finance suggests that the congressional agency problem can be substantially reduced or eliminated if (1) voters agree on their position on a particular goal conflict, (2) voters and courts had complete and costless information about the actions of their representative, and (3) voters could write binding contracts with their representative or senator. Even though the politician would retain the freedom to act contrary to the voters' interests, the contract provides sufficient incentive to follow voters' interests.

In practice none of the three incentives exist in a practical fashion for voters to control their elected representatives. Voters rarely agree on the importance or optimal resolution of all issues. They also lack complete information about the actions of their representatives. Finally, the ability to contract or to enforce it with members of Congress is very limited. The principal sanction is an adverse vote at the next election sometime in the distant future.

Interestingly, the agency problem between voters and members may encourage Congress to delegate responsibility for resolving goal conflicts to regulatory agencies. Congress may have a consensus policy it wants to follow. However, the agreed-upon policy may have adverse consequences for a sufficient number of voters who might be

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11 Much of the return to Congress comes from achieving public objectives and is reflected in reelection. There have, however, been instances of personal gain that comes from fees for speaking, etc., many of which have been severely limited in recent years.

induced to sanction their representative in the next election by voting for a different candidate. Individual members can avoid offending part of their constituency by assigning responsibility for resolving some policy conflicts to the regulatory agencies, thus permitting members to claim credit for any beneficial effects of new legislation while deflecting the heat for the unpopular consequences to the agencies.[12]

The above analysis does not imply that obscuring unfavorable information is always undesirable in dealing with a principal-agent problem.[13] Congressional decisions to assign agencies with implicit responsibility to take unpopular actions may be desirable under some circumstances. For example, the U.S. electoral cycle may induce Congress to prefer trade-offs that achieve short-run benefits at the expense of incurring costs in the distant future and to avoid short-run costs even if it means passing up future benefits. Congress may reduce this bias in policymaking by assigning conflicting policies to a long-lived regulatory agency that does not place as high a discount on future costs and benefits.[14]

Agency problems also arise within Congress because of the way it seeks to conserve its members' time, a scarce resource. The committee system, with oversight responsibility over related sets of issues, not only economizes on time but also creates the

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12 See Kane (1980) for a discussion of the use of the Federal Reserve by Congress as a scapegoat for any deficiencies in the macroeconomic condition of the U.S. Schoenbrod (1993) argues more generally that Congress routinely allocates benefits to specific social groups without explicitly recognizing that it is imposing costs on other social groups. This leaves individual members free to blame the agency when it imposes the necessary costs.

13 Persons (1997) argues in a corporate setting that management misrepresentation may be efficient in certain cases where it reduces monitoring costs.

potential for members of the oversight and funding committees to obtain control rents from regulatory agencies and their constituencies. Members who are particularly interested in a set of economic goals may be able to exercise substantial influence over an agency's choice of priorities. Indeed, these members may be able to induce the agency to establish priorities among the goals in cases where there is almost no chance the full Congress would agree to such priorities.[15] This ability to influence agencies provides a further incentive for the committee writing legislation to delegate goal conflicts to a regulatory agency especially when that agency will be subject to the committee's jurisdiction in the future.[16]

2 Reducing agency problems between Congress and the regulatory agencies

Regulatory agencies play two important roles in setting public policy: (1) they provide Congress with information about the set of efficient policies, and (2) they implement the resolution of conflicting goals delegated to them. In either case, Congress often has delegated authority to more than one of the financial regulatory agencies. An important issue for the current debate is whether and how this division of authority among the agencies influences their ability to perform their roles.[17]

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[14] Blinder (1997) argues that more decisions should be delegated to government agencies in part because the agencies tend to have longer time horizons.

[15] See Noll (1971) and Schoenbrod (1993).

[16] Kroszner and Stratmann (1998) provide an additional reason why oversight committee members may want to exercise control over an agency. They argue that the Congressional Committee structure supports the development of a reputational equilibrium in which committee members gain a reputation for supporting the views of a particular special interest and the special interest group gains a reputation for providing campaign contributions to the member.

[17] This problem has some analogies to those discussed by Coase (1937). These analogies are discussed by Lehn (1999).

One consideration is the relative efficiency of different agency structures in producing information. If economies of scope exist in gathering information across different types of financial services, then internalizing goal conflicts may enhance the efficiency of information production. Alternatively, there may be diseconomies of scope such that information is more efficiently produced by agencies that specialize in particular problems or industries.

