



The Irish Property Review

A quarterly analysis of trends in the Irish property market

Affordability improves but lending flat

- Prices still falling; 10% decline forecast in 2009
- Lower rates and prices boosting affordability
- No sign yet of cyclical bottom

The Irish housing market peaked in price terms in the first half of 2007 and the past two years have seen persistent price falls, amounting to 20% on the main published indices, which is very similar to that recorded in the UK but substantially less than the US. Some builders and developers have cut the price of new homes in Ireland more aggressively than these figures imply (market participants put the cumulative price fall at 25% – 35%) in an effort to shift stock, and prices are now back at mid-2004 levels even on the permanent tsb/ESRI index. This implied improvement in affordability is also evident in our own model, with the average new mortgage for house purchase in 2009 set to fall to €240,000 from €270,000 last year. Average incomes are likely to fall too in 2009 but we still expect the average new mortgage this year to cost 32% of income to service, down from an historic high of over 44% last year. There is no evidence yet in the aggregate data that this improvement in affordability is impacting the market in a material way. Net mortgage lending has been broadly flat since the turn of the year, with gross advances substantially down in the first quarter relative to last year. Even with a modest recovery in the second half of 2009, it is difficult to see net mortgage lending growing anything other than marginally this year.

The fall in house prices continues to prompt a substantial supply response, with the consensus view now seeing only 20,000 completions in 2009 and 15,000 next year from 51,700 in 2008 and 78,000 a year earlier. We expect a 25,000 total this year but if the consensus materialises it implies only around 11,000 new apartments and houses for general sale to the market as over 40% of completions year to date are single homes, presumably largely built to order. The ESRI project annual housing demand of 43,000 a year from 2007 to 2011, so these supply figures suggest that an increasing share of demand will be met from the current excess supply.

The extent of that excess is difficult to quantify given the lack of timely data on transactions but the fact that rents are also still falling implies a substantial supply overhang. The past few months has also seen an acceleration in the pace of house price decline on the permanent tsb/ESRI index. This lags actual transactions, however, and so may be reflective of the gloom that enveloped the Irish (and global) economy over the winter months. Sentiment regarding the global outlook has certainly improved in the past few months and there is some evidence that the UK housing market may be bottoming out. The Irish economic data at the moment implies that the pace of contraction has slowed rather than any imminent recovery. The Irish labour market has therefore continued to deteriorate, albeit with the claimant count rising at a slower pace of late, and the fear of unemployment may well be a more potent factor in the housing market than affordability at the moment. On that basis we expect house prices to fall further, and by 10% in 2009.

Finally, the Irish commercial property market has seen a very sharp fall in capital values, albeit against a backdrop of limited transactions. Yields have now risen to 7.4%, which is high relative to bond yields and the cost of 5-year loans, although the uncertain economic backdrop and expectations of further capital erosion is likely to prevent any near-term recovery.

Dr. Dan McLaughlin

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10% fall forecast in 2009

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25,000 this year

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A substantial improvement in train

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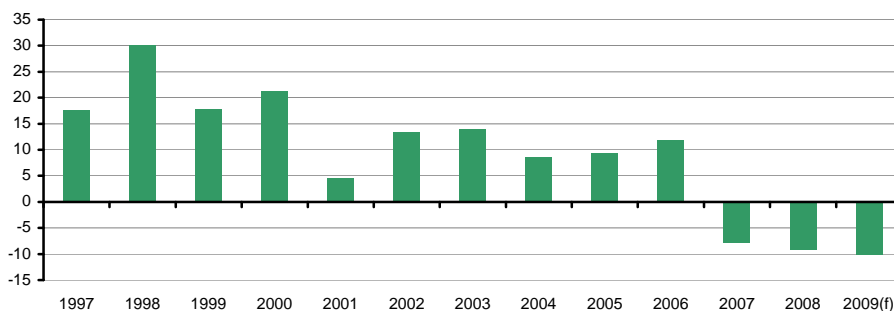
House Prices

Price indices differ in construction...

Measuring residential property prices is not a straightforward exercise, given the heterogeneous nature of the housing market, and a variety of approaches are possible. In Ireland's case the two most widely-quoted sources utilise mortgage data, with a third, a relatively recent addition, using advertised asking prices.

