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July 29, 1996

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Securities and Government Sponsored Enterprises
Committee on Banking and Financial Services
House of Representatives

Dear Mr. Chairman:

This letter responds to your request for information on rates of return for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), as compared with rates of return for U.S. financial corporations and for U.S. corporations in general.

To identify appropriate measures of rate of return for Fannie Mae and Freddie Mac, we reviewed relevant economic and financial literature. We then calculated the rates of return based on data from the Fannie Mae and Freddie Mac 1995 annual reports and from other available sources. To identify appropriate "benchmark" rates of return for U.S. financial corporations and for U.S. corporations in general, we reviewed generally accepted financial sources. We used the Standard & Poor's Financial Group, which includes banks, brokers, insurance companies, savings and loans, and miscellaneous financial companies, to represent U.S. financial corporations and we used the Standard & Poor's 500 Composite, which includes large industrial, transportation, utility, and financial companies, to represent U.S. corporations in general. We conducted our work in Washington, D.C., in June and July 1996 in accordance with generally accepted government auditing standards.

MEASURES OF RATE OF RETURN

On the basis of our review of relevant economic and financial literature, we identified several alternative measures of rate of return that could be useful indicators of financial performance for Fannie Mae and Freddie Mac. These measures include (1) the rate of return on total capital (i.e., total assets or total liabilities and equity); (2) the rate of return on common stock equity; and (3) the earnings yield (i.e., the earnings-price ratio).

The rate of return on total capital is an important profitability ratio, particularly in assessing management's performance; it relates a firm's earnings during the year to the average of total capital employed during the year. However, the investors in a corporation's common stock may be more interested in the rate of return on common stock equity; it relates the amount of earnings available for common stock equity (i.e., earnings less preferred stock dividends) to the average of common stock equity measured in terms of "book value" during the year. The rate of return on common stock equity is frequently used in comparing two or more firms in an industry. Investors in common stock may also be interested in the earnings yield, which is a measure of the current rate of return on their investment; it relates earnings per share of common stock to the current market price of the stock.

Each of these measures of rate of return indicates the general level of profitability of a firm. However, each measure reflects a different aspect of financial performance and produces a different result. For example, in most cases, the rate of return on common stock equity is higher than the rate of return on total capital. This occurs because total capital includes other sources of capital, such as debt and preferred stock, and the interest payments and dividend distributions to these other sources of capital are generally lower than the return on common stock. The corporate practice of financing with debt and preferred stock to increase the return on common stock is known as "leverage."

FANNIE MAE AND FREDDIE MAC RATES OF RETURN

Using the measures described above, we could readily calculate the rates of return for Fannie Mae and Freddie Mac from the financial information presented in their annual reports. We did not attempt to independently verify this financial information or make other judgments regarding the accounting treatment of specific items. The rates of return for Fannie Mae and Freddie Mac could then be compared to "benchmark" rates of return for U.S. financial corporations and for U.S. corporations in general, using available aggregate data. We did not attempt to independently verify this aggregate financial information, which we obtained from generally accepted sources.

Table 1 summarizes the return on total capital (return on assets) for Fannie Mae, Freddie Mac, the financial industry, and the corporate sector for calendar and fiscal years 1991 through 1995.

Table 1: Return on Total Capital (Return on Assets) for 1991-1995

Corporate entity	1991	1992	1993	1994	1995
Fannie Mae	0.97%	0.99%	0.94%	0.87%	0.73%
Freddie Mac	1.27	1.17	1.10	1.03	0.90
Financial industry	0.63	0.76	1.03	1.06	1.12
Corporate sector	1.83	2.09	2.28	2.98	2.99

Note: Total capital (assets) is measured as an average for the year. The financial industry is represented by the S & P Financial Group, and the corporate sector is represented by the S & P 500 Composite.

Sources: GAO analysis based on data from Fannie Mae 1995 Annual Report, Freddie Mac 1995 Annual Report, and Standard & Poor's Compustat Services.

Table 2 summarizes the return on common equity for Fannie Mae, Freddie Mac, the financial industry, and the corporate sector for calendar and fiscal years 1991 through 1995.

Table 2: Return on Common Equity for 1991-1995

Corporate entity	1991	1992	1993	1994	1995
Fannie Mae	28.73%	26.35%	25.27%	24.24%	20.92%
Freddie Mac	23.61	19.40	18.47	19.27	18.73
Financial industry	9.39	10.52	13.52	N/A	N/A
Corporate sector	10.25	12.60	14.57	19.31	N/A

Note: Common equity is measured as an average for the year. The financial industry is represented by the S & P Financial Group, and the corporate sector is represented by the S & P 500 Composite. Certain data for 1994 and 1995 are not available (N/A).