Dewatripont and Tirole (1999) examine the case of information production from the perspective of the incentive to produce costly information. They consider the question: why would an organization consciously set goals for some of their members that differ from optimization of the organization's welfare? Why, in particular, would an agency assign certain agents responsibility to serve as an advocate for a particular cause? They argue that when the rewards to agents are more contingent on the result of the decision process than on actual information production, motivating an agent to gather information on all sides of an issue may be costly or impossible. In contrast, agents that act as advocates for a specific cause may be motivated either to generate more information or generate the same information at lower cost. In their analysis they contrast the approach taken in the U.S. judicial system with the German system. In the United States lawyers are charged with presenting the best case for the defendant and prosecution in the belief that truth will bubble up in the process and can be winnowed out by a judge or jury. Under the German system, however, the judge is charged with seeking the truth, and in doing so he has an important role in examining witnesses and is given sole power to select expert witnesses.

Dewatripont and Tirole's findings suggest that when agencies' sole responsibility is information production then assigning advocates for different social welfare goals may be efficient. The following subsection analyzes the case where Congress has delegated responsibility for resolving a goal conflict to one agency and concludes that information production is also essential in that case. The second subsection then considers the benefits and costs of assigning the role of goal conflicts to different agencies.

2.1 Internal resolution and the need for information

As a base case in analyzing internal resolution, consider a regulatory agency headed by a single administrator who can make decisions without seeking public comment. Further, assume that Congress delegated responsibility for several goals with potentially conflicting policy implications but did not set any ex ante priorities among the goals. Under these assumptions, the agency head would have the maximum flexibility to implement Congress's conflicting goals according to his or her priorities.

The priorities of such an agency head may come from a variety of sources. One determinant that is likely to be important is the agency's self-interest. For example, the staff report of the Senate Committee on Governmental Affairs (1977, vol. 5, chapter 3) discusses a common, fundamental conflict when a regulatory agency is charged with both promoting and regulating an industry. The report argues that the goal of promotion typically dominates other policy goals, a tendency that can have undesirable outcomes. There are several reasons why promotion tends to dominate. First, the agency's importance and even existence depends on the fate of the industry it regulates.[18] Second,

[18] Such a conflict is one reason given for the Federal Home Loan Bank Board's failure to aggressively address the thrift debacle in its early stages.

even if the agency is not assigned responsibility for promoting the industry it regulates, the agency may nevertheless by captured by its regulatees. Third, Kane (1988) has argued that agency heads often take lower-paying regulatory jobs so as to obtain future lucrative employment in the industry they have been regulating. Thus, agency personnel have little incentive to be "tough" on the institutions they regulate.

Congress may offset the tendency of promotion to dominate regulation by legislating priorities among the various goals when it disagrees with those set by an agency. The setting of such priorities will generally have some influence over an agency because most are creatures of Congress and do have a degree of accountability. However, a determined administrator may choose to follow his own priorities and argue that, given the facts, his choice is consistent with Congress's professed priorities. Thus, in order to be assured that an agency is following its priorities, Congress must be ready and able to hold an agency accountable. As an extreme example, Congress held the Federal Home Loan Bank Board accountable for the losses suffered by the Federal Savings and Loan Insurance Corporation and shifted responsibility for regulation thrifts to a newly created agency called the Office of Thrift Supervision. Concern for controlling this agency problem was clearly behind the accountability and reporting provisions of FDICIA.[19]

Kane (1997) emphasizes the importance of transparency in agency decision-making as essential for Congress to hold an agency accountable. He points out that sometimes an agency follows priorities that are not acceptable to Congress or voters and may choose to provide misleading or even false information to justify their actions. Moreover, even in less extreme cases than envisioned by Kane, regulatory agencies have incentives to manage the information available to Congress in order to make their policy decisions appear in the most favorable light possible. This strategy would include publicizing facts and analyses consistent with its policy while disclosing adverse information in more obscure forums.

2.2 Costs and benefits of external resolution

Congress typically applies a variety of methods to obtain information from sources outside the regulatory agencies' direct control. For example, hearings often solicit the opinions of academics and private sector participants. Congress also has established an independent investigative arm, the General Accounting Office, which investigates regulatory agency actions. However, these alternative sources of information are not a complete substitute for receiving full information from the regulatory agency. Congress may not even know that an agency has faced and resolved a problem of conflicting goals. Both academics and the private sector are valuable sources of information but they too may have their own agendas. The limitations on third part information sources has two implications: (1) outside sources may not bring regulatory agency decisions to Congress's attention if they agree with the policies, and (2) outside sources may also have an incentive to distort the information they provide to Congress.

Another way for Congress to obtain information about conflicting goals is to assign responsibility for different goals to different agencies. The different agencies may agree to follow a particular policy and then each provides information consistent with the policy. However, the agencies will often disagree about the appropriate policy. This may take the form of disagreeing about the shape of the efficient frontier, such as whether

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[19] See Carnell (1992).

