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The effectiveness of the counter-cyclical loan-to-value regulation: generic versus sector-specific rules

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This paper considers the optimal design and the implications of the CcLTV regulation in a model economy where there are two types of borrowers from distinct sectors of the credit market. We look at two policy regimes, generic and sector-specific, and compared their effectiveness in enhancing financial and macroeconomic stability. We find that both regimes are effective, especially when the economy is hit by financial and housing demand shocks. This is achieved mainly by reducing the amplification effects of the borrowing constraint channel. The effectiveness of both regimes is, however, shock dependent. When the economy faces a technology shock, their effectiveness is more or less the same. When the economy faces a financial shock, the sector-specific regime significantly outperforms the generic regime in reducing business cycle fluctuations, whereas the opposite is true when the economy is hit by a housing demand shock. The efficiency policy frontiers under the two alternative policy regimes present a clear trade-off between financial and macroeconomic stability, as the authority adjusts its preference between the two policy objectives. The sector-specific CcLTV regime is more effective than the generic CcLTV regime in reducing the volatility of credit and output.

Our findings highlight the importance of identifying the origin of the shock in order to implement the CcLTV regulation appropriately. More importantly, our findings suggest that, in order to enhance the effectiveness of the macro-prudential policy, the regulator should consider borrowers' heterogeneity and tailor the CcLTV regulation according to the specific conditions of each sector of the credit market, rather than to the aggregate credit market condition. In this way, the regulator can directly target the credit market sector, or the borrower type, where systemic risk is developing.