

# The Anatomy of the Transmission of Macroprudential Policies\*

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## Abstract

We analyze the effect of regulatory limits on household leverage on residential mortgage credit, house prices, and banks' portfolio choice. Combining supervisory loan level and house price data, we examine the introduction of loan-to-income and loan-to-value limits on residential mortgages in Ireland. Mortgage credit is reallocated from low- to high-income borrowers and from high- to low-house price appreciation areas, cooling down, in turn, "hot" housing markets. Consistent with a bank portfolio choice channel, banks more affected by the limits drive this reallocation and increase their risk-taking in their securities holdings and corporate credit, two asset classes not targeted by the policy.

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# 1 Introduction

Policymakers have recently proposed and implemented macroprudential policies aimed at limiting household leverage so as to slow down the feedback loop between credit and house prices. The recent academic literature – by showing that build-ups of household leverage have historically led to busts, lower output growth, and higher unemployment (Mian *et al.*, 2017) – has highlighted the importance of these policies, adopted by 58 countries from 1990 to 2016.

In this paper, we provide a comprehensive analysis of the most widely used type of macroprudential regulations, namely, policies that limit household leverage in the residential mortgage market. Combining county level house price data, loan level data on residential mortgages and credit to firms, and bank security level holdings, we study the introduction in 2015 of loan-to-value (LTV) and loan-to-income (LTI) limits for residential mortgages issued by Irish banks.<sup>1</sup> This intervention offers a prime setting for our inquiry because, to avoid the recurrence of a dramatic boom-bust cycle, the lending limits affected a large share of the mortgage market and were immediately effective after the announcement, therefore limiting potential anticipatory effects.<sup>2</sup>

We document that whereas the lending limits affect 43% of the residential mortgage market, mortgage issuance keeps growing after the policy introduction as the market “moves” to conform with the new limits. Our analysis of this reallocation provides three main findings: (i) Mortgage credit is reallo-

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<sup>1</sup>Alam *et al.* (2019) collected data from 1990 to 2016 on the adoption of 17 types of macroprudential policies in 134 countries. LTV and LTI limits have been adopted by 60 and 42 countries, respectively. LTV limits are the most widely used tool in advanced economies.

<sup>2</sup>The household debt/GDP ratio increased from 55% to 101% from 2002 to 2007, followed by -10% GDP growth and a +8% unemployment rate change over the next three years.

cated from low- to high-income borrowers and from counties where borrowers are close to the lending limits to counties where borrowers are more distant from the lending limits; (ii) this reallocation is effective in slowing down house price growth in “hot” housing markets; and (iii) this reallocation is consistent with a *bank portfolio choice* channel as banks more affected by the limits drive the aggregate reallocation and increase their risk-taking in their holdings of securities and credit to firms, two asset classes not targeted by the policy.

Next, we describe these results in detail. First, we show that 43% of the mortgage issuance in the year before the policy would have been affected if the rules had been in place during this period. Nevertheless, the increase in “conforming” issuance offsets the collapse in the issuance of those mortgages that exceed the newly imposed limits, leaving aggregate issuance barely affected. However, not every mortgage is affected in the same way. In the cross-section of counties, urban counties that experienced a high house price appreciation before the policy are closer to the limits (“low-distance” counties) than rural counties with modest pre-policy house price appreciation (“high-distance” counties). In the cross-section of borrowers, high-income borrowers are more distant from the limits than low-income borrowers. We show that residential mortgage issuance moves from low- to high-distance counties and from low- to high-income borrowers after the policy. In particular, high-income borrowers obtain larger loans and increase their leverage.

Second, we show the evolution of house prices is consistent with the observed geographic credit reallocation. House price growth, around 14% year-on-year (YoY) and rapidly increasing at the time of the policy announcement, stabilized below 10% post-regulation. This evolution is driven by low-distance counties where house price growth, well above 20% YoY and rapidly increasing at the time of announcement, collapsed to around 4% post-regulation. As a

result, the lending limits substantially reduced the geographical heterogeneity in house price growth. House prices are also consistent with the reallocation across the income distribution as the differential evolution of house price growth across counties is more pronounced for larger properties, more likely to be purchased by high-income borrowers.

Third, we show our findings are consistent with banks reallocating their assets to maintain their preferred, pre-policy, risk exposure, in what we call a *bank portfolio choice* channel. We exploit bank level heterogeneity by calculating the share of bank issuance that would have been affected if the limits had been in place the year before the policy. After confirming that more-exposed banks drive the aggregate reallocation, we find that more-exposed banks reduce their issuance to borrowers in the bottom quintile of the income distribution by 10% and increase their issuance to borrowers in the top quintile by 15%, controlling for local economic conditions and credit demand. More-exposed banks reduce mortgage rates more than less-exposed banks, inducing high-income borrowers to take out larger loans and increase their leverage. We confirm the role of banks by analyzing banks' holdings of securities and credit to firms, capturing, together with residential mortgages, approximately 80% of banks' assets. We find that more-exposed banks increase their holdings of high-yield securities more than less-exposed banks, relative to the pre-policy period, controlling for stringent security-time and bank-time fixed effects. Similarly, we find that more-exposed banks increase their corporate lending (higher volumes and lower rates), targeting mostly risky borrowers.

The rationale for macroprudential policies is based on the observation that agents over-borrow in good times, not internalizing all the costs of their financing choice (Lorenzoni, 2008; Bianchi, 2011; Bianchi and Mendoza, 2010, 2018; Jeanne and Korinek, 2017). In the U.S., the increase in mortgage credit

contributed to the rapid appreciation of house prices (Favara and Imbs, 2015; Mian and Sufi, 2009, 2019; Adelino et al., 2015; Di Maggio and Kermani, 2017). Their collapse, channeled through the balance sheets of households (Mian et al., 2013; Mian and Sufi, 2014; Hall, 2011; Eggertsson and Krugman, 2012; Midrigan and Philippon, 2018) and intermediaries (Gertler and Kiyotaki, 2011; He and Krishnamurthy, 2013; Brunnermeier and Sannikov, 2014; Chodorow-Reich, 2014), contributed, in turn, to the Great Recession.

We contribute to the growing literature on macroprudential regulation aimed at limiting household leverage, by (i) jointly analyzing, for the first time, mortgage credit, house prices, and bank risk exposure and (ii) showing that banks play an important role in the transmission.<sup>3</sup> A few other papers analyzing LTV/LTI limits find results consistent with ours.<sup>4</sup> DeFusco et al. (2019) show how the Dodd-Frank “Ability-to-Repay” rule (similar to a LTI limit) successfully reduced borrower leverage, and Van Bakkum et al. (2019) show LTV limits caused Dutch borrowers to increase their downpayments. Although they do not analyze the role of banks, Tzur-Ilan (2017) and Igan and Kang (2011) show borrowers move away from hot real estate markets, slowing down house price growth in Israel and Korea, respectively.<sup>5</sup>

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<sup>3</sup>See Aikman et al. (2019), Freixas et al. (2015), Claessens et al. (2013), Claessens (2015), and Gambacorta and Murcia (2017) for excellent overviews of macroprudential policies. Our paper is also related to the literature, empirical (Aiyar et al., 2014; Jimenez et al., 2017; Gropp et al., 2019; Benetton, 2018; Benetton et al., 2017; De Marco and Wieladek, 2015; Ayyagari et al., 2019) and theoretical (Landvoigt and Begenau, 2017; Elenev et al., 2018; Begenau, forthcoming; Kashyap et al., 2014; Malherbe and Bahaj, 2018), on macroprudential policies (mostly capital requirements) aimed at limiting bank risk-taking.

<sup>4</sup>Analyzing the policy of this paper, Kinghan et al. (2017) show LTV fell for first-time and subsequent-time buyers. Compared with their paper, we focus on house prices and document a reallocation of mortgage credit across the income and geographical distributions.

<sup>5</sup>Auer and Ongena (2019) and Basten and Koch (2015) show that capital buffers on

The rest of the paper is structured as follows. [Section 2](#) describes the data and the empirical setting. [Section 3](#) presents some aggregate facts about mortgage credit reallocation. [Section 4](#) analyzes house prices. [Section 5](#) presents the bank portfolio choice channel. [Section 6](#) concludes.

## 2 Setting and Data

[Section 2.1](#) provides some background on the Irish residential mortgage market. [Section 2.2](#) and [Section 2.3](#) describe the macroprudential policy and our data.

### 2.1 Residential Mortgage Credit in Ireland

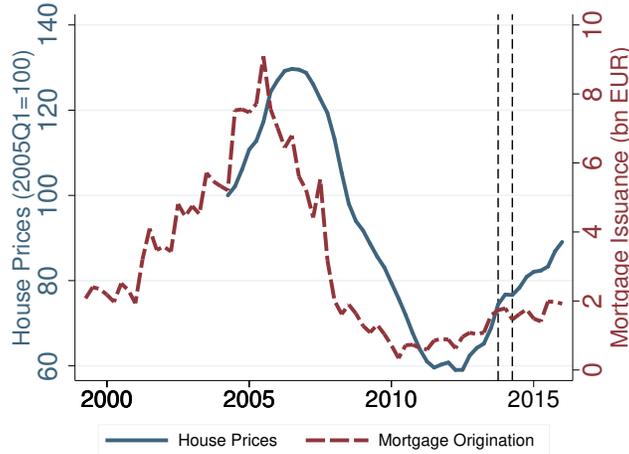
In the years leading up to 2000, Ireland experienced a period of steady economic growth often interpreted as a healthy convergence of the “Celtic Tiger” with the rest of the European Union. However, the surge in output from 2003 to 2007 was of a different type, fueled by a construction boom financed through bank credit ([Honohan, 2010](#)). In [Figure 1](#), we show the issuance of residential mortgages (dashed line) from 2000 to 2016 and observe a stark increase from 2002 to 2007. Issuance then collapsed and started increasing again in 2013. House prices (solid line) followed a remarkably similar pattern.<sup>6</sup>

During the bust of 2007-10, prices declined sharply and construction ac-

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Swiss residential lending led to higher growth in commercial lending and shifted mortgages from less to more resilient banks, respectively. Using Singaporean data, [Agarwal et al. \(2018\)](#) show that policies that impose limits on LTV cause an increase in high-LTI mortgage issuance. These papers do not analyze house prices or banks’ risk exposure.

<sup>6</sup>In the online appendix, we show house price growth for the U.K., the euro area, and the European Union around the same period.



**Figure 1: Ireland Real Estate Boom-Bust.** This figure shows real estate prices from 2005Q1 to 2016Q4 (left axis) and residential mortgage issuance from 2000Q1 to 2016Q4 (right axis). The two vertical dashed lines indicate the first rumors about the macroprudential lending limits and their implementation date, respectively. Sources: Department of Housing, Planning and Local Government and Central Statistics Office.

tivities collapsed. The fall in quarterly Gross National Product (GNP) is estimated to be about 17%.<sup>7</sup> In addition to the sharp decrease in real estate prices, the increase in unemployment from 4.6% in 2007 to 13.3% in 2010 left many households unable to service their debt. This increase in non-performing mortgage credit led to losses for banks that consequently experienced funding dry-ups.<sup>8</sup> In September 2008, public funds had to be used to recapitalize almost all large domestic credit-taking institutions, which needed further government assistance in March 2011 (Lane, 2011; Acharya et al., 2014).

