GAO

Highlights

Highlights of GAO-17-93, a report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

During the 2007–2009 financial crisis, many banking organizations lacked capital of sufficient quality and quantity to absorb substantial losses on mortgages and mortgage-related assets, revealing these assets to be riskier than previously thought. In response to the crisis, banking regulators around the world moved to strengthen requirements for capital adequacy. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act introduced, among other things, new capital requirements for bank holding companies and savings and loan holding companies. Internationally, in December 2010 the Basel Committee on Banking Supervision (which had issued the Basel I and Basel II frameworks) issued the Basel III framework—a comprehensive set of reforms to strengthen global capital and liquidity standards—with the goal of promoting a more resilient banking sector. Under this framework, banks apply risk weights to different assets to determine the amount of capital they need to meet regulatory requirements.

GAO was asked to explain how capital requirements for a mortgage depend upon how it is financed and how the requirements have changed since the crisis. This report examines the risk weights for residential mortgages and certain other mortgage-related assets under the U.S. Basel III-based rule and how they compare to those in effect under prior capital regimes and for nonbank entities. GAO examined information on capital requirements from current and past rules.

GAO received technical comments from the banking regulators, which were incorporated as appropriate.

View GAO-17-93. For more information, contact Lawrance L. Evans, Jr. at (202) 512-8678 or evansl@gao.gov.

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MORTGAGE-RELATED ASSETS

Capital Requirements Vary Depending on Type of Asset

What GAO Found

Rules for capital adequacy require banks to hold a percentage of their assets as capital to act as a financial cushion to absorb unexpected losses. Under current rules, banks must hold capital equal to at least 8 percent of risk-weighted assets. Since the early 1990s, U.S. federal banking regulators have used a risk-weighting system under which banks multiply asset amounts by factors, known as risk weights, to calculate risk-weighted assets. Different types of assets have different risk weights that attempt to capture the assets' relative risk. The Basel III-based final rule adopted in 2013 by the U.S. federal banking regulators incorporates higher risk weights for certain mortgage-related assets while leaving others unchanged from prior capital regimes (Basel I and Basel II). Most banks use the standardized approach for calculating risk-weighted assets, but large internationally active banks use an advanced approach that relies on formulas established by the regulators and inputs from their internal systems.

- Under the standardized approach, the risk weights for single-family residential mortgages are largely unchanged by the final rule. Similarly, the risk weights under this approach for residential mortgage-backed securities (MBS) guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac have not changed since Basel I.
- Under the advanced approach, large internationally active banks use a formula defined in regulation to determine the capital requirements for residential mortgage exposures, which include whole loans as well as MBS guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac. This formula has not changed since it went into effect in 2008 under the Basel II-based rule.
- For both approaches, the ways for determining risk weights for securitization exposures and mortgage servicing assets have changed under the final rule, which may increase these risk weights. As required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the final rule eliminates the use of credit ratings for determining risk weights for securitization exposures, instead relying on regulator-established formulas. Also, the final rule reduces the cap on mortgage servicing assets that can be included in capital calculations and will raise the risk weight from 100 percent to 250 percent.

The Basel III-based final rule largely left in place the historically lower risk weights of MBS guaranteed by Fannie Mae and Freddie Mac vis-à-vis other mortgage-related assets, which can influence the demand for these securities relative to whole loans and privately issued MBS. However, the full impact of changes in risk weights for holdings of mortgage-related assets remains uncertain because insufficient time has passed since these changes took effect, and for some assets the changes have not yet been fully phased in. GAO's recent work suggested that many lenders generally appeared to be participating in residential mortgage lending much as they had before capital requirements changed. Also, data on mortgage debt outstanding and on banks' holdings of different assets indicate that trends in holdings of mortgage debt and mortgage-related assets that predate the changes in risk weights have continued. But increased risk weights for some mortgage-related assets may lead to changes in banks' decisions about securitizing and servicing mortgages.