The most comprehensive price data is published by the Department of the Environment (DoE), collated from the mortgage approvals of mortgage lenders on a quarterly basis. The DoE then simply quotes average house prices (existing and new) for a given quarter, both nationally and for the larger cities, which is not adjusted for either seasonal factors or any change in the mix of houses. Prices peaked on the DoE figures in the second quarter of 2007, and fell over the six consecutive quarters to end-2008 by a cumulative 16.5%, with no figures yet available for the first quarter of 2009. The absence of timely data from the DoE means that market attention tends to focus on the permanent tsb/ESRI house price index, which is published monthly. This is based on agreed sale prices as funded by that lender and a sale is included in the index when the mortgage is drawn down, so the index lags transactions by perhaps three months or more. The index also statistically adjusts the raw data to take account of individual house differences but in the main generally tracks the DoE trend reasonably closely. For example, this index too, shows a market peak in the first half of 2007, albeit in Q1, with a cumulative fall to the end of 2008 of 16%, almost identical to that quoted by the DoE.

House Price Inflation (%) (end-year)

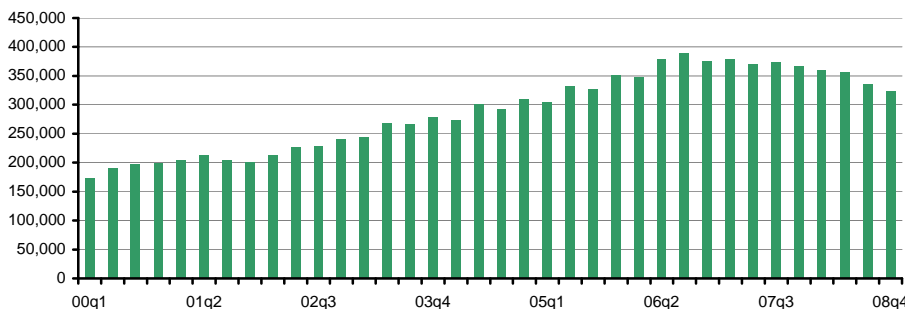


permanent tsb / ESRI

...but all show a similar fall...

The permanent tsb/ESRI house price index is generally thought to under-represent the higher end of the housing market and this is reflected in the average cash price quoted in the index, which stood at €264,000 in the final quarter of 2008, against €323,000 by the DoE.

National House Prices (Euro)



DoE

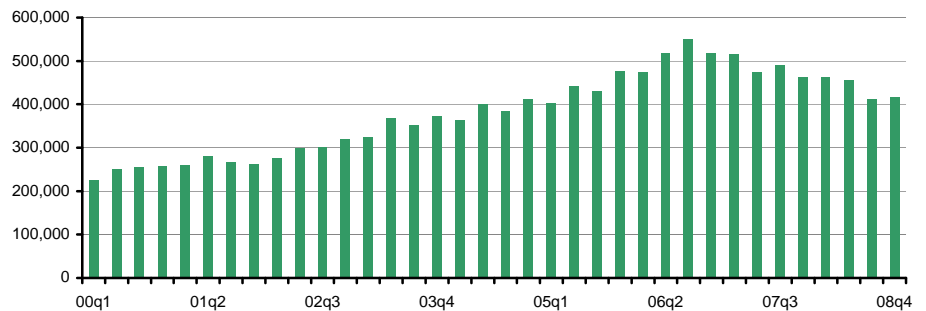
A third national house price index is that quoted by Daft.ie, based on asking prices as quoted on the company's website, again statistically adjusted for the housing mix. This

has a shorter history (to 2005) but also shows the market peaking in the first half of 2007, and a cumulative price fall from peak to the end of 2008 of 16%, so matching the other two indices.

...the pace of decline has accelerated of late...

Asking prices fell by more than 4% in the first quarter of 2009, according to the Daft.ie index, bringing the cumulative decline from the peak to 20%, and again this is similar to the permanent tsb/ESRI index, which recorded a cumulative fall of 20% to April and 21% to May, the latest month available. Curiously, house prices in the UK have also fallen by 20% from the peak (according to the Nationwide index) although that index appears to have bottomed, which is not the case in Ireland. Indeed, the permanent tsb/ESRI index has shown an accelerated rate of decline in recent months, with a fall of 6.2% in the first five months of 2009, against a decline of 9.1% for 2008 as a whole.

Dublin House Prices (Euro)



DoE

...although affordability is improving...

The index may be reflecting the gloom that affected the Irish (and global) economy over the winter months, but it is clear that there is a substantial overhang of supply in the market. The rental market also bears testimony to the scale of excess supply, with rents in the private sector falling 20% in the twelve months to May. This has prompted some builders and developers to cut the price of new homes far more aggressively than captured in the main price indices in order to shift stock and many market participants believe that current prices have fallen by 25% - 35% from the peak. The price of an Irish house is now back to levels last seen in the summer of 2004, even on the permanent tsb/ESRI index, implying a substantial improvement in affordability. This is also captured in our own affordability model, which shows that a combination of historic low interest rates and a fall in the average new mortgage has taken affordability back towards its long run average, and also to its best level since 2004.