Frontier 1 or Frontier 2 in Figure 2 better depicts the efficient frontier. In this case, the mere existence of two agencies that have been following different policies may help to generate additional empirical information about the shape of the efficient frontier. It may even be that because of the different mix of agency goals, agencies may not even be concerned about the same set of goal trade-offs. For example, the Commodity Futures Trading Commission (CFTC) regulates derivative contracts traded on exchanges. Exchange-traded derivatives generally have fixed sizes and contract length, and these terms cannot be altered by either the buyer or seller. In contrast, financial firms developed over-the-counter (OTC) derivatives for use by large, sophisticated market participants where the buyer and seller could set whatever terms they wished. Although the market for OTC derivatives is not regulated, many of the dealers, including the commercial banks, in this market are regulated. The rapid growth of the OTC derivatives market has revealed the strong underlying demand for derivatives that have flexible contract terms. If the CFTC had sole jurisdiction over all derivatives contracts, then the market may not have grown so rapidly given that the derivatives exchanges are the CFTC's primary constituency. Thus, Congress was able to learn something about the efficient set of derivatives regulatory policies that it might not have learned if the CFTC had sole responsibility for derivatives.[20]

If the conflicting goals are assigned to different agencies, then the external resolution of the issue significantly increases the probability of a public debate and in the process leads to a better revelation of the nature of the trade-offs involved and what

[20] However, this learning may have been at the expense of the CFTC's long-time goals, such as that of having the prices set on derivatives transactions be

parties may benefit and be adversely affected. External conflict resolution will often result in a disagreement between the agencies, especially if the agencies perceive themselves to have different "missions." Moreover, a conflict between the agencies is more likely to receive public consideration for a variety of reasons. Regulatory agencies have the resources (for example, public relations budgets) and the opportunities (for example, speeches to trade associations and Congressional testimony) to publicize the differences.[21] The agency heads also typically have some credibility with the press and Congress by virtue of their positions.

An advantage of a public debate between the agencies is that it is likely to discourage regulatory agencies from making arguments based on incomplete or misleading information, and, if they do, then opposing sides have clear incentives to correct the misinformation. An agency that makes obviously bad arguments risks not only embarrassment but also the chance that Congress will resolve the conflict in a manner unfavorable to the agency.[22] Thus, the mere threat of a public debate may discourage an

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transparent.

[21] For example, some academics such as Carron (1982) and Kane (1985) tried to raise public awareness and concern about the emerging thrift debacle in the early and mid-1980s. However, their arguments were offset by disinformation put out by the thrift industry seeking to maximize the value of the deposit insurance subsidy and by the Federal Home Loan Bank Board's general support of the industry. Had there been an agency solely in charge of managing the thrift's deposit insurance fund, then the industry's problems might have been more widely recognized at an earlier stage of the debacle. Such an agency could have helped broadcast the academics' findings and given them additional credibility.

[22] Noll (1971) argues that in many circumstances agencies define success as consisting of two parts: (1) the terms of their decisions are not overturned by Congress or the courts and (2) the agency is fully funded by Congress.

agency from resolving conflicting goals in a manner that would subsequently be reversed in Congress or by the courts.

Although external resolution may have the beneficial effect of increasing public debate, it may also produce some disadvantages. Even if external resolution produces the same regulatory policies as internal resolution, the execution of these policies by a single agency may be more efficient than that obtained by two agencies whose actions need to be coordinated. Moreover, external resolution creates the potential for the conflict to remain unresolved. Each agency may choose to establish regulations consistent with its own priorities even if these regulations conflict with those issued by another agency.[23] The trade-offs here appear to be time versus refinement of the resolution. More timely resolution of the differences may increase the chance that a decision will not be in the best public interest. Ultimately, of course, regulatory arbitrage will take place.

The potential benefits and costs of assigning conflicting goals to different agencies are illustrated in Figure 3. When conflicting goals are assigned to Agency A, then it would resolve the conflict at the point where A'_1 is tangent to the efficient frontier. Similarly, when Agency B, is assigned the conflict, then it would pick the point of tangency between B'_1 and the efficient frontier. If Agency A is assigned goal A and

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[23] For example, the OCC and Federal Reserve disagreement on the appropriate role of bank subsidiaries. The OCC recently modified its Part 5 rules to allow for the possibility that bank subsidiaries may engage in a wider range of activities. In response the Federal Reserve recently proposed extending Sections 23A and 23B of the Federal Reserve Act to bank subsidiaries engaged in activities impermissible to be performed within their parent bank. Although the OCC has incorporated Sections 23A and 23B into its new Part 5 rules, the Federal Reserve's extension of these sections would deprive the OCC of any opportunity to relax the more potentially costly parts of 23A and 23B. The Federal Reserve proposal is a miscellaneous interpretation of 12 CFR 250: Docket R-0977.