<sup>7</sup>The Irish economic performance is better measured with GNP because GDP is inflated by profits of international companies transferred to Ireland because of low corporate tax.

<sup>8</sup>Almost all mortgages in Ireland are held on banks' balance sheets. No active securitization market exists (securitization is solely used to create collateral eligible to be pledged at the European Central Bank). Risk transfer off banks' balance sheets is not common.

| Regulation   | Target Group  | Limits  | Allowances for each bank   |
|--|---|---|--|
| <b>LTV limits</b>  | For primary dwelling homes:                           | <b>First-Time Buyers:</b> Sliding LTV limits from 90%*<br><b>Subsequent Buyers:</b> 80% | 15% of all new lending limits  |
|  | For Buy-to-Let:                                       | 70% LTV limit   | 10% of new lending above the buy-to-let limit is allowed                                   |
| <b>LTI limits</b>  | For primary dwelling homes:                           | 3.5 times income  | 20% of new lending above the limit is allowed  |
| <b>Exemptions</b>  | <b>From LTV limit</b><br>Borrowers in negative equity | <b>From LTI limit</b><br>Borrowers for investment properties                            | <b>From both limits</b><br>* Switcher mortgages<br>* Restructuring of mortgages in arrears |
| *A limit of 90% LTV applies to the first €220,000 of the value of a residential property and a limit of 80% LTV applies to any value of the property thereafter. |   |   |  |

**Table 1: Lending Limits.** This table provides a summary of the lending limits. Source: Central Bank of Ireland.

## 2.2 The February 2015 Mortgage Lending Limits

To avoid a recurrence of this boom-bust cycle, the central bank introduced new macroprudential rules. In the words of Patrick Honahan in January 2015, at that time governor of the Central Bank of Ireland, “What we are trying to prevent is another psychological loop between credit and prices and credit. If we avoid that, we can keep banks safe, we can keep borrowers safe.”

The lending limits were first discussed in October 2014 (date of the first rumors) and announced and immediately implemented on February 9, 2015 (implementation date).<sup>9</sup> In Table 1, we provide an overview of the limits on LTV and LTI ratios on new originations of residential mortgages. The

<sup>9</sup>The lending limits were first proposed in a paper (Consultation Paper 87) published on October 7, 2014 to stimulate discussion by the central bank and available on the Central Bank of Ireland website ([link](#)). The limits were announced and implemented on February 9, 2015. However, mortgages issued after February 9, 2015 could exceed the lending limits if approved before February 9, 2015.

LTI limit is 3.5. The LTV limit depends on the type of borrowers. Lending for primary-dwelling housing (PDH) is limited to 80% LTV. For first-time buyers (FTBs), a more generous LTV limit of 90% is imposed for houses up to €220,000.<sup>10</sup> For any amount exceeding €220,000, the excess amount over €220,000 faces a 80% LTV limit. The measures impose a stricter threshold of 70% for buy-to-let (BTL) properties.<sup>11</sup>

## 2.3 Data

The core of our final data set is the result of combining loan level information on residential mortgages and credit to firms, bank security level holdings, and county level house prices. The loan level data and security register are proprietary data sets obtained from the Central Bank of Ireland.

First, we observe loan level data on the issuance of residential mortgages at a daily frequency from January 2013 to June 2016.<sup>12</sup> We observe all outstanding residential mortgages by the most significant institutions that have to submit loan level data to the Central Bank of Ireland.<sup>13</sup> This sample covers

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<sup>10</sup>First-time buyers are four percentage points or 30% less likely to default than subsequent-time buyers in Ireland (Kelly et al., 2015).

<sup>11</sup>In addition to loans that are exempted from the rule, banks can issue loans exceeding the limits to a small share of borrowers, as shown in the last column of the table. In November 2016, the rules were relaxed, extending the LTV limit for FTBs to 90%. The analysis of this subsequent period goes beyond the scope of this paper.

<sup>12</sup>We combine the *loan level data* until 2015 and the *Monitoring Template Data* after 2015. The latter has to be submitted to the Central Bank of Ireland for regulatory purposes as prescribed by the macroprudential regulations introduced on February 9, 2015. More information is available in the online appendix.

<sup>13</sup>Irish banks that received a public bailout are required to report loan level data. The rest of the significant mortgage issuers in Ireland submit loan level data following the encouragement from regulators and in accordance with data submissions required by the ECB-SSM Comprehensive Assessment in 2013.

more than 90% of the domestic market and consists of the five largest banks. The data set also contains information on borrower income and demographics (e.g., age, marital status) and mortgage type (e.g., first-time buyer, buy-to-let).

Second, we observe loan level data on bank credit to firms at a semi-annual frequency from June 2013 to June 2016. At the bank-firm-period level, we observe credit granted and drawn and the rate charged by banks. We match this information with firm characteristics such as the county of incorporation, industry, and asset class (very small/SME/large). We observe the borrower rating assigned to each loan from internal rating models of each lender.<sup>14</sup> The data have one main limitation. In contrast to most credit registries, our borrower identifier is consistent within a bank over time but not across banks.

Third, we observe bank security level holdings at a quarterly frequency from January 2011 to June 2016. At the security-bank-quarter level, we observe each security  $s$  identified by an International Securities Identification Number (ISIN) held by bank  $b$  at time  $t$ . We match this information with security characteristics (rating and yield) from Datastream.

Fourth, at the bank-month level, we observe monthly balance sheet items from the European Central Bank Individual Balance Sheet Statistics (IBSI).

Fifth, at the county-period level, we observe quarterly house prices from the Irish property website Daft.ie. This data set is publicly available and regularly updated with quarterly reports published on the website.

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<sup>14</sup>The Central Bank of Ireland internal mapping scales are used to classify each internal rating into a consistent categorization between 1 and 6. It ranges from 1 (highest-quality borrower) to 5 (very risky borrower) for non-defaulted loans and equals 6 for defaulted loans.

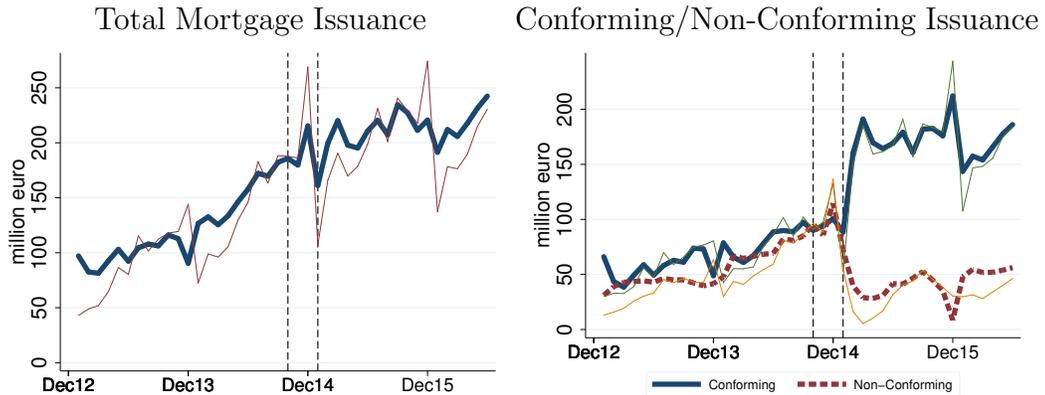
### 3 Some Facts

In this section, we present three aggregate facts. In [Section 3.1](#), we show the originations of residential mortgages seem almost unaffected by the lending limits even if these limits affect more than one third of the market. In [Section 3.2](#), we show that counties and borrowers are differentially exposed to the limits, with urban counties and low-income borrowers being more affected than rural counties and high-income borrowers. In [Section 3.3](#), we show that after the policy, mortgage credit is reallocated from low- to high-income borrowers and from counties where borrowers are closer to the limits to counties where borrowers are further from the limits.

#### 3.1 Evolution of Residential Mortgage Issuance

The lending limits affected a large fraction of the mortgage market as 43% of the volume of residential mortgage issuance (35% of mortgages issued) from October 2013 to September 2014 would have been affected if the policy had been in place during that period. Out of the total €1.6 billion in mortgages in our sample in that period, non-conforming (i.e., not complying with the new rules) mortgages accounted for €0.7 billion. The LTV limits affected the largest fraction of the market. LTV-non-conforming mortgages accounted for €0.5 billion and LTI-non-conforming mortgages accounted for €0.3 billion.

Whereas the lending limits affected more than one third of residential mortgage issuance, originations seem almost unaffected by the policy. In the left panel of [Figure 2](#), we show the evolution of mortgage issuance from January 2013 to June 2016. We find that mortgage credit growth – high since the beginning of 2014 – did not collapse after the implementation of the lending limits. This aggregate evidence suggests an increase in the issuance of *con-*



**Figure 2: Aggregate Residential Mortgage Issuance.** This figure shows the evolution of residential mortgage issuance of our sample banks from January 2013 to June 2016. The left panel shows total mortgage issuance. The right panel shows issuance of conforming (solid line) and non-conforming (dashed line) mortgages. Thick lines are seasonally adjusted and thin lines are not seasonally adjusted. The vertical dashed lines indicate the first rumors and the implementation of the lending limits. Source: Central Bank of Ireland.

*forming* mortgages might have compensated the mechanical reduction of the issuance of *non-conforming* mortgages, as banks followed the new rules. In the right panel, we show the evolution of originations of conforming (solid line) and non-conforming (dashed line) mortgages and confirm the two time-series diverge starting in February 2015.<sup>15</sup>

### 3.2 Exposure to the Lending Limits

We now show that counties and borrowers are differentially exposed to the lending limits. First, we define a county level variable *Distance*, which measures the average distance of borrowers in a county from the lending limits in

<sup>15</sup>The non-conforming issuance is strictly positive after the policy because the new rules allow banks to exceed the limits for a limited fraction of their issuance. In the online appendix, we show mortgage originations keep increasing even when weighted by LTV and LTI.

the year prior to the first rumors about the policy.<sup>16</sup> In [Figure 3](#), we show the county level distance from the lending limits. Darker colors indicate counties that are closer to the lending limits. Perhaps not surprisingly, urban counties – and the Dublin area in particular – are closer to the lending limits. These are the counties that experienced a larger house price increase before the policy and where households were therefore more likely to borrow close to the to-be-imposed limits. Substantial heterogeneity exists in the distance from the lending limits across counties: The average distance is 0.21, the median distance is 0.23, and the standard deviation is 0.15.<sup>17</sup>

Second, in [Table 2](#), we divide households who obtain a mortgage in the year prior to the policy in five quintiles based on their income.<sup>18</sup> The income distribution is negatively skewed as the average income of the top quintile is almost double the average income of the fourth income quintile. High-income borrowers also have lower LTV and lower LTI and tend to be older and less likely to be single or first-time buyers than lower-income borrowers.

