Effectiveness of Loan-To-Value Ratio Policy and Its Transmission Mechanism – Empirical Evidence from Hong Kong

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Summary

This paper provides a non-technical summary of two recent empirical studies to shed light on key important issues regarding the implementation of loan-to-value (LTV) policy as a macroprudential tool, including its effectiveness, potential drawbacks and its transmission mechanism to improve financial stability. Empirical evidence suggests that LTV policy is effective in reducing systemic risk associated with boom-and-bust cycles in property markets. Although the LTV policy may be associated with higher liquidity constraints on homebuyers, we show that the mortgage insurance programme (MIP) can mitigate this drawback without undermining the effectiveness of LTV policy. Thus, MIPs play an important role in enhancing the net benefits of LTV policy. Concerning the transmission mechanism, empirical evidence suggests that the policy pass-through to property market activities may be weak. By contrast, there is clear evidence that tightening LTV cap would reduce household leverage and credit growth, and that lower leverage plays a major role in strengthening banks' resilience to property price shocks. This finding supports the view that household leverage would be an optimal target of LTV policy.