Macroprudential Policy and Housing Markets

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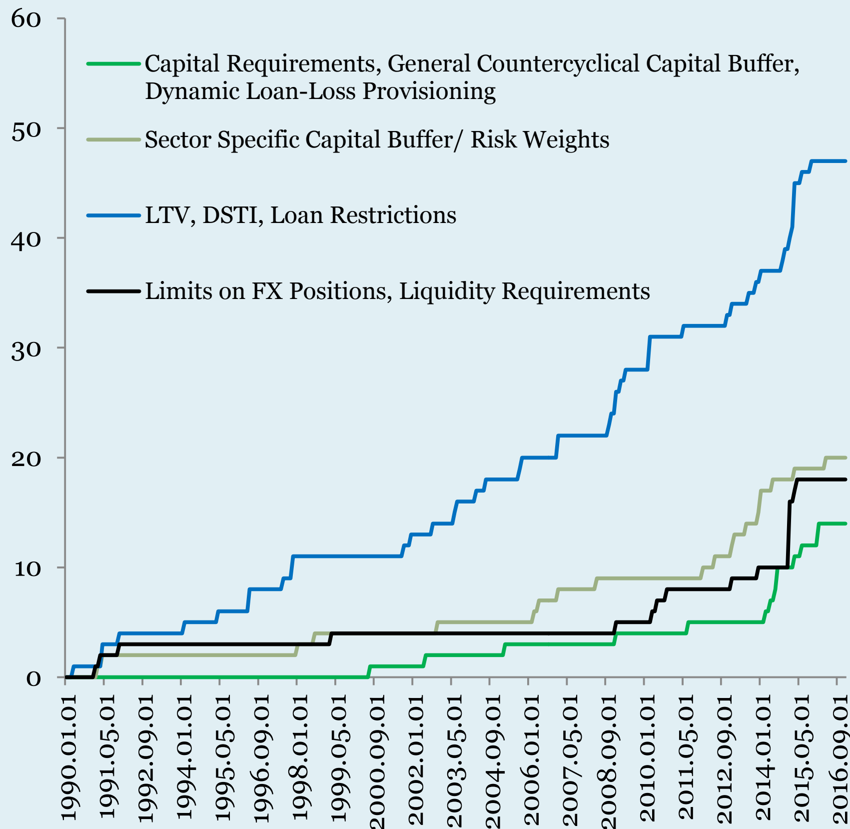
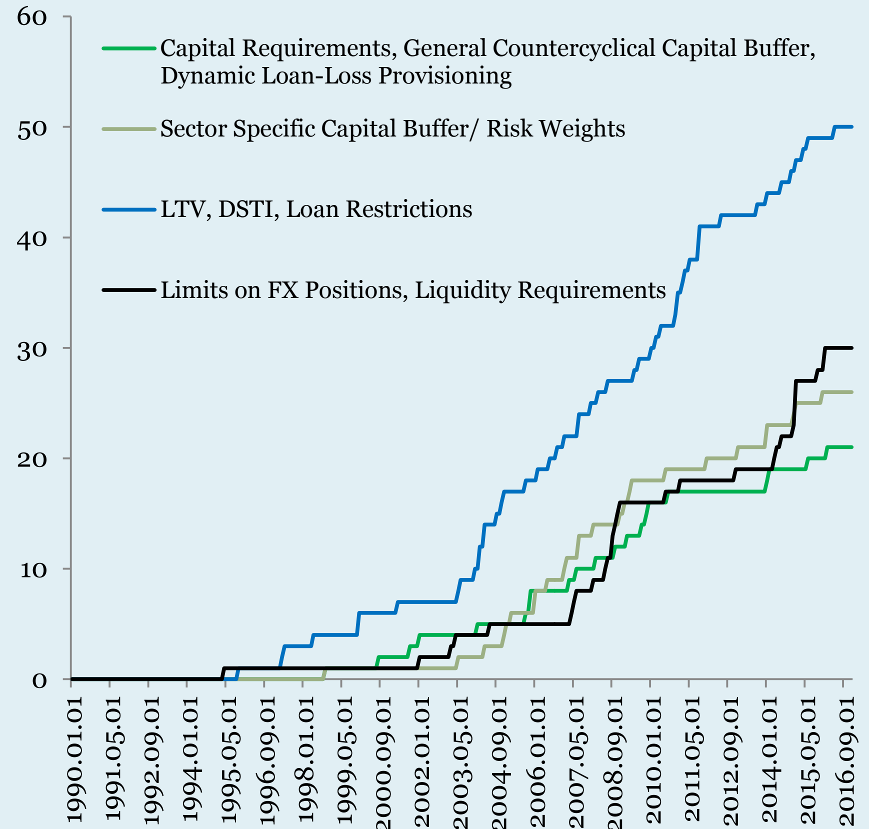
Growing use of macroprudential policies