Agency B is assigned goal B then a variety of solutions are possible. One of the agencies may effectively be able to force the other to accept its solution, in which case policy would result in something close to A'_1 or B'_1. Alternatively, the two agencies could coordinate their actions to resolve the conflict at C_1. A third possibility, however, is that the two agencies will not coordinate their actions, and each may attempt to obtain its own unconditional optimum with the result that the position obtained lies well inside the efficient frontier at a point such as C_2. Under any of these alternatives, Congress may change the outcome via legislation, setting priorities among the goals or legislating a particular policy. The potential danger, however, is that Congress may be unable to change inappropriate policy because none of the alternatives has sufficient political support to be adopted into law.

3 Implications of alternative structures for conflict resolution

Analysis of internal versus external resolution of goal conflicts suggests that neither approach is necessarily optimal in all circumstances. Moreover, it is doubtful that all goal conflicts could be resolved either internally within an agency or externally between two or more agencies. Our economy is so interconnected that internal resolution of all conflicts would likely require a single super agency in charge of all regulatory issues. The creation of a super agency that would internalize all potential conflicts from the environment to banking also would dilute the level of senior staff and administrator expertise.[24] Such dilution would undercut one of the reasons for creating regulatory agencies in the first place. Internal resolution provides superior coordination of policy.

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[24] However, see the discussion below of placing all regulatory agencies under the executive branch.

However, internal resolution may also result in inferior policies being followed relative to what the agency would have done if its actions had been subject to public debate, especially when the agency's constituency is narrow relative to the individuals affected by the agency's decisions. Conversely, it is impossible to assign all conflicting goals to separate agencies. The set of potential goals from financial regulation is simply too large. The advantages and disadvantages of external resolution are the mirror image of those for internal resolution.

In practice, the U.S. financial regulatory system is designed to mitigate the disadvantages associated with both internal and external conflict resolution. Agency decisions are subject to a variety of mechanisms that encourage public debate, and these mechanisms serve to reduce the problems associated with internal conflict resolution. Similarly, several mechanisms exist to promote coordination between multiple agencies, which may tend to alleviate the problems associated with external conflict resolution.

3.1 Generating public debate with internal conflict resolution

The ultimate in internal conflict resolution is to have a single individual capable of making unilateral changes in regulations without providing any opportunity for public debate. Congressional oversight provides some limits on the ability of agencies to adopt inappropriate policies. Further, a number of mechanisms exist that create an opportunity for public debate when the final decision about goal conflicts is made by a single agency.

3.1.1 Review of decisions by the judicial system

A regulatee that is subject to an enforcement action, and that disagrees with the regulation underlying the enforcement action, may appeal to the courts for judicial review.

However, the grounds for seeking such judicial review are limited.[25] The regulatees may ask for the regulation to be overturned on a variety of grounds, including claims that the statute upon which the regulation, is based is unconstitutional, the agency exceeded its statutory powers in issuing the regulation or the agency did not follow proper procedure in approving the regulation. However, the courts do not want to assume primary responsibility for writing regulations, and they often seek to defer to the regulatory agencies absent a showing that the agency has "arbitrarily or capriciously" exceeded its authority. Hence, regulatees that seek judicial review merely on the grounds that an agency gave priority to the wrong public policy goal are unlikely to be successful.

3.1.2 Public comment on proposed regulatory changes

All U.S. financial regulatory agencies must provide an opportunity for public comment on proposed new regulations and revisions to existing regulations.[26] These public comment periods limit an agency's ability to act in secret and can be helpful in avoiding unintended policy conflicts. However, the comment periods will not necessarily force a public debate of the issues. Moreover, the fact that regulatory agencies must solicit public comment does not prevent them from ignoring the comments and proceeding with their intended plans. Interested parties must have sufficient resources to analyze the facts, law, and political situation in order to make suggestions that will likely influence a

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[25] The general terms for judicial review of agency actions is set out in the Administrative Procedures Act of 1946. See Robinson (1991, chapter 5) for a discussion of the issues of who can ask for judicial review and the scope of that review.

[26] See 5 U.S.C. 553.

regulatory agency.[27] Further, to be assured of a public debate of the issue, they must have the resources to publicize the proposed changes and a willingness to use those resources in order to be assured that their concerns reach a broader audience.

3.1.3 Regulatory agencies headed by Boards rather than a single administrator

The advantage of external resolution in improving agencies' decisions may be partially obtained within a single agency by requiring the agency decisions to be approved by a board rather than a single individual. If an agency's regulatory decisions must be approved by a board then all decisions must undergo some scrutiny, which may reduce the potential that very bad decisions will be made. Indeed, Noll (1971, p. 102-103) notes that if someone on the board chooses to dissent, they are in the best position to use available data and staff to develop strong arguments for that dissent. The existence of a board also provides some institutional memory and political insulation, which may be especially valuable when Congress delegates decisions that have substantially different short- and long-run consequences.

