How Does Loan-To-Value Policy Strengthen Banks' Resilience to Property Price Shocks – Evidence from Hong Kong

Eric Wong
Hong Kong Monetary Authority

and

Andrew Tsang
Hong Kong Monetary Authority

and

Steven Kong
Hong Kong Monetary Authority

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Summary

This paper attempts to shed light on one important policy question. Should LTV policy be assigned to target household leverage, credit growth or property prices in pursuit of financial stability? Three findings in this paper consistently support the view that operationally it would be optimal for LTV policy to primarily address excess household leverage, and that there are significantly limitations in using this tool to stabilise credit growth and property prices.

First, although there is evidence that LTV cap tightening in Hong Kong since 2009 has dampened both borrowers' leverage and credit growth, the former effect is estimated to have played the major role in reducing the sensitivity of mortgage default risk to property price shocks.

Second, the policy effect on credit growth is found to be state-dependent and its effectiveness crucially hinges on whether loan demand or supply is the binding factor in determining loan growth, suggesting that calibrating this tool to target credit growth needs an accurate estimate of loan demand and supply. Operationally, the model risks in estimating these variables could pose challenges for policymakers.

Third, we find signs of a low sensitivity of the demand for properties to caps on LTV ratios, which is suggestive of weak direct policy pass through to the property market.

These findings together speak in favour of a simple rule that guides the timing of adjusting LTV caps. In principle, reversing the tightening measure may be considered only when household leverage is less of a macroprudential concern.

A reversal of the current credit cycle should not be taken as a clear sign for relaxing the measure. Contrary to the conventional view that relaxing LTV caps could help to moderate the downward phase of the credit cycle, our finding suggests that the stabilising effect is likely to be weak if the decline in loan growth reflects mainly a sharp drop in the demand for properties. In such circumstances, other policy tools may be needed to stabilise credit growth.