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Like Public Utilities: Regulating Fannie Mae and Freddie Mac

What's to be done with Fannie and Freddie? Until recently, the debate was between ''nationalization'' and ''privatization,'' with no apparent middle ground. Now, following passage of the Restoring American Financial Stability Act of 2010, a consensus may perhaps be emerging that Fannie and Freddie, which are government-sponsored enterprises, could be regulated like public utilities.

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Though the author is an expert in the regulation of public utilities, he specifically disclaims in-depth expertise on the economics of the government-sponsored enterprises. Nor, he notes, is it necessarily the case that his colleagues at NERA would agree with the questions raised herein. The purpose of this piece is to begin to ask some questions about how treating the GSEs like public utilities would work.

There may be some value in considering whether the public utility model makes sense for the government-sponsored enterprises (GSEs) and how that model would be applied. As early as October 2008, Ben Bernanke identified the public utility model as an option to consider, noting that with a public utility model, the regulator would monitor ''safety and soundness'' and would ''also establish pricing and other rules consistent with a promised rate of return to shareholders.''[1] As another example, Hank Paulson, in a recent *Washington Post* op-ed, stated that:

> We must eliminate the inherent conflict between public purpose and private ownership that was destabilizing to the GSEs. Congress could eliminate that tension by restructuring Fannie and Freddie to create one or two private-sector entities that would purchase and securitize mortgages with a credit guarantee explicitly backed by the federal government and paid for by the new entity. These privately owned entities would be set up like public utilities and governed by a rate-setting commission that would establish a targeted rate of return.[2]

Note that Mr. Paulson stated that the GSEs should be regulated

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like public utilities, which may imply some uncertainty on his part about whether they really have the characteristics of a public utility.[3] Treating the GSEs like public utilities begs a number of questions, beginning with:

- What is a public utility?
- Are the GSEs public utilities?
- What lessons can be learned from other public utility industries?
- In terms of restoring the GSEs' financial integrity, what financial restructuring and related actions would be needed?
- How would Freddie and Fannie operate?
- What regulatory oversight would be required? How would the GSEs' ''rates'' be set? Would Fannie and Freddie face the economically correct incentives?
- How would the ''explicit guarantee,'' if any, work? How would the price for that explicit guarantee be set?
- How would the regulatory institutions be set up to ensure that Fannie and Freddie act in the public interest?

Regulating the GSEs as public utilities may be a practical way to solve the problem of maintaining the availability of mortgage financing in the near term. There are undoubtedly numerous challenges ahead in devising exactly how public utility regulation could be applied to the GSEs—and there may well be potential drawbacks to this approach. The purpose of this essay is not to prescribe how the Federal Housing Finance Agency (FHFA) regulatory oversight of the GSEs should work. Rather, it will touch upon some of the potential lessons that can be learned from over 100 years of public utility regulation of electric utilities.

I. What Is a Public Utility?

Let's start by defining what it means to be a public utility.

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Holburn and Spiller identify the unique characteristics of utilities relative to other industries: ''first, their technologies are characterized by large specific, sunk investments; second, their technologies also exhibit important economies of scale and scope; and third, their products are massively consumed.''[4] Spiller and Tommasi argue, along the same lines, that ''[w]hat separates the utility sector from the rest of the economy is the combination of the three features.''[5] Let's consider these in turn:

- *Asset specificity*. Freddie and Fannie as entities—putting aside their portfolios of mortgages—would not seem to have a great deal of ''asset specificity.'' The GSEs aren't themselves highly capital-intensive and do not invest in long-lived, highly specialized assets that have little value for other use—such as distribution and transmission plant or electric generating units. The GSEs help finance long-lived mostly fixed-rate mortgages (which typically provide the mortgagor with a free option to refinance at will), which would seem to be fundamentally different from the kinds of assets that public utilities typically own.
- *Economies of scale*. While Fannie and Freddie currently have a 65 percent share of the mortgage market, this does not necessarily mean that they have meaningful economies of scale (when Ginnie Mae is included, their market share is currently 95 percent). It may simply mean, for example, that other entities have been unable or unwilling, over the last several years, to compete in this market given market conditions. On the other hand, the ''channels'' that Fannie and Freddie have developed with mortgage originators and servicers may be unique, giving rise to economies of scale in the securitization of mortgages. This, ultimately, is an empirical question that is beyond the scope of this essay.
- *Widespread domestic consumption*. Fannie and Freddie are fundamentally ''wholesalers'' rather than retailers. Thus, while Fannie and Freddie are major players in the secondary mortgage market, most consumers pay their

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mortgage to a mortgage servicer and likely don't know who ultimately holds their mortgage.