Sources: GAO analysis based on data from Fannie Mae 1995 Annual Report, Freddie Mac 1995 Annual Report, Standard & Poor's NYSE Stock Reports, and Standard & Poor's Analysts' Handbook (1995 Annual Edition).

Table 3 summarizes the earnings yield for Fannie Mae, Freddie Mac, the financial industry, and the corporate sector for calendar and fiscal years 1991 through 1995.

Table 3: Earnings Yield for 1991-1995

Corporate entity	1991	1992	1993	1994	1995
Fannie Mae	9.73%	8.94%	8.60%	9.79%	8.00%
Freddie Mac	10.08	7.93	7.98	9.25	8.52
Financial industry	8.18	7.57	9.20	10.14	N/A
Corporate sector	4.47	4.51	4.86	6.66	N/A

Note: The financial industry is represented by the S & P Financial Group, and the corporate sector is represented by the S & P 500 Composite. Certain data for 1995 are not available (N/A).

Sources: GAO analysis based on data from Fannie Mae 1995 Annual Report, Freddie Mac 1995 Annual Report, Standard & Poor's NYSE Stock Reports, and Standard & Poor's Analysts' Handbook (1995 Annual Edition).

In making this comparison, it should be kept in mind that Fannie Mae and Freddie Mac possess unique firm characteristics, including federal government sponsorship. Furthermore, recent years have been characterized by dramatic changes in the financial industry and, more generally, in the corporate sector of the U.S. economy. These considerations suggest that a comparison of rates of return, based on the above data, should be viewed with caution.

OTHER CONSIDERATIONS

In performing this analysis, we did not attempt to make any adjustments for possible differences between accounting values and "economic" values. For example, in a recent report, we stated that Fannie Mae and Freddie Mac receive substantial economic benefits as a result of federal government sponsorship, such as the investor perception of an "implicit" guarantee on their securities or credit enhancement on their other financial obligations.[1] However, substantial disagreement remains regarding the appropriate characterization and valuation of these benefits. Therefore, for this analysis, we have incorporated only generally accepted accounting and financial data.

In addition, some observers have presented alternative measures of rate of return in reviewing the financial performance of Fannie Mae and Freddie Mac. For example, in a recent study, the Congressional Budget Office calculated average annual rates of return on common stock investments in Fannie Mae and Freddie Mac for the period 1990 to 1995.[2] This rate of return differs in form and substance from those in our analysis. The average annual rate of return on common stock investments includes both capital gains (i.e., stock price appreciation) and dividends received; therefore, it reflects both general stock market movements and the dividend policy of the firm. The period 1990 to 1995 was characterized by a generally strong stock market and rising corporate earnings and dividends, which enhanced the rate of return on common stock investments.

ENTERPRISE COMMENTS

We obtained comments on a draft of this letter from senior enterprise officials, including Fannie Mae's Vice President of Regulatory Activities and Freddie Mac's Director of Agency Relations. Freddie Mac stated that it had no comments on the draft letter at the present time. Fannie Mae stated that successful, well-managed companies such as Fannie Mae and Freddie Mac generally have returns on equity that are higher than an average company. Fannie Mae also stated that Fannie Mae and Freddie Mac are not as cyclical as other companies and, therefore, their returns remained high in 1991 and 1992 despite the relatively poor performance of the U.S. economy overall in those years. We did not draw any conclusions about the various rates of return because this was not within the scope of our work.

Neither Fannie Mae nor Freddie Mac commented on our data sources or methodology. Fannie Mae provided additional data on the return on total capital for 1991 through 1995, which we verified and included in table 1. Fannie Mae also provided additional data on the return on common equity for 1994 and 1995, which we reviewed and chose not to include in table 2 because it had not been calculated in a comparable way.

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[1]FNMA and FHLMC: Benefits Derived From Federal Ties (GAO/GGD-96-98R, March 25, 1996). See also Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

[2]Congressional Budget Office, Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac (May 1996).

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We appreciate the opportunity to provide you with information on rates of return for Fannie Mae and Freddie Mac. We will send copies of this letter to Fannie Mae and Freddie Mac and other interested parties. If you or your staff have any further questions, please contact me at (202) 512-8678.

Sincerely yours,

Thomas J. McCool

Thomas J. McCool
Associate Director, Financial
Institutions and Markets Issues

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