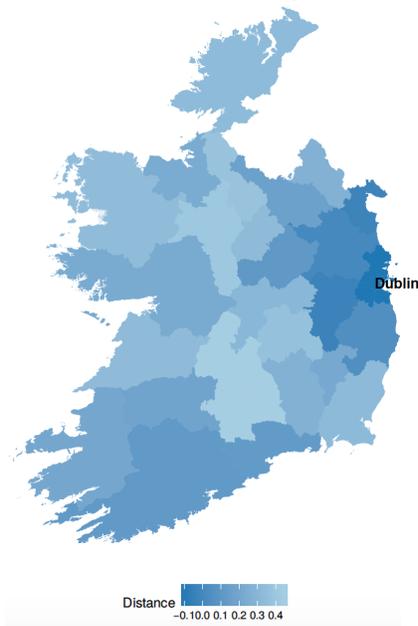
Borrowers across the income distribution are differentially exposed to the LTI and LTV limits. Somewhat mechanically, the distance from the LTI limit increases monotonically with income. Low-income borrowers are the closest and high-income borrowers are the furthest from the limit. This monotonicity

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<sup>16</sup>We proceed in three steps. First, for each mortgage, we measure the distance from the respective LTV and LTI limits. Second, given the very different scales of LTV and LTI, we rescale both distances to have a mean of zero and a standard deviation of one. Third, we average these two distances at the county level. See the online appendix for details.

<sup>17</sup>In the online appendix, we (i) show that counties closer to the limits are more densely populated and experienced a sharper house price appreciation before the policy than more distant counties and (ii) show the distance from the LTV and LTI limits, separately.

<sup>18</sup>Income quintiles are based on the January 2014 income distribution and adjusted monthly for Irish wage inflation using OECD data.



**Figure 3: Counties and Lending Limits.** This figure shows county level distance from the limits. Darker colors indicate less distant counties. Source: Central Bank of Ireland.

does not apply to the distance from the LTV limit: Borrowers in the bottom quintile of the income distribution are, on average, further away from the LTV limit than borrowers in the second to fourth quintiles, whereas borrowers in the top quintile are the furthest from the limit.<sup>19</sup> In sum, the LTV and LTI limits do not seem to be the most binding for the same type of household. To measure how tight the regulation is for households based on their income, we create a standardized measure of the distance from both the LTV and LTI limit. This measure shows that borrowers in the top-income quintile are by far the most distant from the lending limits compared with other borrowers.

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<sup>19</sup>On the one hand, high-income borrowers tend to face stricter LTV limits because they are often second- or subsequent-time buyers. On the other hand, low-income borrowers tend to face laxer LTV limits because they are often first-time buyers.

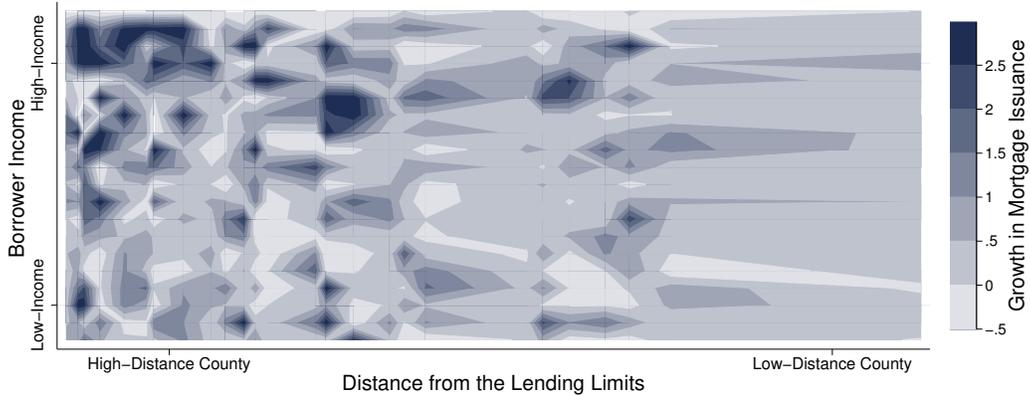
|                                 | Unit   | <i>Income Quintiles</i> |         |         |         |         |
|---------------------------------|--------|-------------------------|---------|---------|---------|---------|
|                                 |        | Q1                      | Q2      | Q3      | Q4      | Q5      |
| <i>Borrower Characteristics</i> |        |                         |         |         |         |         |
| Income                          | €      | 32,635                  | 47,659  | 64,899  | 91,756  | 168,129 |
| Married                         | %      | 16.5                    | 36.2    | 49.0    | 66.8    | 65.1    |
| Age                             | Years  | 34.2                    | 35.3    | 36.2    | 37.7    | 40.0    |
| First-Time Buyer                | %      | 82.7                    | 78.1    | 65.1    | 41.7    | 27.0    |
| Buy-to-Let                      | %      | 1.7                     | 2.3     | 3.2     | 4.3     | 8.4     |
| No. Borrowers                   | Units  | 1,559                   | 2,023   | 2,378   | 1,977   | 2,664   |
| <i>Loan Characteristics</i>     |        |                         |         |         |         |         |
| Size                            | €      | 95,030                  | 127,008 | 168,902 | 215,070 | 235,801 |
| LTV                             | %      | 77.2                    | 77.2    | 78.3    | 76.7    | 71.8    |
| LTI                             | Units  | 3.2                     | 3.0     | 3.0     | 2.7     | 2.3     |
| House Value                     | €      | 133,518                 | 177,142 | 230,458 | 298,620 | 385,940 |
| Term                            | Months | 326                     | 328     | 326     | 314     | 286     |
| Fixed Rate                      | %      | 44.9                    | 41.8    | 40.3    | 34.9    | 24.4    |
| Rate                            | %      | 4.15                    | 4.26    | 4.25    | 4.26    | 4.27    |
| Distance from LTI Limit         | Units  | 0.54                    | 0.75    | 0.73    | 1.00    | 1.28    |
| Distance from LTV Limit         | Units  | 6.73                    | 5.92    | 3.64    | 4.22    | 10.00   |
| Stand. Distance from Limits     | Units  | -0.13                   | -0.10   | -0.09   | -0.02   | 0.45    |

**Table 2: Summary Statistics by Household Income.** This table shows household and loan characteristics by household income quintile during the 12-month period before the policy implementation from February 2014 to January 2015. Income quintiles are adjusted monthly for wage inflation. Source: Central Bank of Ireland.

### 3.3 Reallocation of Residential Mortgage Credit

We now document, non-parametrically, a mortgage credit reallocation from counties where borrowers are closer to the lending limits (“low-distance” counties) to counties where borrowers are more distant from the lending limits (“high-distance” counties) and from low-income to high-income borrowers.

We show this reallocation in [Figure 4](#). On the x-axis, the 26 counties are ordered based on their distance from the limits: high-distance counties on the left and low-distance counties on the right. On the y-axis, borrowers are grouped and ordered in 20 ventiles based on their position in the income distribution: low-income borrowers on the bottom and high-income borrowers on the top. In sum, a point in the heatmap is an income group-county group



**Figure 4: Reallocation of Mortgage Credit.** This figure shows the reallocation of mortgage credit across counties and across the income distribution of borrowers. The x-axis shows counties ranked according to their distance from the limits. The y-axis shows borrowers ranked according to their position in the income distribution (20 ventiles). Each point in the map indicates the change of mortgage issuance in the post-period (February 2015 to January 2016) compared with the pre-period (February 2014 to January 2015). Darker colors indicate higher growth of issuance.

pair. For each pair, we compute the change in mortgage origination from the pre-policy period (February 2013 to January 2014) to the post-policy period (February 2014 to January 2015). Darker colors indicate higher growth.

We observe darker colors on the left, toward the top, and especially in the top-left corner. In sum, this figure documents that the growth in mortgage issuance after the policy implementation has been driven by high-distance counties and high-income borrowers.<sup>20</sup>

We confirm this reallocation using the following specification:

$$Y_{cht} = \alpha + \gamma_{ct} + \eta_{ch} + \beta Post_t \times Distance_{ch} + \epsilon_{cht} \quad (1)$$

<sup>20</sup>In the online appendix, we show a heatmap where the post-period is from February 2014 to January 2015 and the pre-period is from February 2013 to January 2014. In this “placebo” figure, we do not observe a reallocation to high-income borrowers and high-distance counties.

|                        | Volume            | Loan Size         | LTV              | LTI               |
|------------------------|-------------------|-------------------|------------------|-------------------|
| Distance $\times$ Post | 0.154<br>(0.0630) | 0.339<br>(0.0506) | 10.33<br>(1.352) | 0.339<br>(0.0564) |
| County-Time FE         | ✓                 | ✓                 | ✓                | ✓                 |
| County-Bucket FE       | ✓                 | ✓                 | ✓                | ✓                 |
| Observations           | 7,243             | 7,240             | 7,145            | 7,051             |
| R-squared              | 0.717             | 0.507             | 0.253            | 0.491             |

**Table 3: Reallocation of Mortgage Credit, Parametric Evidence.** This table shows estimation results from specification (1). The dependent variable is the logarithm of total mortgage volume, the logarithm of the average loan size, the value-weighted LTV, and the value-weighted LTI. *Distance* is the distance from the lending limits at the county-income bucket level, measured from October 2013 to September 2014. Standard errors clustered at the county-income bucket level in parentheses. Source: Central Bank of Ireland.

where  $c$  is a county,  $t$  is a month, and  $h$  is a borrower income bucket. We divide borrowers into 20 income buckets to ensure borrowers are similar enough to properly capture mortgage demand. The sample includes 24 months and runs from February 2014 to January 2016. The key independent variable is the interaction term between a *Post* dummy equal to 1 from February 2015 to January 2016 and the (pre-policy) distance from the lending limits for each county-income bucket pair. We saturate the specification with county-time fixed effects to capture county time-varying heterogeneity (e.g., county-specific demand for credit) and county-income bucket fixed effects to capture time-invariant borrower characteristics.

We show the estimation results in Table 3. In the first and second columns, the dependent variables are the logarithm of mortgage issuance and the average loan size, respectively. We find that a one standard deviation increase in the distance from the limits is associated with a 6.2% higher issuance and a 13.6% higher loan relative to the pre-period. We also find, in columns (3) and (4), that a one standard deviation increase in the distance from the limits is associated with a 4.13 percentage points higher LTV and a 0.14 percentage points higher

LTI relative to the pre-period. In sum, these estimation results confirm the reallocation of mortgage credit from low- to high-income borrowers and from low- to high-distance counties documented in the heatmap.

## 4 House Prices

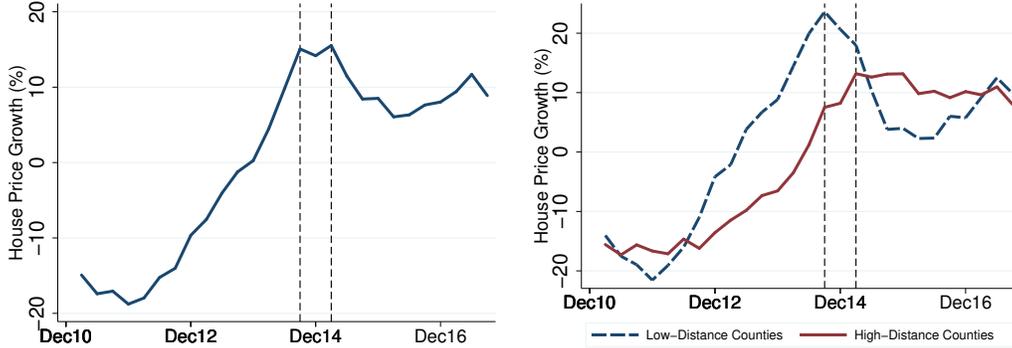
In this section, we show the time-series evolution of house prices is consistent with the mortgage credit reallocation documented in the previous section.