Issues:

- Macroprudential objectives
- Tools for housing risks
- Effectiveness at achieving objectives
- Operational considerations:
  - When to act
  - Considering benefits and costs
- Use in combination with other tools

Definition and Rationale

- **Macroprudential policy: use of primarily prudential tools to limit systemic risk** (IMF 2013, IMF-FSB-BIS 2016).
  - The risk of disruptions to the provision of financial services that can cause serious negative consequences for the real economy (IMF, FSB and BIS, 2009).
  - By mitigating systemic risks, macroprudential policy aims ultimately to **reduce the frequency and severity of financial crises**.
    - contributing to overall macroeconomic stability

Intermediate objectives

- *Intermediate objective No. 1:* Macroprudential policy seeks to increase the **resilience** of banks and borrowers to aggregate shocks (IMF, 2013).
  - by **building buffers** that help maintain the ability of the financial system to provide credit to the economy under adverse conditions.
- *Intermediate objective No. 2:* Macroprudential policy seeks to **contain the build-up** of systemic vulnerabilities over time (IMF, 2013).
  - by reducing procyclical **feedback** between **asset prices** and **credit**, and containing unsustainable increases in **leverage, debt burdens** and **volatile funding**.

Measures for booms in housing markets

Tools	Definition	Purpose/Transmission
Sectoral capital requirement	Forces lenders to hold extra capital against their mortgage exposures, in order to protect against unexpected losses.	•Increases **banking sector resilience** to shocks •Credit supply: increasing funding costs can increase lending rates and reduce **credit supply**
Limits on loan-to-value (LTV) ratios	Imposes a limit on the size of collateralized loans relative to the appraised value of an asset (e.g. a house and or vehicle)	•**Resilience:** bolstering borrowers' and lenders' resilience to **asset price shocks;** reduces borrowers' incentive to **default** strategically •Credit demand: **reduces loan demand** •Expectations: may reduce household expectation of increased prices
Caps on debt service-to-income (DSTI) or debt-to income (DTI)/ Loan-to Income (LTI) ratios	DSTI cap restricts the size of the debt service payment to a fixed fraction of household income. DTI (LTI) cap restricts the size of debt (mortgage loan) to a fixed multiple of income.	•Similar to LTV. Differences: - Enhancing borrowers' resilience to **interest rate and income shocks** - Functions as an **automatic stabilizer** when house price growth exceeds income growth

Effectiveness in achieving objectives

- **Capital requirements:**
  - Can increase **resilience** of banks, but marginal changes may have only moderate effects on credit growth when introduced in the midst of a boom (Crowe and others (2013) and recent case studies: e.g., *Switzerland*, *Sweden*
- **Limits on LTV:**
  - LTV limits increase **resilience** of borrowers, by reducing borrower default rates in the event of shocks (*Hong Kong:* Wong and others (2011), *Korea:* Lee (2012), *Ireland:* Hallissey and others (2014))
  - Can reduce **credit growth** in the upswing, e.g., IMF, 2011b, Lim and others, 2011), while effects on **asset prices** often found to be weak (He, 2014; Arregui and others, 2013, Jacome and Mitra, 2015)
  - **May need adjusting** when asset prices and credit move in tandem and existing settings become non-binding (Kuttner and Shim, 2013).
- **Limits on DSTI/DTI:**
  - DSTI/DTI limits affect both **resilience** and credit extension, e.g., Hallissey and others (2014), Kuttner and Shim (2013)
  - Stronger effects on credit than LTV; can serve as anchor when asset prices move faster than income (Arregui and others, 2013, Kuttner and Shim 2013).