Second-hand Irish House Prices (Nationally)

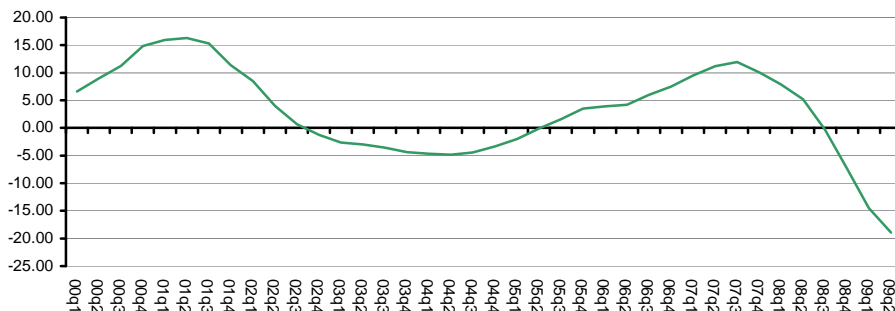
	€ 0	% change	year-over year (%)
1999	163.3	21.4	
2000	190.6	16.7	
2001	206.1	8.2	
2002	227.8	10.5	
2003	264.9	16.3	
2004	294.7	11.2	
2005	330.4	12.1	
2006	371.5	12.4	
2007	377.9	1.7	
2008 q1	359.3	-2.1	-5.4
2008 q2	356.6	-0.7	-7.8
2008 q3	335.8	-5.9	-10.3
2008 q4	323.4	-3.7	-11.9

DoE estimates

...prices may fall another 10% this year.

Potential buyers have other concerns, however, particularly the state of the Irish labour market, which saw the claimant count rise by 30,000 a month in early 2009. This pace has thankfully slowed in recent months (to 13,000 in May) but the unemployment rate is still climbing, and is currently at 11.8%. Sentiment regarding the global economic outlook has also improved in the past few months, but even if this translates into more buyer interest in Ireland it will probably be the autumn before this becomes apparent in the permanent tsb/ESRI index. Consequently, we expect the pace of price declines to slow although the index is still likely to show a 10% fall for 2009 as a whole.

Private Sector Rent (% change)



Central Statistics Office (CSO)

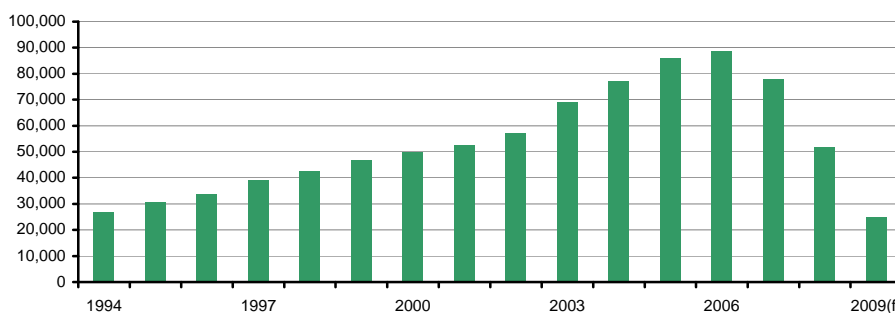
House Completions

25,000 forecast for 2009...

House building in Ireland, as measured by completions, peaked in the final quarter of 2006, and the pace of decline subsequently gathered pace, notably through 2008. The annual completions figure for last year was 51,724 according to the Department of the Environment (DoE), which represents a 34% decline on 2007. The total still added to the housing stock, of course, but by 2.8%, the smallest percentage increase since 1995.

The outturn was stronger than the consensus view and marginally above our own forecast (50,000) perhaps reflecting an undue reliance by forecasters on Bond Registrations as a proxy for housing starts. These may well understate the completion figure for housing schemes and apartments anyway but they do not capture individual house completions. The latter category was always important in Ireland but has risen sharply as a proportion of total completions in the past few years, to one-third of the total in 2008 from a quarter in 2007. Moreover, data for the first quarter shows individual housing accounts for 42% of the 7,611 houses completed.