First, we show non-parametric evidence. In the left panel of [Figure 5](#), we show yearly growth in house prices from January 2011 to June 2017. House price growth stopped increasing at the time of the first rumors about the policy and then stabilized around 10% after the implementation.<sup>21</sup> In the right panel, we plot house price growth for high-distance (solid line) and low-distance (dashed line) counties. Low-distance counties experienced a stark contraction of house price growth after the policy implementation, whereas house price growth remained stable at the pre-policy level in high-distance counties.<sup>22</sup> In the online appendix, we show the slowdown in house price growth in low-distance counties is driven by small properties, and the relative stability of house price growth in high-distance counties is driven by large properties. This evidence is consistent with the documented credit reallocation across counties

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<sup>21</sup>Survey data show that households anticipated, at the time of the first rumors, a decline in house prices exactly because of the soon-to-be announced limits (see online appendix).

<sup>22</sup>The relatively more elastic housing supply in high-distance compared with low-distance counties might explain why house price growth did not increase in high-distance counties after the policy. The evolution of planning permissions granted did not change after the policy in low-distance counties (66% in 2012Q4-2014Q4; 69% in 2014Q4-2016Q4) but substantially increased in high-distance counties (-2% in 2012Q4-2014Q4; 81% in 2014Q4-2016Q4).



**Figure 5: House Price Changes.** The top panel of this figure shows the evolution of yearly house price growth. The bottom panel shows the evolution of yearly house price growth for high-distance and low-distance counties separately. The vertical dashed lines indicate the first rumors about the limits and their implementation date. The sample period runs from January 2011 to June 2017. Source: Central Bank of Ireland, Daft.ie.

and, to the extent that property size is correlated with the income of the buyers, with the reallocation across the distribution of borrowers' income.<sup>23</sup>

Second, we show parametric evidence consistent with the mortgage credit reallocation across counties and across the income distribution. In particular, we estimate the following specifications at the county ( $c$ ) level and at the county-property type ( $c, p$ ) level:

$$\Delta HP_c = \alpha + \beta Distance_c + \epsilon_c \quad (2)$$

$$\Delta HP_{cp} = \alpha + \beta_1 Distance_c \times Size_p + \beta_2 Distance_c + \beta_3 Size_p + \epsilon_{cp} \quad (3)$$

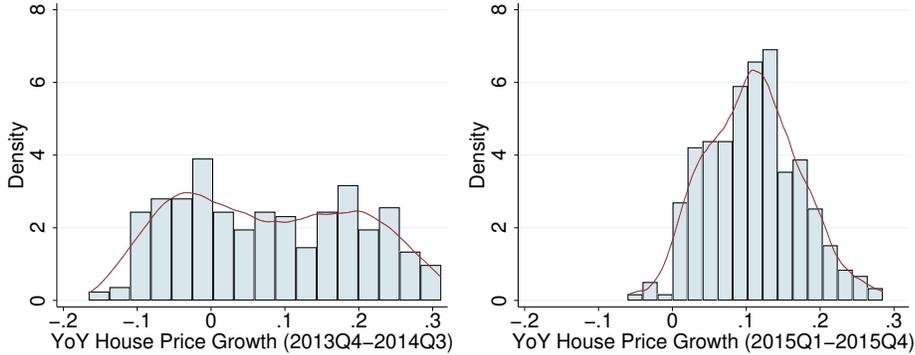
<sup>23</sup>See Figure A.7 in the online appendix. Table 2 shows borrower income is strongly correlated with the price of the property purchased. In the online appendix, we attempt to map the number of bedrooms to the income of buyers by regressing the price of the residential property collateralizing the residential mortgage (from the credit registry data) on property size-county level house price data. We find these loadings are consistent with high-income (low-income) borrowers predominantly buying large (small) properties. Of course, this mapping is not perfect, because, for example, high-income borrowers might buy a one-bedroom property to rent it out.

| LHS: $\Delta\text{HP}$               | (1)              | (2)              | (3)              | (4)              | (5)              |
|--------------------------------------|------------------|------------------|------------------|------------------|------------------|
| <i>Distance</i> $\times$ <i>Size</i> |                  | 0.007<br>(0.003) | 0.007<br>(0.003) | 0.007<br>(0.003) | 0.007<br>(0.003) |
| <i>Distance</i>                      | 0.296<br>(0.072) | 0.276<br>(0.076) |                  | 0.276<br>(0.077) |                  |
| <i>Size</i>                          |                  | 0.012<br>(0.000) | 0.012<br>(0.000) |                  |                  |
| Country FE                           |                  |                  | ✓                |                  | ✓                |
| Size FE                              |                  |                  |                  | ✓                | ✓                |
| Observations                         | 54               | 270              | 270              | 270              | 270              |
| R-squared                            | 0.360            | 0.281            | 0.736            | 0.468            | 0.924            |

**Table 4: House Prices and Lending Limits.** This table shows estimation results from specification (3) in column (1) and specification (3) in columns (2)-(5). The dependent variable is the change in house prices between 2014Q3 and 2016Q4. *Distance* is the county level distance from the lending limits. *Size* is the number of bedrooms (1 to 5). Standard errors clustered at the county level in parentheses. Source: Central Bank of Ireland, Daft.ie.

where the dependent variable is the change in house prices from 2014Q3 to 2016Q4, *Distance* is the county level (pre-policy) distance from the lending limits, and *Size* is an integer equal to the number of bedrooms.<sup>24</sup> We interact *Distance* with the measure of property size to check whether the effect of the lending limits changes depending on the type of property. We show the estimation results in Table 4. The county level estimation in column (1) confirms the positive correlation between changes in house price growth after the policy and county level distance from the lending limits. In columns (2)-(5), we show the county-property size level estimation. We confirm that house price growth increased more in high-distance counties than in low-distance counties, and this

<sup>24</sup>The geographical breakdown of the house price data is more granular than the mortgage level data as we observe house price data for each of the 22 Dublin postal districts. Given that we cannot compute the distance from the lending limits at this more granular level, we assume the distance is constant within a county. We then cluster our standard errors at the county level to take into account that standard errors might be correlated within counties.



**Figure 6: Distribution of House Price Growth.** This figure shows the change in the distribution of house price growth. The left and right graphs show the density of YoY house price growth before (4 quarters from 2013Q4 to 2014Q3) and after (4 quarters from 2015Q1 to 2015Q4) the policy, respectively. Source: Daft.ie.

different evolution is more pronounced for larger properties. These results are consistent with the documented reallocation of mortgage credit across counties and – to the extent that property size is correlated with the income of the buyers – across the income distribution.

Third, we show that, following the introduction of the lending limits, the geographical distribution of house price growth became less fat-tailed. The left and right panels of Figure 6 show the distribution of house price growth across counties before and after the policy, respectively. The distribution in the post-period is substantially less fat-tailed (standard deviation from 0.12 to 0.06) and has a similar, slightly positive, skew (skewness from 0.12 to 0.15) compared with the pre-period. In sum, this figure suggests the lending limits also reduced the geographical heterogeneity in house price growth.

## 5 Bank Credit Reallocation

In this section, we show the reallocation of mortgage credit from low- to high-distance counties and from low- to high-income borrowers is consistent with

a “bank portfolio choice” channel. According to this channel, banks react to the policy by reallocating their assets to maintain their preferred, pre-policy, risk exposure. In [Section 5.1](#) and [Section 5.2](#), we show the mortgage credit reallocation is driven by banks more exposed to the policy. In [Section 5.3](#), we show that banks increased their risk exposure in asset classes not targeted by the policy like holdings of securities and credit to firms.

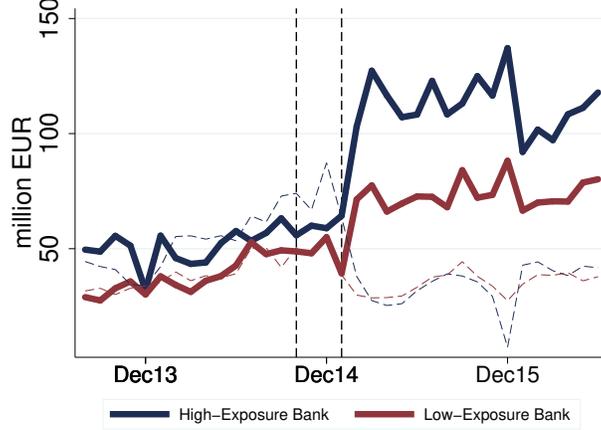
## 5.1 Mortgage Credit Reallocation

The bank portfolio choice channel has a clear cross-sectional implication: Banks with a larger fraction of non-conforming issuance in the pre-policy period drive the mortgage credit reallocation compared with banks with less non-conforming issuance. Following this intuition, we measure banks’ differential exposure to the policy based on the importance of non-conforming issuance relative to a bank’s total mortgage issuance during the year before the first rumors about the policy. In particular, for each bank  $b$ , we define

$$Exposure_b = \frac{\sum_{t=Oct13}^{Sep14} \text{Non-Conforming Mortgage Issuance}_{bt}}{\sum_{t=Oct13}^{Sep14} \text{Total Mortgage Issuance}_{bt}} \quad (4)$$

where the numerator is the sum of total non-conforming mortgage issuance between October 2013 and September 2014 and the denominator is the sum, over the same period, of total mortgage issuance.

We validate our measure in [Figure 7](#), where we show the evolution of conforming mortgages issued by high-exposure banks (exposure above median, blue line) and low-exposure banks (exposure below median, red line). The thin dashed lines show non-conforming mortgage issuance, collapsing for both groups of banks after the policy implementation. This figure documents that



**Figure 7: Issuance and Bank Exposure.** The figure shows the issuance of conforming (solid thick lines) and non-conforming (dashed thin lines) mortgages for high-exposure (above median exposure) and low-exposure (below median exposure) banks from January 2013 to June 2016. The vertical lines indicate the first rumors and the implementation date of the limits. All time series are seasonally adjusted. Source: Central Bank of Ireland.

high-exposure banks experience a greater drop in non-conforming issuance and a greater increase in conforming issuance than low-exposure banks.