It is not immediately obvious that the GSEs have the three signal characteristics of public utilities: asset specificity, economies of scale and scope, and massive consumption. Nevertheless, it seems possible, even probable, that treating the GSEs like public utilities could provide needed stability to the mortgage market, while perhaps assuaging some of the incentive problems associated with past GSE practices, thereby buying time to decide exactly what should be done with the GSEs.

The designation of a public utility, whether explicit or de facto, is largely a question of how best to set up durable institutions and governance structures to support investment by the public utility—thereby allowing the public utility to meet its obligation to provide efficient, safe, adequate, and reliable service in the short and long terms. In recent decades, an important focus of public utility regulation has been on accommodating efficient competition where feasible, taking care to avoid subsidizing either new entrants or incumbents.

II. Regulatory Tasks

The question of whether Fannie and Freddie meet the criteria of a public utility seems open for debate, although it seems fairly clear that the GSEs are ''affected with the public interest.'' But, let's assume that they do meet the criteria. What benefits could public utility regulation of the GSEs provide? What would Fannie and Freddie do differently if they were public utilities and were regulated as such?

A. Accounting information

For U.S. utilities, the Federal Energy Regulatory Commission Form 1 is the bedrock foundation of public utility regulation—no other country has anything even remotely comparable. Similarly, very detailed disclosure of the creditworthiness of the mortgages held or guaranteed by the GSEs may be needed to accommodate effective regulation of the GSEs. After all, the roots of the financial crisis may go back as far as 1993, which according to some observers is ''when Fannie and Freddie began stocking up on subprime and other risky loans while reporting them as prime.''[6] Adequate disclosure—and diligent auditing of the adequacy of that disclosure—is viewed as a means of dealing with such problems.

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B. Financial restructuring

Given the FHFA's role as ''conservator'' of the GSEs, it may be useful to explore the ways in which U.S. public utilities have, over the years, been restructured financially. Typically, this involves a bankruptcy court to deal with settling the competing claims of debt holders, preferred stock holders, common shareholders, and others. The U.S. Securities and Exchange Commission (SEC) had this role in the restructuring of the utility holding companies pursuant to the Public Utility Holding Company Act of 1935. In some cases, a public utility commission effectively has this role, *e.g.*, in instances where the public utility chooses not to file for bankruptcy protection.

Keep in mind that while Fannie and Freddie are investor-owned enterprises, much of their ''core capital'' has been provided by the U.S. government. The U.S. government has invested about $150 billion in the GSEs in the form of senior preferred stock, with a 10 percent dividend rate, the dividends of which are being paid on schedule. In order to do so, funding is being provided by the U.S. Treasury. Continued payment of these dividends without the need for additional draws on the U.S. Treasury would be a worthy short-term goal. A longer-term goal would be for the

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GSEs to restore their financial integrity sufficiently to allow them to raise new capital to replace the senior preferred stock owned by the U.S. government. Whether financial restructuring is necessary before the GSEs can move out of conservatorship is an unanswered question. Rigorous financial analysis will no doubt be needed.

The U.S. Security and Exchange Commission's experience in restructuring electric utility holding companies in the 1940s may be instructive. James Bonbright, the pioneer of public utility regulation and property valuation, and Benjamin Graham, the father of financial analysis, worked together in testifying on property valuation and financial issues before the SEC. In testifying together in cases having to do with the restructuring of utility holding companies, Graham's practical experience was used to confirm Prof. Bonbright's theories.[7] Graham described the SEC's duties in these cases having to do with the recapitalization plans and security offerings of public utility holding company systems as: (1) the ''formation of standards of value''; (2) the ''gathering of relevant data in the individual case''; and (3) the ''application of the standards to the data, to arrive at a definite valuation.''[8]

There may also, of course, be lessons to be learned from the financial restructurings of Public Service Company of New Hampshire (PSNH) and Long Island Lighting Company (LILCO) in the 1980s and those of the California utilities in the wake of the Western energy crisis in the early 2000s, among others. The California cases may be noteworthy given that only one of those utilities filed for bankruptcy protection, while the other two did not.