The existence of a board cannot fully capture the advantages of external resolution since members of the board are operating under the same statutory framework and are of the same agency. Hence, they are more likely to agree that their agency's primary mission takes precedence over its other goals. Further, even when board members disagree, they will usually have an incentive to quietly compromise in order to maximize the board's flexibility in the future. Finally, the President's Advisory Council on Executive Organization (1971, p. 34--otherwise known as the Ash Commission) argues that boards

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[27] Kerwin (1994, 170) says "organizational resources and political sophistication are … prerequisites to effective participation."

by their nature have difficulty formulating "major policy statements or rules." The council further argued that commissions tend to prefer "to wait for a suitable case to come along which will force the issue, though often in a narrow fact situation."

3.1.4 Competing oversight agencies

The financial regulatory system is unique from most other regulatory setups in the U.S. economy in that it allows for competing regulatory agencies for identical institutions. The three bank agencies have important differences in policy responsibilities (such as the FDIC having responsibility for the insurance funds), but the mix of goals assigned to their bank supervisory functions is nearly identical. While the agencies often agree on policy, the differences in their responsibilities provide a starting point for their policy differences, while their competition for constituents may help to exaggerate these policy differences. When the agencies disagree then they may publicize their differences and seek support for their respective positions.

The SEC and CFTC also compete with each other and the banking agencies. Further, both the SEC and CFTC work in part through self-regulatory organizations (SROs) organized in the private sector. Examples of these SROs include the stock exchanges, the futures and options exchanges, and the Financial Accounting Standards Board (FASB). These SROs have broad discretion to set rules, complying with SEC or CFTC goals. Given that the SROs can set some of the rules a natural mechanism exists for externalizing some debates. If the SRO sets rules that do not match the SEC or CFTC priorities, then the agencies must either try to persuade the SRO to change its policies or the federal regulatory agency can take public action to force compliance. In either case the issue has been forced into the public arena. Moreover, the various exchanges (stock, futures, and options) need not and often do not set exactly the same rules. This competition among the SROs may work like competition among the bank regulatory agencies for clients.

Competing regulators can be an effective way to force external resolution of some issues that would otherwise be subject to internal resolution. Kane (1984) argues that government regulatory agency heads tend to over-regulate due to their desire to avoid problems during their, usually short, tenure. Competition between regulatory agencies for regulatees counteracts this incentive, since over-regulated firms tend to be less competitive and to shrink in the face of less regulated competition. As a consequence, an over-regulating agency that wants to retain its regulatees must either change its policy or attempt to persuade Congress to force competing agencies to adopt more costly regulation. Absent congressional intervention, this form of regulatory arbitrage will permit industries to adapt more readily to changes in the economic environment.

Probably the biggest limitation on competing regulators is that competition is most likely to result in external resolution when one regulatory agency takes actions that adversely impact some firms subject to regulation. If the competing regulators agree on a policy that the regulated firms regard as beneficial, then the process of competition for regulatees is unlikely to generate any further public debate.

3.2 Generating consistent policies with external conflict resolution

If two or more agencies are assigned different goals that have conflicting policy implications, it is possible that the agencies will adopt inconsistent policies. Congress may act to set priorities and eliminate the policy inconsistency. However, the above analysis suggests that Congress cannot always resolve the conflict in a timely manner. Several mechanisms also exist to generate consistency in situations where conflicting goals have been assigned to more than one agency.

3.2.1 Separating supervision from regulation

One of the costs of organizing regulators by sets of related policy goals is that a firm may have multiple regulators imposing duplicative or contradictory requirements on the firm. However, part of these costs may arise not because more than one agency writes the regulations but rather because more than one agency is charged with supervising compliance with the regulations. If each firm had a single supervisor, then duplicative monitoring costs could be reduced, thereby reducing costs imposed on regulatees. Moreover, a single supervisor may be in a position to interpret potential conflicting regulatory requirements so that regulatees achieve an efficient trade-off between the two regulatory objectives. An example of a regulation in which supervision is partially divorced from regulation is the Truth in Lending Act, which the Federal Reserve writes but which is enforced by each of the banking agencies for their respective commercial banks and by the Federal Trade Commission for nondepository lenders.

A further potential benefit of separating supervision from regulation is that two or more agencies would develop direct experience with the regulation. Sometimes the agencies will reach different conclusions about the optimal trade-off, and they could force an external debate about the importance of the various policy goals.

One potential problem with a complete separation of supervision from regulation is that the agency writing the regulation may lack sufficient information about regulatees' operations to write rules that are effective but that do not impose excessive costs on regulatees or supervisors. A simple solution to this problem is to make sure that the regulator is assigned some supervisory responsibility.