Having shown non-parametric evidence of cross-sectional variation in bank credit reallocation, we estimate a triple difference-in-differences specification, obtained by adding the bank exposure defined in (4) to specification (1):

$$\begin{aligned}
 Y_{bcht} = & \alpha + \gamma_{ct} + \eta_{ch} + \mu_{bt} + \beta_1 Post_t \times Distance_{ch} \times Exposure_b \\
 & + \beta_2 Distance_{ch} \times Exposure_b \\
 & + \beta_3 Post_t \times Distance_{ch} + \epsilon_{bcht} \tag{5}
 \end{aligned}$$

where the unit of observation is bank  $b$ , county  $c$ , household income bucket  $h$ , and month  $t$ . Again, we divide borrowers into 20 income buckets and our sample period runs from February 2014 to January 2016. In addition to the county-time and county-income bucket fixed effects used in (1), we add bank-time fixed effects to ensure our results are not driven by the non-random nature

|  |             | Volume            | Loan Size         | LTV                | LTI               |
|--|-------------|-------------------|-------------------|--------------------|-------------------|
| Distance $\times$ Exposure $\times$ Post | $(\beta_1)$ | 1.763<br>(0.688)  | 4.349<br>(0.780)  | 108.6<br>(22.51)   | 2.028<br>(0.986)  |
| Distance $\times$ Exposure               | $(\beta_2)$ | -4.308<br>(0.614) | -5.042<br>(0.675) | -112.1<br>(18.98)  | -2.070<br>(0.835) |
| Distance $\times$ Post                   | $(\beta_3)$ | -0.633<br>(0.293) | -1.607<br>(0.321) | -37.34<br>(9.591)  | -0.614<br>(0.405) |
| $\beta_1 + \beta_2$                      |             | -2.544<br>(0.468) | -0.692<br>(0.360) | -3.451<br>(11.693) | -0.042<br>(0.444) |
| County-Time FE                           |             | ✓                 | ✓                 | ✓                  | ✓                 |
| County-Bucket FE                         |             | ✓                 | ✓                 | ✓                  | ✓                 |
| Bank-Time                                |             | ✓                 | ✓                 | ✓                  | ✓                 |
| Observations                             |             | 13,052            | 13,048            | 12,838             | 12,708            |
| R-squared                                |             | 0.593             | 0.454             | 0.189              | 0.407             |

**Table 5: Bank Mortgage Credit Reallocation.** This table presents the results from specification (5). The sample period runs monthly from February 2014 to January 2016. The unit of observation is county-month-bank-income bucket. The dependent variables are the logarithm of mortgage volume, the logarithm of the median loan size, the value-weighted LTV, and the value-weighted LTI. *Exposure* is defined in (4), and *Post* is a dummy equal to 1 from February 2015 to January 2016. Standard errors double clustered at the bank-county level in parentheses. Source: Central Bank of Ireland.

of bank exposure to the policy (e.g., high-leverage banks being more exposed to the limits and changing their lending decision after the policy).

We present the estimation results in Table 5. The independent variables are issuance volume, loan size, value-weighted LTV, and value-weighted LTI, in columns (1) to (4), respectively. The positive coefficient  $\beta_1$  shows the credit reallocation documented in Section 3 is primarily driven by banks more exposed to the limits. The sum of the first two coefficients ( $\beta_1 + \beta_2$ ) being very close to zero in columns (2)-(4) shows that banks maintained a similar loan size, LTV, and LTI after the policy compared with the pre-policy period, suggesting banks, while conforming with the new limits, issued mortgages with similar

characteristics to the mortgages they issued before the policy.<sup>25</sup> However, the negative sum of the first two coefficients in column (1) suggests banks were forced to partially reduce their mortgage issuance and were, therefore, unable to completely “undo” the new limits.

Table 3 and Table 5 suggest banks, especially those highly exposed to the policy, tried to undo the limits by lending to borrowers more distant from the lending limits, namely, high-income borrowers and borrowers located in high-distance counties. To further confirm this interpretation, we estimate, in various subsamples of borrowers, the following specification:

$$Y_{bcht} = \alpha + \beta Post_t \times Exposure_b + \gamma X_{b,t-1} + \nu_b + \eta_{ct} + \theta_{ht} + \epsilon_{bcht} \quad (6)$$

where our unit of observation is bank  $b$ , county  $c$ , household income bucket  $h$ , and month  $t$ . The partition of borrowers in income buckets, the sample period, the definitions of  $Post_t$  and the  $Exposure_b$  variables are unchanged. In addition to county-time, bank, and income bucket-time fixed effects, we include lagged bank time-varying controls (logarithm of total assets, equity capital ratio, and loans/total assets).

We run our specification in subsamples based on borrower income quintiles. We show the estimation results in Table 6 where each column corresponds to an income quintile. In Panel A and Panel B, the independent variables are total loan volume and mortgage size, respectively. We find that more-exposed banks increase their loan issuance to high-income (Q5) borrowers and reduce

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<sup>25</sup>The p-values of a  $\beta_1 + \beta_2 = 0$  test on whether are 0.055, 0.768, and 0.924 in columns (2)-(4), respectively.

|                             | Income Quintiles    |                     |                    |                    |                    |
|-----------------------------|---------------------|---------------------|--------------------|--------------------|--------------------|
|                             | Bottom              |                     |                    |                    | Top                |
|                             | Q1                  | Q2                  | Q3                 | Q4                 | Q5                 |
| <b>Panel A: Loan Volume</b> |                     |                     |                    |                    |                    |
| Post × Exposure             | -1.311<br>(0.553)   | -0.570<br>(0.552)   | -0.307<br>(0.642)  | -0.773<br>(0.615)  | 2.085<br>(0.928)   |
| Observations                | 2,404               | 2,786               | 2,947              | 2,512              | 1,929              |
| R-squared                   | 0.496               | 0.505               | 0.582              | 0.590              | 0.655              |
| <b>Panel B: Loan Size</b>   |                     |                     |                    |                    |                    |
| Post × Exposure             | -0.546<br>(0.386)   | -0.773<br>(0.273)   | -1.050<br>(0.469)  | -1.856<br>(0.476)  | 4.591<br>(1.250)   |
| Observations                | 2,404               | 2,786               | 2,947              | 2,512              | 1,929              |
| R-squared                   | 0.446               | 0.359               | 0.360              | 0.369              | 0.476              |
| <b>Panel C: LTV</b>         |                     |                     |                    |                    |                    |
| Post × Exposure             | -91.148<br>(14.915) | -30.657<br>(14.100) | -0.421<br>(16.285) | -6.747<br>(12.749) | 67.309<br>(26.549) |
| Observations                | 2,363               | 2,755               | 2,896              | 2,466              | 1,866              |
| R-squared                   | 0.389               | 0.264               | 0.242              | 0.265              | 0.372              |
| <b>Panel D: LTI</b>         |                     |                     |                    |                    |                    |
| Post × Exposure             | -4.855<br>(6.830)   | 3.548<br>(4.521)    | 5.461<br>(4.001)   | 2.357<br>(4.193)   | 4.453<br>(1.579)   |
| Observations                | 1,396               | 1,775               | 1,929              | 1,743              | 1,267              |
| R-squared                   | 0.426               | 0.419               | 0.484              | 0.492              | 0.538              |
| Bank Controls               | ✓                   | ✓                   | ✓                  | ✓                  | ✓                  |
| Bucket-Time FE              | ✓                   | ✓                   | ✓                  | ✓                  | ✓                  |
| Bank FE                     | ✓                   | ✓                   | ✓                  | ✓                  | ✓                  |
| County-Time FE              | ✓                   | ✓                   | ✓                  | ✓                  | ✓                  |

**Table 6: Bank Mortgage Credit Reallocation, Heterogeneity across Households.** This table shows regressions at the bank-county-income bucket level separately for each income quintile. Income quintiles are adjusted monthly for wage inflation. The dependent variables are the logarithm of volume of mortgage issuance (Panel A), the logarithm of the average loan size (Panel B), the value-weighted LTV (Panel C), and the value-weighted LTI (Panel D). *Exposure* is defined in (4), and *Post* is a dummy equal to 1 from February 2015 to January 2016. Time-varying bank level controls include the logarithm of total assets, equity-capital ratio, and the loans/assets ratio. Control variables are lagged by one period. Standard errors double clustered at the bank-county and month level in parentheses. Source: Central Bank of Ireland.

it to low-income (Q1) borrowers compared with less-exposed banks. The top-income quintile borrowers also obtain larger loans than other quintiles after the policy. More precisely, a one standard deviation higher  $Exposure_b$  leads to a 10% decrease in total mortgage issuance to low-income (Q1) borrowers and to a 15% increase in mortgage issuance to high-income (Q5) borrowers. These results are consistent with more-affected banks reallocating credit to richer households that are further away from the limits and thus likely have more room to increase their LTV and LTI, while still conforming with the limits.

In Panel C, we consider the (volume-weighted) LTV as a dependent variable. We find that more-exposed banks reduced their LTV compared with less-exposed banks in income quintiles Q1 and Q2, consistent with the limits affecting these banks more and with low-income households being more constrained. For households in the bottom income quintile, a one standard deviation higher  $Exposure_b$  implies a 6.6 percentage points lower LTV. However, in the top-income quintile, more-affected banks *increased* their LTV compared with less-exposed banks. Borrowing from banks with a one standard deviation higher  $Exposure_b$  leads to a 4.9 percentage points higher LTV in the top-income quintile. Hence, by issuing larger loans to high-income households, banks can partially make up for the lost business caused by the policy introduction. In Panel D, the independent variable is the (volume-weighted) LTI. Similar to the finding for the LTV, we document a significant increase in the LTI for high-income households borrowing from more-exposed banks. More precisely, a one standard deviation higher  $Exposure_b$  implies a 0.3 percentage

points increase in the loan-to-income ratio of high-income borrowers.<sup>26</sup>

## 5.2 Mortgage Rates

Having shown evidence consistent with bank portfolio choice driving mortgage credit reallocation, we now analyze mortgage rates to understand why high-income borrowers and borrowers located in high-distance counties take out larger loans and increase their leverage after the policy introduction.

We first examine the time-series evolution of mortgage rates for each quintile of the income distribution. In Panel A of [Table 7](#), we document that although rates are falling for all borrowers during our sample period, borrowers in the top quintile (Q5) experience a reduction of 46 basis points compared with a reduction of 29 basis points for borrowers in the bottom quintile (Q1).<sup>27</sup>

Having shown that high-income borrowers experience the largest reduction in mortgage rates around the introduction of the lending limits, we resort again to the cross-section of banks to capture the bank portfolio choice channel. In particular, we re-estimate specification (6), using the mortgage rate as a dependent variable. We show the estimation results in Panel B of [Table 7](#), where columns correspond to income quintiles. We find that households in the top-income quintile were charged lower rates if they borrowed from banks more affected by the lending limits, consistent with more-exposed banks offering favorable interest rates to high-income households who take larger loans.<sup>28</sup>

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<sup>26</sup>In the online appendix, we show non-parametric evidence consistent with exposed banks driving high-income borrowers' LTV and LTI increase in the post-regulation period.

<sup>27</sup>Irish banks do not offer mortgage rates based on the income of borrowers. Banks typically offer an interest rate-LTV schedule, allowing borrowers to self-select into products.

<sup>28</sup>Banks have several ways to influence the rates charged to clients, including offering more

| <b>Panel A</b> |    | Pre  | Post | Difference |
|----------------|----|------|------|------------|
| Bottom         | Q1 | 4.12 | 3.84 | -0.29      |
|                | Q2 | 4.24 | 3.85 | -0.39      |
|                | Q3 | 4.21 | 3.81 | -0.40      |
|                | Q4 | 4.21 | 3.80 | -0.40      |
| Top            | Q5 | 4.24 | 3.78 | -0.46      |

| <b>Panel B</b> | <b>Income Quintiles</b> |                  |                   |                   |                   |
|----------------|-------------------------|------------------|-------------------|-------------------|-------------------|
|                | <b>Bottom</b>           |                  |                   |                   | <b>Top</b>        |
|                | <b>Q1</b>               | <b>Q2</b>        | <b>Q3</b>         | <b>Q4</b>         | <b>Q5</b>         |
| Post×Exposure  | 0.628<br>(0.607)        | 0.668<br>(0.501) | -0.224<br>(0.573) | -0.205<br>(0.842) | -1.427<br>(0.641) |
| Bucket-Time FE | ✓                       | ✓                | ✓                 | ✓                 | ✓                 |
| Bank FE        | ✓                       | ✓                | ✓                 | ✓                 | ✓                 |
| County-Time FE | ✓                       | ✓                | ✓                 | ✓                 | ✓                 |
| Observations   | 2,366                   | 2,666            | 2,717             | 2,220             | 1,682             |
| R-squared      | 0.482                   | 0.538            | 0.491             | 0.472             | 0.516             |

**Table 7: Mortgage Rates.** Panel A shows (value-weighted) mean interest rates paid by borrowers in different quintiles of the income distribution from February 2014 to January 2015 and from February 2015 to January 2016. Panel B shows estimation results from specifications (6) separately for each income quintile. The unit of observation is month-income bucket-bank. The dependent variable is the mortgage rate. *Exposure* is defined in (4), and *Post* is a dummy equal to 1 from February 2015 to January 2016. Standard errors clustered at the bank-time level in parentheses. Source: Central Bank of Ireland.

