

NEEP OUTLOOK CONFERENCE

**Remarks by
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The Boston Fed has had a long affiliation with NEEP.

Director of Research Lynn Browne and other members of the Research Department have served on NEEP's Board. We routinely look to NEEP for guidance on what is happening in the New England economy.

As NEEP celebrates its 25th anniversary, I want particularly to draw attention to the organization's role in promoting regional cooperation. While others try to incite the "war between the states," NEEP plays a valuable role in fostering communication about our common challenges.

This conference -- focused as it is on electricity restructuring -- is both timely and important in influencing New England's future. Energy policies nearly always have been important to the region. Oil imports became an issue in the 1970s. Later, the region debated the merits of nuclear power, demand side management, and independent power generators. But clearly, the impending deregulation of electric power generation is a watershed event.

Like many of you, I come with questions about what is happening in the electricity industry and its economic and financial repercussions. I expect the information conveyed here today to help my understanding of these breaking developments.

I would like to take a few minutes to explore, from my vantage as a regulator, three lessons from deregulation in an industry I know quite well -- banking:

- first, technology is the primary catalyst that drives both change in an industry and the need for deregulation;
- second, regulatory oversight becomes more difficult rather than simpler as deregulation occurs; and
- third, both the industry and the regulators need to keep their eyes on one major reason why we regulate in the first place -- the prevention of systemic risk. We need to emphasize practices that reduce such risk even in a fully deregulated environment.

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The past two decades have witnessed profound changes in the banking industry. These changes have been brought about by a combination of technological and market changes that have acted together to make deregulation inevitable.

Let me cite just a few examples. Technology has commoditized many traditional bank services and allowed non-bank competitors to enter credit and service markets that were traditional bank strongholds. Foreign competitors, whose ability to compete here in the U.S. is increasingly enhanced by technology, and who fairly early on were allowed to have a nationwide presence, also contributed to pressure on bank earnings and mobility. Recognition of these pressures led to deposit interest deregulation, reductions in reserve requirements, expansion in bank powers, and now, with the Reigle-Neal bill, the full lifting of geographic restrictions by the end of 1997.

Technology has also revolutionized banking products. It made such products simultaneously more complex and less subject to regulatory restrictions which, by and large, traditionally have

focused on balance sheet entries. Derivatives are a prime example of this phenomenon -- they could not have been developed or traded without advances in technology.

The parallels between banking deregulation and the current move to deregulate the electric utility industry seem obvious: First, technology is the catalyst and second, deregulation seems unavoidable.

Some form of electric utility deregulation is *required* because technology is enabling non-utilities to generate power at a low cost. These suppliers can attract the most sophisticated electricity customers away from traditional utilities. Somehow, businesses must be allowed to take advantage of the potential for reduced costs, and the distribution system must adapt to a more diverse array of supply and brokering relationships.

In addition, deregulation appears *possible* because of the advances in computers and telecommunications. Keeping track of which entity is buying electricity or transmission services from

whom and at what price is no longer the daunting task it once was.

This interaction of technology and the regulatory process suggests that the structure of electricity markets will continue to evolve over a long period. We cannot predict the pace or nature of technological change. Bank regulators in the late 1970s and early 1980s could not foresee how technology would affect the financial marketplace of the 1990s. Thus banking continues to be reregulated and restructured. I would imagine that the electric utility industry changes of the mid 1990s will only be the beginning as well.

The job of a regulator in a deregulating industry requires a great deal of agility. Indicators of an institution's health, or lack thereof, and the sources of risk to an industry, evolve over time. In the banking world, we used to look at balance sheets, focus on specific transactions, and evaluate positions at a moment in time. Today, we know that the bank's balance sheet can change in an

instant, and that the risks it faces are more likely *off* balance sheet than *on*.

In some respects, market changes have served to ease the job of the banking regulator. Keen competition has reduced the number of banking institutions, and caused them to focus on efficiency and rates of return. The market thus forces a certain element of discipline -- at times a very harsh discipline -- onto individual companies.

Also, banking operations are much more functionally and geographically diverse, which can act to limit risk. Greater geographic diversification means there is less vulnerability to the economic ups and downs of a small area. This could make a rerun of the New England banking collapse of the early 1990s less likely.