Two dangers of separating supervision and regulation are not so easily addressed. First, one supervisor may choose to use its discretion under regulations written by another agency to place virtually no weight on the other agency's policy goal. [28] The second danger is that the agency in charge of regulation will foresee the possibility of weak supervision and seek to write a regulation that removes all of the supervisor's discretion. If taken to an extreme such tight rule writing could eliminate many of the benefits of separating supervision from regulation.

3.2.2 Using a coordinating board to set priorities

In some respects the existence of multiple agencies overseen by a coordinating board appears to be an optimal way to resolve conflicts. Potentially all significant conflicts would get the benefit of a public debate as the agencies debated the issues. Yet the coordinating board could prevent the individual agencies from adopting contradictory policies by establishing priorities and requiring each agency's regulations to conform to the overall priorities. Congress could step in to change the priorities but a timely, coordinated decision would arise even if Congress deferred to the agencies.[29]

Upon closer inspection, however, coordinating boards are in many respects analogous to a single unified regulatory agency with a board consisting of its division

[28] Again, shifting of agency priorities is more difficult when headed by a board than when headed by a single individual.

[29] A bill approved by the House of Representatives Banking Committee in 1997 would have created such a coordinating board as a part of its financial modernization proposal. See Taylor (1997) for a brief description of the "National Financial Services Council."

directors and each of the individual agencies acting more like unusually autonomous divisions of the agency. The operating responsibilities of the board members and their greater degree of autonomy may make them somewhat more independent than the directors of a unified regulatory agency. However, members of the coordinating board still would have an incentive to keep decisions internal and seek a quiet compromise whenever possible just like members of the board of a unified regulator. Moreover, to the extent that an agency adopts a position of independence within the coordinating board, it is also likely to seek maximum operation independence. Finally, coordinating boards are subject to a type of agency problem in which individual agency heads have incentives to weaken the influence and effectiveness of the board so as to maintain their control and authority over individual decisions and to protect agency discretion.

The analysis in this section suggests that coordinating boards should not be viewed as an alternative, which is completely different from multiple regulatory agencies or a single, unified regulator. Instead, the coordinating board should be viewed as lying on a continuum from pure internal resolution to pure external resolution. The coordinating board allows a trade-off between the policy vetting benefits of externalization and greater coordination arising from internalization of goal conflicts where the point on the trade-off depends on the autonomy exercised by the different agencies in practice.

3.2.3 Coordination through the president

The issue of coordinating the policies of different financial regulatory agencies arises in part because boards that are independent of the executive branch run almost all of the financial regulatory agencies.[30] The president can oversee the resolution of all goal conflicts that are assigned to different parts of the executive branch and, in theory, conflicting policies need exist only to the minimum extent required by statutes.

The placement of all financial regulatory agencies within the executive branch is similar to the use of a coordinating board in terms of its position on the internal-external conflict resolution continuum. The end result may look like pure internal resolution if senior administration officials set their own priorities and order agency officials to comply with those priorities. Conversely, the result may look almost like external resolution if the administration allows each of the agencies to pursue its own agenda. In practice, coordination is likely to be enforced in areas the White House determines are important whereas conflict may be allowed in areas where the White House perceives a lower payoff to coordination.

4. Conclusions

Financial modernization legislation designed to relax or eliminate the existing boundaries between industries and to harmonize regulation of transactions appears inevitable at some point in the future. When such modernization occurs, Congress is likely to reconsider the existing structure of the financial regulatory agencies and evaluate the question of whether changes in this structure would be desirable. An important consideration in the debate over financial regulatory structure should be the resolution of conflicts that may arise among different policy goals it is designed to achieve. Congress

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30 The issue of the appropriateness of independent agencies has been extensively debated for several decades, and a full review of that literature is outside the scope of this paper. See the staff report of the Senate Committee on Governmental Affairs (1977, volume 5, chapter 1) for a discussion of the role of independent agencies.

has assigned responsibility for achieving a variety of goals to the financial regulatory agencies. Oftentimes policies intended to foster one goal will have an adverse impact on the achievement of another goal. How the conflicts between these policy goals are resolved often depends to a substantial degree on the structure of the financial regulatory agencies. For this reason, the issue of financial regulatory structure is not a mere "turf" issue but is rather an important element in setting financial regulatory policy. Indeed, the issue of regulatory structure is too important for the debate to be left solely to the regulatory agencies. The agencies' incentives are to overemphasize the importance of disputes they have with other agencies to support their case for continuing independence and deemphasize conflicts that they already resolve internally to maintain their existing powers.

In place of the current approach of allowing the existing agencies to frame the debate, the analysis in this paper may be used to develop a systematic approach to sorting through some key issues in establishing a new financial regulatory structure.

1. What are the important conflicts among the goals?

The analysis should begin by determining the primary goals of financial regulation. The goals currently assigned to one or more of the regulatory agencies would be a good place to start such a list. Some items may then be added to the list and others eliminated in recognition of the changes that have occurred within the financial system.