Conversely, low-income households borrowing from more-affected banks faced relatively higher rates after the introduction of the limits. In sum, these results are consistent with more-exposed banks offering lower rates to attract high-income borrowers to take out larger loans, thus trying to make up for the business lost because of the introduction of the lending limits.

One obvious question is why high-income borrowers, especially those located in high-distance counties, were not borrowing as much *before* the lending

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fixed- or non-fixed-rate mortgages.

limits. Two explanations are possible. First, banks suffered large losses exactly from high-income borrowers during the 2008-10 bust and therefore might have been reluctant to increase credit to these borrowers when the housing market started to pick up again.<sup>29</sup> Second, banks might have a risk-shifting incentive to tilt their mortgage issuance toward low-distance counties such as the Dublin area, because the payoffs of these mortgages are more correlated with banks’ legacy assets (Malherbe and Bahaj, 2018; Landier et al., 2015).

### 5.3 Other Asset Classes

In the previous sections, we have shown that, after the policy introduction, banks issued mortgages with similar characteristics to the mortgages they previously issued, but partially reduced their total mortgage issuance. In this section, we show that banks, consistent with the bank portfolio choice channel, increased their risk-taking in their holdings of securities and credit to firms, two types of investments not targeted by the policy.

#### 5.3.1 Security Holdings

We use security level holdings data and examine whether banks changed their risk exposure in this asset class. Following Davis and Haltiwanger (1992), we define the “net buys” of security  $s$  by bank  $b$  from  $t - 1$  to  $t$  as follows:

$$NetBuys_{s,b,t} = \frac{Holdings_{s,b,t} - Holdings_{s,b,t-1}}{0.5(Holdings_{s,b,t} + Holdings_{s,b,t-1})} \in [-2, 2] \quad (7)$$

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<sup>29</sup>In the online appendix, we show our sample banks experienced the largest losses from high-income high-LTV borrowers during the 2007-10 bust.

where *Holdings* is the euro value of holdings. Compared with percentage changes, this measure also captures final sales, corresponding to a value of -2, and initial purchases, corresponding to a value of 2.

We exploit again the cross-sectional heterogeneity in bank exposure to the lending limits. In particular, we estimate the following specification:

$$NetBuys_{sbt} = \alpha + \beta Exposure_b \times Post_t \times Yield_{st} + \gamma_{bt} + \eta_{st} + \epsilon_{sbt} \quad (8)$$

where the unit of observation is security  $s$ , bank  $b$ , and quarter  $t$ .<sup>30</sup> The independent variable of interest is the triple interaction term between bank exposure defined in (4), a *Post* dummy equal to 1 in the post period, and the yield of the security. In our most conservative estimation, we include bank-time and security-time fixed effects to capture time-varying bank heterogeneity and time-varying security heterogeneity, respectively.

We show estimation results in Table 8, where we progressively saturate the regression with more stringent fixed effects. Column (4) includes all the pairs of two-way fixed effects. The coefficient of interest, stable across specifications, indicates more-exposed banks increase their holdings of risky securities compared with less-exposed banks after the policy implementation. In columns (5) and (6), we distinguish between the buying and selling behavior of banks. *Buys* are defined as the logarithm of the amount of security  $s$  bought by bank  $b$  at time  $t$ , and zero otherwise. Similarly, *Sells* are defined as the logarithm of the amount of securities sold. We find that more-exposed banks buy more and sell less high-yield securities than less-exposed banks.

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<sup>30</sup>We observe security level holdings at a quarterly frequency.

|                     | Net Buys         |                  |                  |                  | Buys             | Sells             |
|---------------------|------------------|------------------|------------------|------------------|------------------|-------------------|
|                     | (1)              | (2)              | (3)              | (4)              | (5)              | (6)               |
| Exposure×Yield×Post | 0.021<br>(0.008) | 0.019<br>(0.009) | 0.057<br>(0.016) | 0.067<br>(0.022) | 0.290<br>(0.098) | -0.251<br>(0.102) |
| Time FE             | ✓                |                  |                  |                  |                  |                   |
| Security FE         | ✓                | ✓                |                  |                  |                  |                   |
| Bank-Time FE        |                  | ✓                |                  | ✓                | ✓                | ✓                 |
| Security-Time FE    |                  |                  | ✓                | ✓                | ✓                | ✓                 |
| Observations        | 7,707            | 7,707            | 7,707            | 7,707            | 7,707            | 7,707             |
| R-squared           | 0.247            | 0.281            | 0.943            | 0.949            | 0.919            | 0.915             |

**Table 8: Bank Portfolio Reallocation, Holdings of Securities.** This table shows the estimation results from specification (8). The unit of observation is security-bank-quarter. The sample runs at a quarterly frequency from 2013Q1 to 2016Q2. The dependent variable is defined in (7). *Exposure* is defined in (4), *Post* is a dummy equal to 1 from 2015Q2 onwards, and *Yield* is the yield of the security. Double-interaction terms and uninteracted terms (when not absorbed by fixed effects) are not shown for brevity. Standard errors clustered at the security level in parentheses. Source: Central Bank of Ireland.

### 5.3.2 Credit to Firms

We now use the corporate loan level data and analyze whether banks changed their credit supply to firms. To this end, we adapt specification (6) and estimate the following specification:

$$Y_{bclqt} = \alpha + \beta Post_t \times Exposure_b + \gamma X_{bt-1} + \delta_{bc} + \eta_{clqt} + \epsilon_{bclqt} \quad (9)$$

We measure the credit provided by bank  $b$  to firms in county  $c$ , industry  $l$ , of quality  $q$  in semester  $t$ ; that is, we group firms into clusters based on their county, industry, and quality at time  $t$  and investigate the lending behavior of banks to a cluster of firms (Acharya et al., 2018).<sup>31</sup> We form clusters based on county and industry because firms in a particular industry in a particular

<sup>31</sup>We observe loan level credit to firms at a biannual frequency.

county share many characteristics and are thus likely affected in a similar way by macroeconomic developments that might influence credit demand.

Note that because we do not have a unique firm identifier across loans, we are unable to analyze credit extended to the *same* firm by different banks (Khwaja and Mian, 2008). To determine the quality of a firm that receives a loan, we use the ratings obtained by the Central Bank of Ireland that employs a rating scale from 1 (best) to 5 (worst).<sup>32</sup> We divide firms into three quality buckets: high quality (rating 1-2), medium quality (rating 3-4), and low quality/high risk (rating 5).

The dependent variable is either the change in log (stock of) credit granted ( $\Delta VOLUME$ ) or the change in the interest rate charged ( $\Delta RATE$ ). Similar to the previous section, we are interested in the coefficient of the interaction term between the *Post* dummy and the bank exposure to the policy. We include industry-county-quality-time fixed effects to control for credit demand of firms and other variables that are shared by firms of similar quality operating in the same county and industry. We also include bank-county fixed effects to capture time-invariant bank-county heterogeneity (e.g., time-constant heterogeneity in the geographical preference of banks).

We show estimation results in Table 9. In Panels A and B, the dependent variable is the change in volume of credit and change in interest rate charged, respectively. Column (1) considers the full sample. The estimates document that more-exposed banks increase their lending volume to firms and decrease the price of corporate loans more than less-exposed banks. In a next step, we

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<sup>32</sup>These ratings come from the banks' internal models but are homogenized by the Central Bank of Ireland to ensure the rating classes correspond to similar probabilities of default.

PANEL A

| LHS: $\Delta VOLUME$                  | Sample  |         |           |         |
|---------------------------------------|---------|---------|-----------|---------|
|                                       | Total   | Risky   | Non-Risky | Total   |
| Exposure $\times$ Post                | 1.382   | 2.761   | 0.740     | 0.697   |
|                                       | (0.401) | (0.659) | (0.435)   | (0.449) |
| Exposure $\times$ Post $\times$ Risky |         |         |           | 2.253   |
|                                       |         |         |           | (0.547) |
| Exposure $\times$ Risky               |         |         |           | -0.182  |
|                                       |         |         |           | (0.307) |
| Time-Varying Bank Controls            | ✓       | ✓       | ✓         | ✓       |
| Industry-County-Quality-Time FE       | ✓       | ✓       | ✓         | ✓       |
| Bank-County FE                        | ✓       | ✓       | ✓         | ✓       |
| Observations                          | 10,092  | 3,227   | 6,865     | 10,092  |
| R-squared                             | 0.525   | 0.569   | 0.493     | 0.527   |

PANEL B

| LHS: $\Delta RATE$                    | Sample  |         |           |         |
|---------------------------------------|---------|---------|-----------|---------|
|                                       | Total   | Risky   | Non-Risky | Total   |
| Exposure $\times$ Post                | -0.719  | -1.677  | -0.234    | -0.187  |
|                                       | (0.195) | (0.557) | (0.268)   | (0.262) |
| Exposure $\times$ Post $\times$ Risky |         |         |           | -1.753  |
|                                       |         |         |           | (0.674) |
| Exposure $\times$ Risky               |         |         |           | 0.058   |
|                                       |         |         |           | (0.367) |
| Time-Varying Bank Controls            | ✓       | ✓       | ✓         | ✓       |
| Industry-County-Quality-Time FE       | ✓       | ✓       | ✓         | ✓       |
| Bank-County FE                        | ✓       | ✓       | ✓         | ✓       |
| Observations                          | 10,007  | 3,183   | 6,823     | 10,007  |
| R-squared                             | 0.478   | 0.508   | 0.463     | 0.479   |

**Table 9: Bank Portfolio Reallocation, Credit to Firms.** This table shows the estimation results of specification (9). The unit of observation is bank-industry-county-quality-time. The sample runs at a bi-annual frequency from 2013H1 to 2016H1. *Exposure* is defined in (4) and *Post* is a dummy equal to 1 from 2015H1 to 2016H1. A risky loan has a rating equal to 5. The dependent variables are the change in log (stock of) credit granted in Panel A and the (value weighted) change in the interest rate charged in Panel B. Standard errors clustered at the bank-county level in parentheses. Source: Central Bank of Ireland.

split our sample firms into risky (rating 5) and non-risky (rating 1-4) firms and re-run our specification (9) separately for these two groups of borrowers. The estimation results in columns (2) and (3) show that although a credit expansion in the corporate sector occurs for both risky and non-risky firms, the effect is economically and statistically more pronounced for risky firms relative to the pre-period. A one standard deviation higher *Exposure* leads to a 10 percentage points higher credit supply to firms and a 20 percentage points higher credit supply to risky firms. These results are confirmed in the last column of Panel A, where we employ a triple interaction of our bank exposure variable with a *Post* dummy and a dummy for whether the borrowing firms are risky. The coefficient shows the increase in loan volume is mostly driven by an increase toward risky firms. Similarly, in Panel B, we find the decrease in the cost of bank loans is mostly benefiting risky firms.