When to act: considering indicators

Core indicators	• House price appreciation rate • House price-to-rent ratio and house price-to-disposable income ratio • Household loan growth • Share of household (mortgage) loans to total credit
Additional indicators	• House price appreciation rate by region and types of properties • Actual Loan-to-Value (LTV) ratio (average and distribution) • Actual Debt service-to-income (DSTI) ratio (average and distribution) • Actual Household Debt-to-disposable Income (DTI) ratio (average and distribution) • Share of systemically risky financial products, such as FX loans or interest-only loans

When to act: forceful vs preemptive action

- May need forceful action when several indicators signal advanced build-up of risks.
- Where indicators display only moderate risks, it can be useful to take early and less forceful action preemptively.
  - UK: LTI ratio caps not initially binding, but intended to affect distribution if prices were to accelerate.
  - Ireland: LTV and LTI ratio caps as insurance against risks from incipient turn-around in the housing cycle.
- May want to introduce the ability to take further measures/ tighten, when initial calibration is not sufficient to contain risks.

Considering costs and benefits

- **Design and implementation should consider efficiency costs for borrowers from a reduction in financial services**.
  - Well-targeted approaches can reduce these costs
    - e.g., tighter limits on speculative borrowers and more generous limits on first-time buyers, as in *Ireland, Israel, Korea* and *Singapore*
  - Caps on exposure to particular types of borrowers, such as caps on the exposure to high LTV/LTI loans do not prohibit, but only constrain the provision of such credit.
    - as introduced in *New Zealand, the United Kingdom, and Ireland*
- **Implementation should also consider costs to output growth**.
  - Effects of tightening tools on output can be large (esp. LTV and DSTI)
  - A **gradual approach** can mitigate the costs
    - e.g., as in the *Netherlands*.
- **Well-tailored design** and a **gradual approach** to the tightening of tools can help achieve benefits while reducing costs.

Use in combination with other policies

- Prudential measures should be complemented by **other policies** if
  - **asset prices** are driven up by other factors **and**
  - this leads to increases in household **indebtedness,**
- Asset prices can be driven up by **supply constraints interacting with strong demand**
  - Demand from **foreign investors**
  - Demand from increased **immigration** (movement of people)
  - Demand for mortgage debt from **tax incentives**
- This can include structural and fiscal policies.

Use in combination with other policies

- **Removing supply constraints**
  - Lack of supply of can push up prices (e.g., *Australia, Hong Kong SAR, Israel, Sweden, United Kingdom*).
  - Consideration can be given to structural measures to boost supply:
    - Relaxation of zoning restrictions
    - Higher taxes on unused land
- **Removing fiscal distortions**
  - Some countries provide generous tax relief for mortgage interest payments (*Denmark, Sweden, Netherlands*).
    - This creates incentives in favor of mortgage debt and can prop up asset prices.
  - Removal of these distortions should be considered (as in the *Netherlands*).
- **Actively using fiscal tools**
  - Fiscal tools can affect prices more directly than prudential tools:
    - e.g., stamp duties (*as in Singapore, Hong Kong SAR, United Kingdom*), or capital gains taxes (as in *Korea*)

References

- IMF, 2013, "Key Aspects of Macroprudential Policy"
- IMF, 2014, Staff Guidance Note on Macroprudential Policy
  - Main note
  - Detailed Guidance on Instruments
  - Considerations for Low Income Countries
- IMF-FSB-BIS, 2016, Elements of Effective Macroprudential Policies - Lessons from International Experience