The second part of the analysis of goals is to determine which goals are likely to have conflicting policy implications. The easiest part will be identification of goals with conflicting implications that are already resolved externally; here the only problem may be eliminating relatively minor conflicts whose importance has been overemphasized. A somewhat more difficult problem is that of identifying conflicts that are currently being resolved internally. The last and most difficult is the identification of potential conflicts that have not been important in the past but are likely to become so in the future as the financial services industry evolves.

2. Should Congress resolve the conflict by legislatively setting policy?

In principle Congress may resolve all of the conflicts by setting detailed policies and leaving the agencies to merely administer the policies. The issues arise in having Congress establish detailed policies: (1) is it feasible, and (2) is it desirable? One consideration in determining whether it is feasible for Congress to establish detailed policies is whether Congress has sufficient information and expertise to set the best policy for the current financial system. In many cases in the financial services area a lack of information is not a barrier to a congressional resolution because a number of issues have been debated over an extended period of time.

A more serious feasibility problem is that no consensus may exist in Congress on many important issues. Congress may be forced to delegate some issues to the regulatory agencies in order to effect reform.

Probably the most serious weakness of detailed legislative solutions for many problems is the rapidly changing nature of the financial services area. Information processing lies at the heart of the production of most financial services. As such, the rapidly declining costs of communicating and processing information have been and are likely to continue to have a direct impact on the optimal structure for the provision of financial services. Thus, legislative policy solutions that may be highly effective in addressing conflicting goals in 2000 may be virtually irrelevant to addressing the problems of 2010. If Congress could be certain to revisit the issue in a timely manner, then the pace of change in the industry may not be an important consideration. However, whatever policy Congress sets will likely result in a group of private sector participants that benefit from the policy and may be successful in efforts to delay or prevent change.[31] Yet in many cases sticking with an outdated policy may be worse than adopting a suboptimal policy that is adjusted with changes in the financial system. Thus, as a general rule in financial services Congress should seek to set priorities and to hold the agencies accountable but provide flexibility in implementation to the agencies. Probably the most important exception to this rule would occur in cases where Congress lacks adequate tools to insure that an agency is complying with Congress's priorities.[32]

3. Should conflicting goals be delegated to a single agency or more than one agency?

Given that Congress should and will assign goals with conflicting policy implications, a question arises as to whether better policies will result if resolutions of these conflicts are assigned to a single agency or more than one agency. Unfortunately, this simple question does not have a simple answer.

Some goal conflicts have the potential for making private financial services providers choose between complying with two conflicting policies. For example, a bank

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[31] A similar issue arises with respect to regulatory agency structure itself. The act of establishing a regulatory agency may change the political dynamics in ways that are difficult to subsequently change. As an example of a legislative change that also changed subsequent political dynamics (albeit not directly dealing with regulatory structure) is provided by Irwin and Kroszner (1998). They show that the adoption of the Reciprocal Trade Agreements Act of 1934 changed the political dynamic for Republicans from log-rolling in favor of individual pieces of additional trade protection to support for broad-based tariff reductions.

[32] Arguably, such a problem has arisen in the area of government risk bearing through the safety net provided to banks.

could be told to make certain types of loans by an agency devoted solely to CRA while simultaneously being told that such loans are unsafe and unsound by an agency devoted solely to protecting the deposit insurance fund. In such cases internalization of the conflict may be necessary.

If external resolution would not generate such conflicts, the next question is whether it is desirable. Assigning the conflicts to multiple agencies has the benefit of encouraging debate and a solution that balances competing priorities, especially when there may be uncertainty as to where the best interests of society lie. However, the multiple agency approach is more costly and need not yield a better solution. The various agencies may each pursue policies that are not aligned with the interests of society as a whole and the involvement of more than one agency may result in conflicting policies that Congress cannot resolve in a timely fashion. Each agency is also likely to engage in costly efforts to maintain its continued existence. In many instances, the conflicts between some goals may not be sufficiently important to merit the creation of a new agency, or the expected life of the problem may be far less than the likely tenure of a new agency created to address the problem. In most cases Congress may be best served by asking whether it may be able to obtain something close to its desired outcome by assigning the problems to a single agency, setting clear priorities for the agency, and holding the agency accountable for its actions.

4. For those conflicts solved via internal resolution, what is the best way to motivate the agency to follow appropriate policies?

The current system focuses heavily on mandating procedural steps in order to provide transparency and encourage public debate. Congress also mandates public reporting both on a regular basis and on an event-driven basis such as when an application is processed or a depository fails. Many of the procedural steps for regulatory agency actions are mandated across all regulatory agencies, but additional mandatory reporting may be desirable to address some conflicts.