## 6 Conclusion

We provide a comprehensive micro-level analysis of the transmission of macro-prudential policies aimed at limiting household leverage in the residential mortgage market and, in turn, reducing the feedback loop between credit and house prices. Combining loan level data on residential mortgages, county level house prices, and detailed data on banks' other assets, we examine the February 2015 introduction of LTV and LTI limits in Ireland.

The policy caused a substantial reallocation of credit. In particular, we document a reallocation of mortgage credit from low- to high-income households and from low- (urban) to high-distance (rural) counties. This reallocation is consistent with the evolution of house price growth, which stopped increasing at the time of the rumors about the policy, driven by a collapse in low-distance

counties. We find this reallocation is consistent with a bank portfolio choice channel. Consistent with the goal of keeping their risk exposure unchanged, banks increased their risk exposure in credit to firms and holdings of securities, the two largest asset classes not targeted by the regulation.

Our analysis of the transmission of macroprudential regulation opens up a promising area for future research. In particular, our results on bank asset allocation naturally call for the development of equilibrium models to measure how macroprudential regulation affects welfare and the likelihood of busts. Having documented, in a partial equilibrium framework, how limits to household leverage affect bank portfolio choice and house prices, we provide a set of correlations and suggested transmission mechanisms that these equilibrium models should take into account.

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# For Online Publication<sup>1</sup>

## A.1 Data Sources

The data on bank lending, including loan and borrower characteristics, is obtained from the Central Bank of Ireland. In particular, the data on mortgages is obtained from the Loan Level Data from the Central Bank of Ireland (Financial Stability Division) up to to January 2015 and from the Monitoring Templates from the Central Bank of Ireland (Financial Stability Division) from January 2015 to June 2016. The data on commercial lending is obtained from the Central Bank of Ireland (Financial Stability Division). Bank quarterly security holdings are from the Central Bank of Ireland (Statistics Division). Monthly bank balance sheet variables are from the Individual Balance Sheet Items ECB survey. The county level house prices are from [www.daft.ie/report](http://www.daft.ie/report). The regional house prices are from Central Statistics Office of Ireland.

The loan level characteristics are (i) date of origination, (ii) amount outstanding (current and at origination) (iii) interest rate and interest type (current and at origination), and (iv) data on collateral (location, type, purpose, and value; all at origination). The borrower level characteristics (measured at origination of the loan) include (i) the type of borrower (FTB, SSB, BTL), (ii) age, marital status, occupation, and (iii) total household income.<sup>2</sup>

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<sup>1</sup>Date: May 2019. Not for publication. The views expressed in this paper are solely the responsibility of the authors and should not be interpreted as reflecting the views of the Reserve Bank of India or the Central Bank of Ireland. All results have been reviewed to ensure that no confidential information is disclosed. All errors are our own.

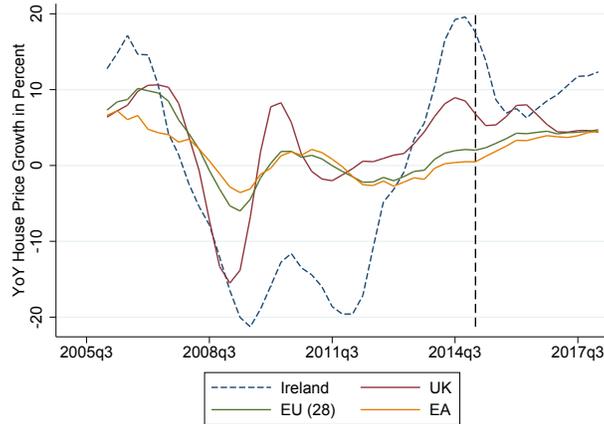
<sup>2</sup>For one of our banks, this income is missing from 2010 to 2014. As we expect heterogeneity in the bank-borrower match across banks, we do not assume that income will be the same for similar borrowers across banks. In particular, we use the period where we have the income data to construct a scalar that measures how income of costumers of this specific bank behaves differently from all other borrowers. For the period we do not have income data for this specific bank, we then take the average income of a similar borrower in terms of loan- and borrower characteristics and multiply it with the scalar.

## A.2 Distance from the Lending Limits

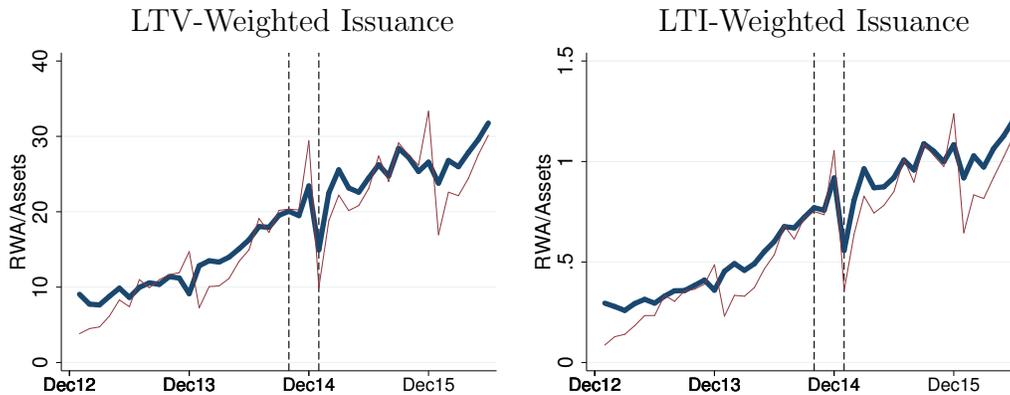
To calculate the distance of a typical borrower (in a county or in a county-income bucket) from the lending limits we proceed in several steps:

1. For each mortgage in our sample during the 12 months before the first rumors about the regulation (Oct13 - Sep14) we calculate the distance of the mortgage from both the LTV and the LTI limit that applies to this mortgage.
2. If the mortgage was exceeding the limit (i.e., would have violated the the lending limits, had they already been in place), we set the distance equal to zero.
3. This leads to an average distance in our sample of 14.69 for the LTV limit and 0.94 for the LTI limit. In order to compute the average distance across both limits for each mortgage, we have to rescale the distances.
4. We rescale both the distance from the LTV and the distance from the LTI limit to have a mean of zero and a standard deviation of one. The average distance (across both limits) of a particular mortgage is then calculated as the average of the rescaled LTV distance and the rescaled LTI distance for any given mortgage.
5. In a last step we calculate the mean of the mortgage level average distance at the level of interest, namely county level ( $Distance_c$ ) or county-income bucket level ( $Distance_{ch}$ ), measured from October 2013 to September 2014.

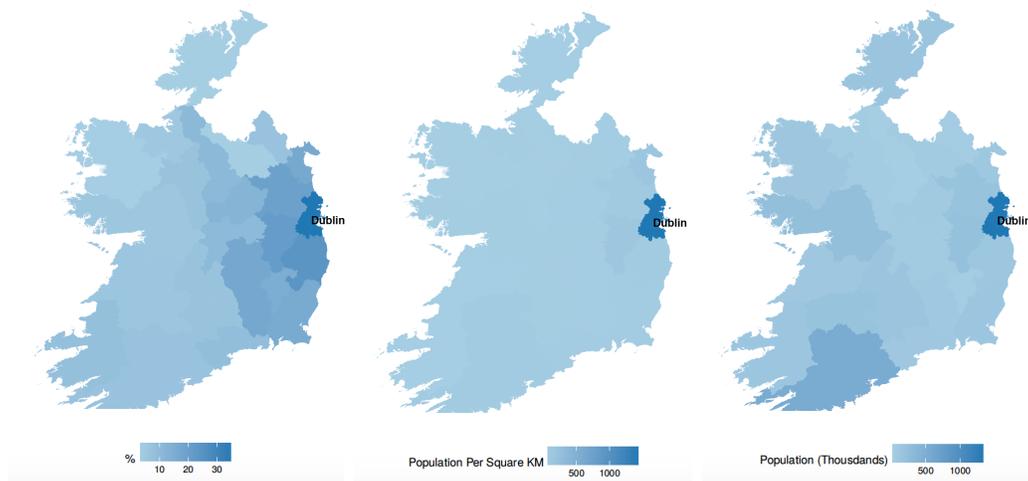
### A.3 Additional Figures



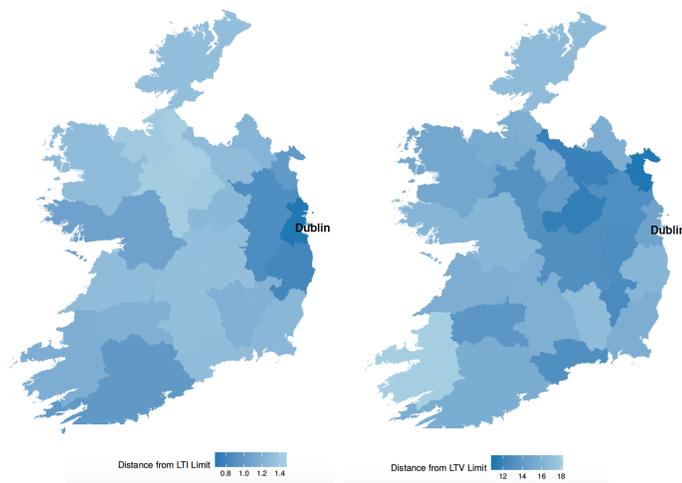
**Figure A.1: House Price Growth Outside Ireland.** This figure shows house price growth (YoY) for Ireland, the U.K., the Euro Area, and the European Union (28). The vertical dashed line indicates the introduction of the lending limits. Source: Eurostat.



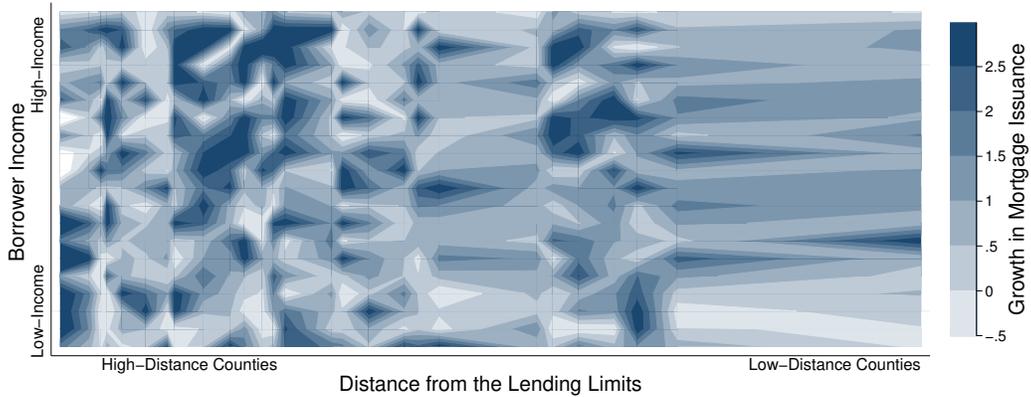
**Figure A.2: Aggregate Residential Mortgage Issuance.** This figure shows the evolution of residential mortgage issuance of our sample banks weighted by LTV and LTI from January 2013 to June 2016. The left panel shows LTV-weighted monthly mortgage issuance divided by total assets (percentage). The right panel shows LTI-weighted monthly mortgage issuance divided by total assets (units). Thick lines are seasonally adjusted and thin lines are not seasonally adjusted. The vertical dashed lines indicate the first rumors about the limits and their implementation. Source: Central Bank of Ireland.