However, expansion into new markets can also introduce new sources of concentration that are hard to predict in advance. Who would have thought, for example, that a peso crisis in Mexico would affect the markets in the Philippines?

On the whole, I would say the job of a banking regulator has become more challenging, and this has to be true for regulators of electric utilities as well.

Utility regulators are well versed in issues of consumer protection, and this will remain important. However, the transition to a competitive market can be especially painful. The potential benefits of competition in the form of lower electricity rates may not naturally accrue as fast to small businesses and residential customers as for larger businesses. And after the transition, in a freer market, prices can rise as well as fall.

Utility regulators, like bank regulators, also face the issue of how many power producers are necessary in a market to ensure credible competition. What indicators can be constructed to measure the degree of competition?

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No matter how much regulation changes, we must continue to focus on why government regulates at all: to ensure that the critical system being regulated as a whole benefits the public as a

whole. In banking, a primary justification for regulation is to ensure financial stability. Regulators must keep problems at individual banks from interfering with the flow of transactions across the economy. Diversification of banking activities and adoption of new techniques for risk management have, on the whole, served to create a fitter banking system and a reduction of the threat of systemic crisis.

But risks remain. We are dealing with a situation of increased linkages -- banks are doing more and more business with each other and with other financial institutions that may not be very familiar to them or to the regulators. Financial instruments are becoming more and more complicated. And senior management is only just starting to respond with better systems of control.

The trick for bank regulators is to prevent problems from spreading *without* inhibiting banks from competing. For example, we have spent a lot of time in the past few years discussing what do to contain the risks inherent in derivatives. We are not in a position to micro-manage banks' use of these instruments. Indeed,

micro-management may not be what's called for. The spectacular losses suffered in a Daiwa, Barings, Orange County, or Kidder-Peabody situation stem not from the esoteric nature of the instruments involved, but from the lack of old-fashioned management controls and common sense. Thus it is incumbent on regulators to examine an institution's overall risk management strategy and ensure those controls and that common sense prevail as well.

And, of course, banking regulators must be prepared to act to prevent a crisis from running out of control -- as the Federal Reserve did after the 1987 stock market crash, when it encouraged commercial banks to keep lending to securities houses that were supporting troubled customers.

Similarly, utility regulators even, or should I say *especially* in a time of deregulation, must have systemic risk in mind.

If a major bank fails, that could cause a run on other banks. If an electricity network fails, we could see widespread disruptions in the supply and quality of power.

In the past, financial failures in the electric utility industry have been rare. The WPPS bond default stands out as an unusual exception. But this may not be the case in the future. In a freer market, some players will win and others will lose. Who will pay for the wreckage? Will customers suffer disruptions in service?

The new electricity regime may usher in a wave of consolidation, from which may emerge large regional, national, or even international power companies. Like the banks, they may move into diversified portfolios and sophisticated hedging strategies that make their financial situation more opaque. The collapse of an unregulated subsidiary could threaten the health of the parent utility. Are there adequate disclosure standards to ensure that investors are aware of utilities' new risk exposures?

We have learned in banking that it's impossible to predict from historical experience what shocks might occur that threaten the system's integrity. As the rules change in electric generation, the system may be shocked in new ways. The web of transactions

may become more dense, and may change shape daily. Is the transmission grid flexible enough to handle this new fluidity?

The subject of systemic risk is very complex, and I do not presume to be able to lay out the answers for the electricity industry. But I do believe that there are lessons to be learned from the financial industry.

In conclusion, let me say once again how pleased the Boston Fed is to co-sponsor this morning's events. Restructuring offers the potential for lowering electricity costs in this region, and I expect that the New England economy will reap benefits as a result.

As one who has spent her career in banking at a time of tremendous change in that industry, I predict that the initiatives being discussed today, while important and innovative, are only the start of a very long journey. Technologies and markets will continue to evolve, and regulations will change with them. But even the first round of initiatives poses new challenges to utility regulators in terms of containing risks and ensuring the system's

integrity. Deregulation may be spreading to more industries, but good regulatory practices will be as important as ever.