House Completions (Units)

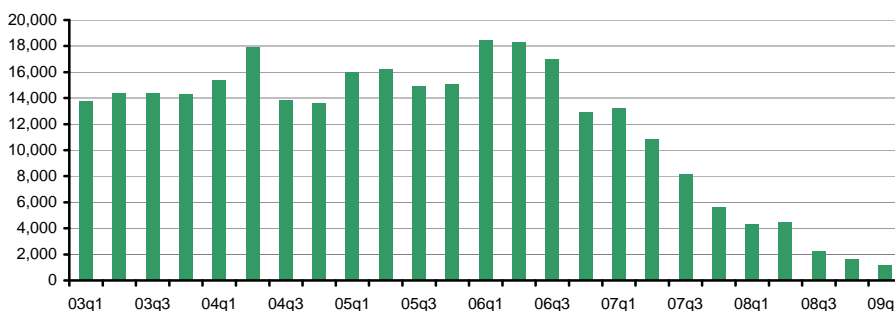


DoE

...but over 40% are built to order.

The first quarter outturn implies that the current consensus figure of 20,000 completions for 2009 may be too low and we feel a total of 25,000 is more likely. That would still be consistent with under 14,000 new houses and apartments supplied by builders and developers with individual house completions accounting for the balance. The former is more in line with the Bond Registration data which showed a 71% fall in Registrations in the year to the fourth quarter of 2008, to 1,617, and a further decline in the first quarter to just 1,166. Commencement notices (recorded by Local Authorities) have also continued to slow, declining to 2,461 in the first quarter of 2009 from 7,713 a year earlier. The number of planning permissions has also declined, albeit less precipitously, to over 67,000 in 2008 from 84,000 a year earlier, although the five-year window on permissions makes it much less useful as a short-term predictor of supply.

New House Guarantee (Units)



DoE

The combination of falling house prices and falling rents implies that there is still excess housing supply in the market, although the absence of formal data on transactions makes it impossible to be precise about the supply overhang. One simple approach is to use the ESRI estimates for housing demand, which is largely based on demographic trends. The Institute puts demand at an average 43,000 per annum over the period 2007-2011 which if true implies that the consensus supply of 20,000 this year and only 15,000 next is substantially below requirements, thus helping to reduce the existing excess supply of available property.

Irish Housing Supply

	Housing Completions	New Home Registrations
1996	33,700	23,769
1997	38,842	27,080
1998	42,349	29,067
1999	46,512	33,852
2000	49,812	34,613
2001	52,602	28,845
2002	57,695	51,157
2003	68,819	56,859
2004	76,954	60,782
2005	86,000	62,284
2006	88,400	66,650
2007	78,000	38,352
2008	51,700	12,676

DoE

Mortgage Lending

Gross lending has slowed precipitously...

The Irish Central Bank, acting on behalf of the ECB, conducts a quarterly survey of Irish banks in terms of loan demand and credit standards. The data shows that banks tightened credit standards on residential mortgages from late 2007 and particularly in the first half of 2008, but that demand has eased substantially over that period. Not surprisingly, gross mortgage lending has slowed very sharply, both for house purchases and other purposes. The number of new mortgages for house purchase fell to under 54,000 in 2008, for example, from over 84,000 in 2007 and a cycle high of around 111,000 in 2006. The first quarter of 2009 has seen this trend intensify, with only 5,508 new mortgage loans for house purchase, a 59% decline on the previous year. The sums lent have fallen at a faster pace, given the decline in house prices and hence in the average mortgage, to less than €1.4bn in the first quarter, from an annual total of €14.5bn in 2008 and €27.8bn in 2006.

Loans to first-time buyers fell by an annual 52% in the first quarter of 2009 but this held up much better than buy-to-let, which fell by 77% and mortgages taken out by borrowers seeking to move house, down by 60%, the latter percentage decline was also replicated in the top-up market, with the re-mortgage market down by 82%. The result left overall gross mortgage lending in Q1 at just less than €2bn, against €23bn for 2008 as a whole and a peak of some €40bn in 2006.

Mortgage Lending for House Purchase

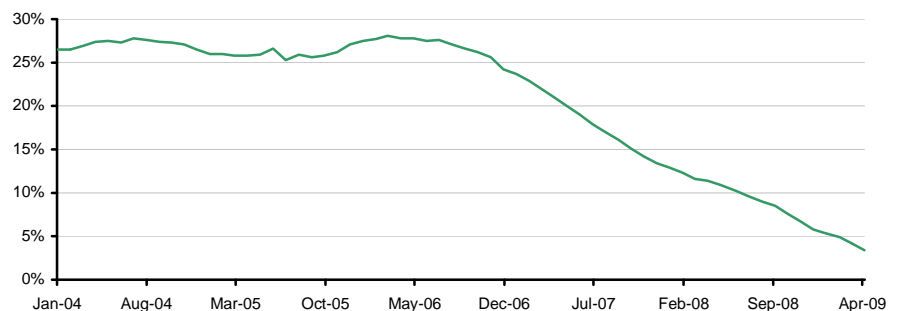
	No. of Mortgages	Average Value (€000)	Total Market (€bn)
2003	97,817	159	15.6
2004	108,225	186	20.1
2005	110,495	220	24.4
2006	110,790	251	27.8
2007	84,195	267	22.5
2008	53,616	271	14.5
2009(f)	28,000	241	6.7

IBF

...and net lending may be flat at best in 2009.