The state commission (or FERC for ''wholesale'' utilities) has the task of setting rates that, going forward, give the public utility a reasonable opportunity to recover its costs, including the cost of capital. Given a public utility's need to continually raise new capital to fund capital expenditures and refinance existing debt, the public utility commission sets rates that allow the public utility to meets its obligation to serve going forward. To accomplish this, the public utility is allowed to charge rates that reflect its prudently incurred costs. Ordinarily, this would allow the public utility to raise necessary capital at a reasonable cost in good markets and bad, now and in the future. While there can be a ''fine line between financial success and failure in the utility industry,'' modest rate relief can allow a ''financially crippled'' utility to ''show almost miraculous recovery,'' thereby reestablishing its ability to meet its obligation to serve.[9]

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C. Rate regulation

For electric utilities, the threshold regulatory task is to set just and reasonable retail rates, based on prudently incurred costs. There is more to public utility regulation than that, of course, but, with electric utilities, it is very clear who the retail customers are, and over the years ways have been devised as to how to best set the rates that they pay to the public utility, *e.g.*, how to calculate the revenue requirement and how to specify the rate design. With Fannie and Freddie, the ratemaking may be quite different.

The GSEs' core function is to ''securitize'' mortgages. The GSEs buy mortgages from originators, ''package'' them into mortgage securities that are sold in the capital markets, and send funds back to the originator.[10] When the GSEs ''package'' mortgages, they collect a ''credit guarantee fee'' from the lender that sold them the loan. The crux of the ratemaking problem for the GSEs seems to have to do with how to set a credit guarantee fee that is commensurate with the riskiness of the enterprise. This begs a rudimentary question: is it really possible to set an *ex ante* credit guarantee fee? Given the systemic

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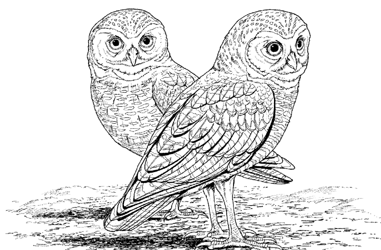
nature of the risk involved, could ways be devised so that the credit guarantee fee could change over time? These are difficult questions to answer. The purpose of this essay is not, of course, to try to answer all of these questions.

With electric utilities, a crucial ratemaking task is determining the forward-looking cost of equity capital necessary to provide equity investors with a fair rate of return that is commensurate with alternative investments. Here, the crucial ratemaking questions appear to be: what profit margin would the GSEs need so that their credit guarantee fee would be commensurate with the risk taken by the GSEs? Further, what credit guarantee fee, if any, would the U.S. Treasury receive in compensation for the guarantee—whether explicit or implicit—that they provide? The GSEs' ''revenue requirement,'' of sorts, would be the total credit guarantee fee that they receive plus their investment income on owned mortgages.

D. Accommodating competition

Over the last 25 years, a major focus of public utility regulation has been on accommodating competition, where feasible. When regulating the GSEs, is there an opportunity to find ways to ensure that the regulation does not somehow lock in the GSEs' market share, presenting an artificial barrier to new entry by competitors? Are there lessons to be learned from electric restructuring and the introduction of wholesale and retail competition?

In the late 1990s, electric utilities in some states were restructured to accommodate retail competition in the provision of the electricity commodity. Competitively neutral means were devised to ensure that retail



marketers, including utility affiliates, have an opportunity to compete. Given that one of the goals of restructuring the GSEs may be to reduce the GSEs' market share over time, care would be needed to allow this to happen while preserving or replacing the economies of scale and scope that the GSEs may provide. There are serious questions about the applicability of the public utility model to the GSEs, including whether the GSEs would have incentives to hold ''portfolios of securitized mortgages [that are] seriously skewed toward the risky end of the curve.''[11] Regulatory approaches consistent with competitive neutrality may be one means of assuaging these concerns.

There is also the question of how to replace an implicit guarantee with an explicit guarantee. In electricity, competitively neutral system benefits charges have been devised in some states to preserve the funding for programs that might not be funded by a competitive market. In telecommunications, as another example, competitively neutral ''universal service'' funding programs have been devised. Similarly, could ways be devised so that the explicit guarantee, if any, could be provided in a way that enables other capable mortgage entities to also receive an explicit guarantee?

Another question along these lines is whether the GSEs have ''essential facilities,'' which, if regulated, could be used to support some form of competition. Fannie and Freddie have developed highly detailed and specific requirements about what mortgages meet their criteria. AEI policy analyst Peter J. Wallison has suggested that the ''public utility'' version of Fannie and Freddie would:

> [B]uy mortgages from originators and securitize them; the main difference is that as public utilities Fannie and Freddie would probably be prohibited from holding mortgage portfolios. In this model, their guarantee fee rates and costs would be limited so they would pay a steady dividend to their shareholders, allowing them to raise capital, and regulation would limit their risk taking.[12]