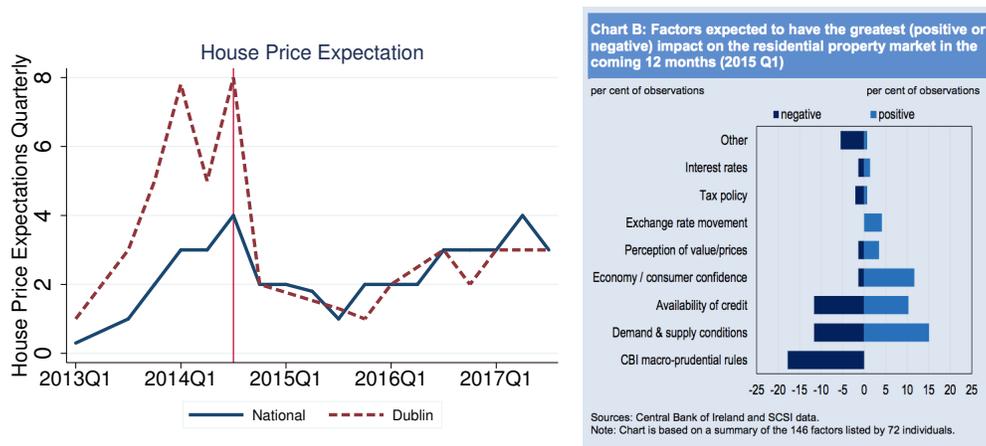
**Figure A.3: Demographics and House Price Appreciation Across Counties.** The left panel of this figure shows county level increase in house prices from their lowest point after the bust to September 2014. Darker colors indicate a larger increase in house prices. The center panel shows county level density. Darker colors indicate more densely populated counties. The right panel shows county level population (thousands). Darker colors indicate more populated areas. Source: Central Bank of Ireland, Daft.ie



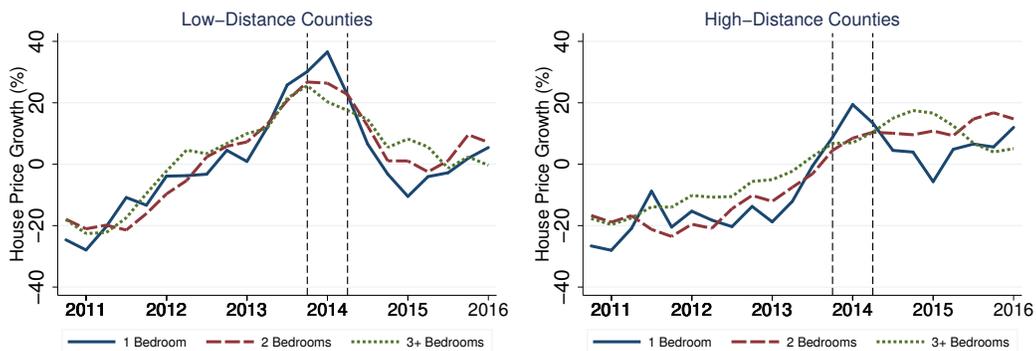
**Figure A.4: Counties and LTI Lending Limits, Counties and LTV Lending Limits.** The figure on the left shows county level distance from the LTI lending limits. This figure on the right shows county level distance from the LTV lending limits. Darker colors indicate counties that are less distant. Source: Central Bank of Ireland.



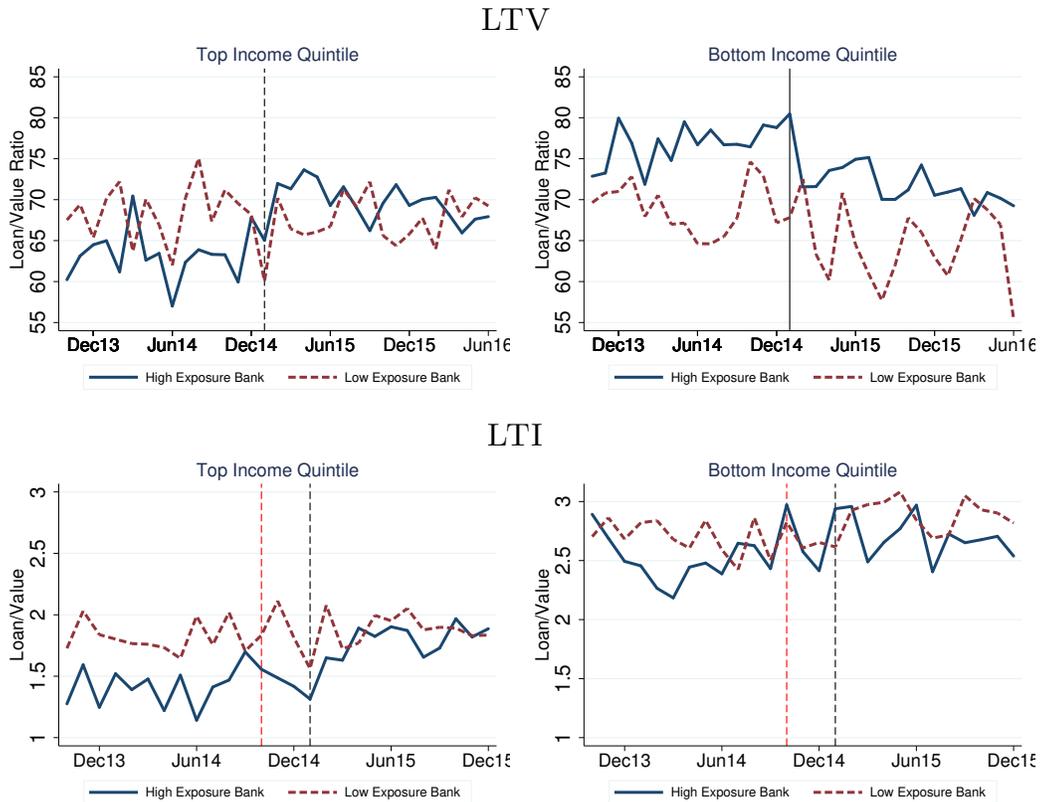
**Figure A.5: Reallocation of Mortgage Credit, Placebo.** This figure shows the growth of mortgage credit across counties and the across the income distribution of borrowers before the policy implementation. The x-axis shows counties ranked according to their distance from the lending limits. The y-axis shows borrowers ranked according to their position in the income distribution (20 ventiles). Each point in the map indicates the change of mortgage issuance in the post-period (February 2014 to January 2015) compared with the pre-period (February 2013 to January 2014). Darker colors indicate higher growth of mortgage issuance, as indicated by the legend on the right.



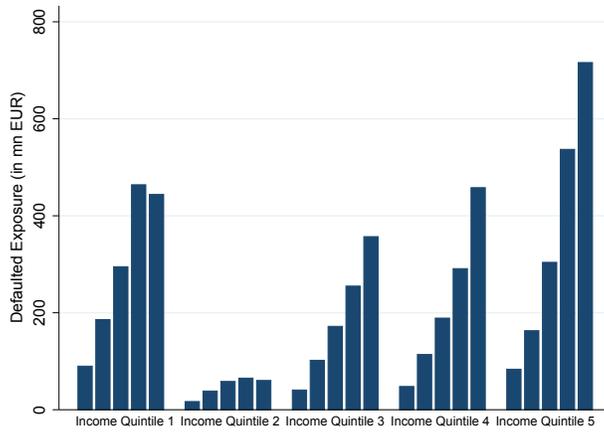
**Figure A.6: House Price Expectations.** This figure shows survey evidence suggesting that the first rumors about the limits caused households to revise their expectations about house prices downward, especially in low-distance counties. The left panel shows the evolution of house price expectations in Dublin (dashed line) and at the national level (solid line) at a quarterly frequency. The right panel shows a breakdown of factors affecting expectations in 2015Q1. Source: Central Bank of Ireland.



**Figure A.7: House Price Changes and Property Type.** These figures shows the evolution of yearly house price growth for 1-bedroom properties (solid line), 2-bedroom properties (dashed line), and 3-bedroom or larger properties (dotted line). The top (bottom) panel shows data for low-distance (high-distance) counties. The vertical dashed lines indicate the first rumors and the implementation date of the lending limits. The sample period runs from January 2011 to June 2017. Source: Central Bank of Ireland, Daft.ie.



**Figure A.8: LTV and LTI, High and Low Exposure Banks, Top Vs. Bottom Income Quintile.** This figure shows the evolution of LTV (top panel) and LTI (bottom panel) of mortgage issuance by high-exposure (solid line) and low-exposure (dashed line) banks from October 2013 to June 2016. Blue lines corresponds to high exposure banks (exposure above median). Red lines corresponds to low exposure banks (exposure below median). Income quintiles are obtained from the January 2014 income distribution and adjusted monthly for Irish wage inflation. Source: Central Bank of Ireland.



**Figure A.9: Defaulted Exposure accumulated during the run-up to the Financial Crisis.** This figure shows the defaulted exposure of Irish banks from 2000 to 2012. The bars represent the loss of the individual LTV Quintiles which are shown in an ascending order from left to right within each income quintile. It is calculated by multiplying the default intensity for a bucket with the total original exposure of the bank in that bucket. We create 25 buckets based on income and LTV quintiles where the former is scaled according wage growth figures. Source: Central Bank of Ireland.

## A.4 Additional Tables

|                  | <i>Income Quintiles</i> |                      |                      |                      |                     |
|------------------|-------------------------|----------------------|----------------------|----------------------|---------------------|
|                  | Q1                      | Q2                   | Q3                   | Q4                   | Q5                  |
| LHS: House Price |                         |                      |                      |                      |                     |
| <i>HP1BR</i>     | 0.632<br>(0.399)        | 0.779**<br>(0.394)   | 1.131**<br>(0.439)   | 0.0431<br>(0.657)    | -0.796<br>(1.030)   |
| <i>HP2BR</i>     | -1.315***<br>(0.391)    | -1.568***<br>(0.379) | -2.492***<br>(0.449) | -2.280***<br>(0.736) | -2.441*<br>(1.266)  |
| <i>HP3BR+</i>    | 0.593***<br>(0.156)     | 0.717***<br>(0.154)  | 1.070***<br>(0.184)  | 1.496***<br>(0.299)  | 2.314***<br>(0.519) |
| Observations     | 1,862                   | 2,356                | 2,752                | 2,339                | 3,323               |
| R-squared        | 0.155                   | 0.206                | 0.183                | 0.178                | 0.189               |

**Table A.1: House Prices, Number of Bedrooms, Borrower Income.** This table shows the estimation results for the following specification:  $CollateralPrice_{lct} = \alpha + \beta_1 1BRHP_{ct} + \beta_2 2BRHP_{ct} + \beta_3 3BR^+HP_{ct} + \epsilon_{lct}$ . The unit of observation is loan  $l$ , county  $c$ , and quarter  $t$ . The dependent variable is the price of the residential property used as collateral (from the credit registry data). The independent variables are the house prices (from the county level house price data) for one-bedroom properties, two-bedroom properties, and three-or-more-bedroom properties. The specification is estimated separately in each quintile of the borrower distribution. Source: Central Bank of Ireland, Daft.ie.