Arguably a weakness of the current system is that it fails to use incentive contracts to either reveal information or to motivate directly agency heads. As an example of an incentive contract to reveal information, Wall (1997) proposes that the FDIC issue a debt contract whose repayment depends on the condition of the deposit insurance fund. Such a contract would provide independent evidence on the state of the fund. Examples of incentive contracts to directly motivate agency heads are the contracts on inflation rates that several nations have adopted with their central banks.

5. For those conflicts solved via external resolution, what is the best way to minimize the harm arising from conflicting policies?

When Congress chooses to assign potential conflicts to more than one agency, then it should expect that the agencies would occasionally disagree. Public disagreement between agencies with different goals and the associated debate over important policy issues is one of the primary advantages of assigning possibly conflicting goals to different agencies. This may be especially useful if there is uncertainty about society's interests or these interests may be changing over time. Viewed in this light, conflicts between agencies are often desirable, and the absence of conflict should raise questions about the need for more than one agency.

Moreover, merely assigning conflicting goals to different agencies does not imply that the potential conflicts will result in harmful, actual conflicts. In many cases the agencies will work out an accommodation because they believe such a result is the best policy or because they fear that failure to reach a resolution will invite an undesirable congressional response. In some other cases one agency may be able to force its will, leaving the others free to protest but without any ability to change the policy. The recent controversy between the SEC and the Federal Reserve on the accounting for derivatives is such a case in which case the SEC imposed its preferences. In many of these cases Congress gets the benefit of a public debate between the agencies without the cost of having a policy outcome that is worse than had both problems been assigned to a single agency. If Congress disagrees with the resolution then it may pass legislation to correct the "error."

One way of reducing the potential for harmful policy conflict is to separate supervision from regulation. Such separation, where feasible, could be a low-cost way of inducing public debate while insuring that policies ultimately adopted do not conflict. Another way of reducing the potential for harmful conflicts is to place a coordinating board above the respective agencies. The use of a coordinating board has the potential for allowing public debate on important conflicts while insuring that a coordinated solution is ultimately adopted. However, a coordinating board is not a "third" approach to resolving conflicts that is distinct from internal and external resolution. Rather it may best be thought of as providing a point on a continuum from pure internal to pure external resolution.

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Figure 1

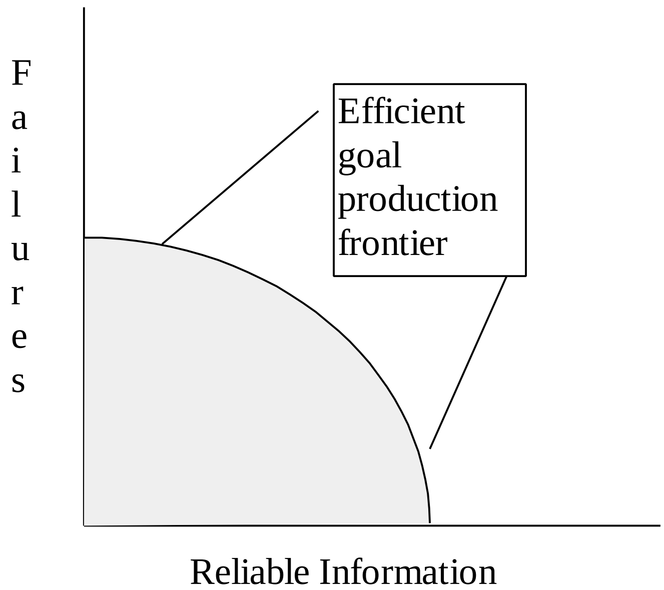

Figure 2

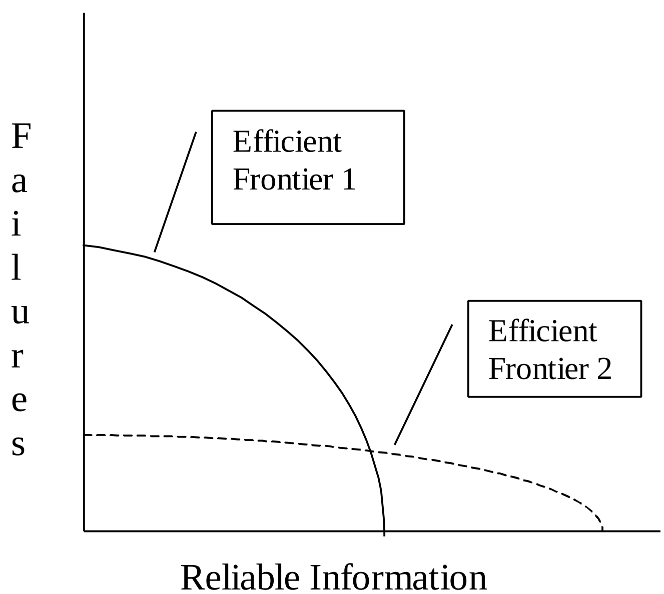

Figure 3