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In this approach, Fannie and Freddie's securitization channels would essentially be viewed as ''essential facilities,''[13] thereby suggesting that the GSEs may be ''affected with the public interest'' and perhaps justifying regulating the GSEs like public utilities. To accommodate efficient competition, policymakers would need to explore carefully how to best accomplish this regulation.[14]

III. Conclusion

The purpose of this brief essay is not to opine on whether the GSEs should be regulated like public utilities. Indeed, when policymakers talk about applying a public utility model to the GSEs they may merely be recognizing that independently structured, expert regulation is needed. Treating the GSEs like public utilities is an interesting and potentially beneficial one but many questions would first need to be answered. Nevertheless, applying the public utility model to the GSEs may be a necessary component of any reform effort.■

Endnotes:

1. Dr. Bernanke also raised a concern about the efficiency incentives provided by the public utility model. Ben S. Bernanke, The Mortgage Meltdown, the Economy, and Public Policy, at UC Berkeley/UCLA Symposium,, Berkeley, CA, Oct. 31, 2008, at http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm.

2. Hank Paulson, *Housing Policy Must Be Set on a Sustainable Basis*, WASHINGTON POST, July 30, 2010, at A19. Secretary Paulson first raised this possibility in a speech before the Economic Club of Washington on Jan. 7, 2009. *See*: Henry M. Paulson, Jr. (Jan. 7, 2009), Remarks by Treasury Secretary Henry M. Paulson, Jr. on the *Role of the GSEs in Supporting the Housing Recovery*, before Economic Club of Washington, U.S. Dept. of the Treasury Press Release HP-1345. Retrieved September 22, 2010 from

http://www.ustreas.gov/press/releases/hp1345.htm.

3. Similarly, Rep. Barney Frank has stated that Fannie and Freddie have ''become a kind of public utility,'' which ''finances housing in America to a great extent.'' *See*: http://thehill. com/blogs/blog-briefing-room/news/74333-barney-frank-fannie-and-freddie-now-a-public-policy-instrument and http://www.huffingtonpost.com/2010/01/05/barney-frank-fannie-fredd_n_411941.html.

4. Guy L.F. Holburn and Pablo T. Spiller, *Institutional or Structural: Lessons from International Electricity Sector Reforms*, published in THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS, Eds. Eric Brousseau and Jean-Michel Glachant (Cambridge, MA: MIT Press, 2002) [footnotes omitted].

5. Pablo T. Spiller and Mariano Tommasi, *The Institutions of Regulation: An Application to Public Utilities*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS, Eds. C. Ménard and M.M. Shirley (Dordrecht: Springer, 2005), at 518–520.

6. Peter J. Wallison, *The Price for Fannie and Freddie Keeps Going Up*, WALL ST. J., Dec. 30, 2009.

7. Irving Kahn and Robert D. Milne, *Benjamin Graham: The Father of Financial Analysis*, Financial Analysts Research Foundation, Occasional Paper No. 5, at 22–23.

8. Benjamin Graham, *The SEC Method of Security Analysis*, THE ANALYSTS JOURNAL, Vol. 2, No. 3 (3rd Q. 1946). Reprinted in BENJAMIN GRAHAM, BUILDING A PROFESSION, CLASSIC WRITINGS OF THE FATHER OF SECURITY ANALYSIS, Ed. Jason Zweig (New York: McGraw Hill, 2010), at 35.

9. Jerome E. Hass, *How to Get Con Ed Out of the Capital Market Doghouse*, FINANCIAL ANALYSTS J., Nov.-Dec. 1974, at 30, 34.

10. See: http://www.freddiemac.com/corporate/company_profile/our_business/index.html (accessed on September 22, 2010).

11. Peter J. Wallison, *The Dead Shall Be Raised: The Future of Fannie and Freddie*, AEI Outlook Series, American Enterprise Institute for Public Policy Research, Jan.-Feb. 2010, at 3-4.

12. *Id*.

13. The tests for an ''essential facility'' are: (1) is the input controlled by a monopolist?; (2) is the input essential to the sustainability of competition?; (3) is the input neither available from other sources nor capable of being duplicated?; (4) is the input likely to be duplicated in the future by a competitor or specialist?; and (5) is it technically feasible for the incumbent to share the input? See: Karl McDermott, Kenneth Gordon, William Taylor and Agustin Ros, *Essential Facilities, Economic Efficiency, and a Mandate to Share: A Policy Primer*, Edison Electric Institute, Jan. 2000.

14. Given the moral hazard concerns associated with ''private label'' mortgage securitization, the question of whether or not to prohibit the GSEs from holding mortgage portfolios would need to be considered carefully. *See*: Wallison, *supra* note 11.

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