The substantial improvement in affordability seen in 2009 may well boost demand eventually, but it seems inevitable that total gross lending will fall precipitously this year, and we forecast a total of €10.4bn, including €6.7bn for house purchase, the latter the lowest since 1999.

Mortgage Lending (%)



Central Bank

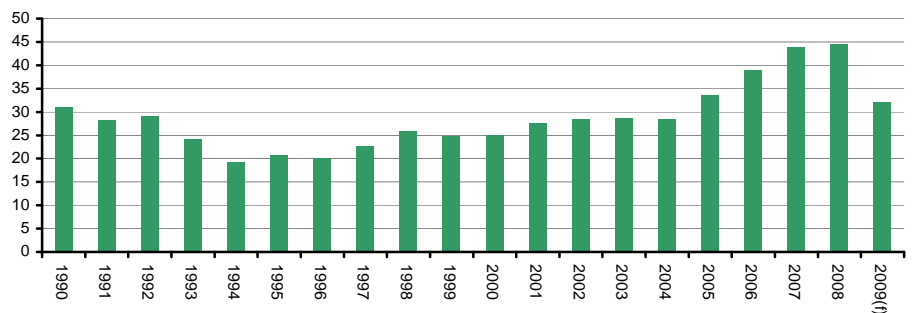
Mortgage redemptions have also slowed, but in recent months gross lending has been broadly offset by redemptions, leaving net mortgage lending largely flat. The outstanding mortgage stock has therefore been unchanged at €148bn since the turn of the year, although it is still marginally up (3.4%) on the figure twelve months earlier. Our gross lending forecast implies little or no growth in net mortgage debt over the course of the year, leaving the annual growth rate at end-2009 at 1%.

Affordability

Affordability depends on income, interest rates and the average loan...

The concept of affordability, the cost of servicing a mortgage relative to income, is intuitively appealing as a guide to likely trends in the housing market. In practice though, data limitations often mean that any affordability index has its flaws. Our own model uses gross income (and gross mortgage payments) which means it may underestimate any improvement in affordability if accompanied by a fall in personal tax rates, as over the last decade in Ireland. Similarly, though, it may overstate any improvement in 2009, given that personal tax rates have risen. Moreover, it does not capture other fiscal incentives to specific borrowers, such as the abolition of stamp duty for first-time buyers. Nonetheless, the index has some explanatory power in that it encompasses data back to the mid-1970's and captures broad trends in affordability since then. The average new mortgage cost 39% of income to service in the early 1980's, for example, reflecting mortgage rates of over 14%, but only 20% in the mid-1990's, as interest rates fell sharply and incomes rose.

Affordability (%)



Economic Research Unit (ERU)

...and is set to improve substantially this year.

On average, a new mortgage absorbed 29% of income from 1975 to 2008, and it was only by 2005 that the improvement in affordability seen in the 1990's had deteriorated to the long run average. The next few years saw a much sharper deterioration, however, reflecting a combination of much higher mortgage levels and rising interest rates. This culminated in a reading of 44.4% in 2008, driven by an average new mortgage for house purchases of €270,000 and an average mortgage rate over the year in excess of 5%.

Affordability

	Mortgage Cost (% of average earnings)
1995	21
1996	20.2
1997	23.1
1998	26.2
1999	24.7
2000	24.9
2001	27.4
2002	28.5
2003	28.7
2004	28.4
2005	33.5
2006	38.8
2007	43.9
2008	44.4
2009(e)	32.1

Economic Research Unit (ERU)

The size of the average new mortgage fell as 2008 progressed; however, reflecting the fall in house prices, and by the fourth quarter was under €250,000. The first quarter to 2009 saw a marginal rise but it is likely now that the average new mortgage this year will

be substantially lower than last, at perhaps around €240,000. Similarly, mortgage rates have fallen precipitously in the wake of ECB monetary easing, adding a further boost to affordability. Against this, the average income may well fall in nominal terms in 2009 (we have pencilled in a 1% decline in wages) but this still translates into a substantial fall in the cost of servicing a new mortgage, to 32% of income from 44.4% in 2008.

This improvement in affordability may ultimately translate into an increase in mortgage demand although in the shorter term uncertainty about the economic outlook, fear of unemployment and the prospect of further personal tax increases may well provide an offset.

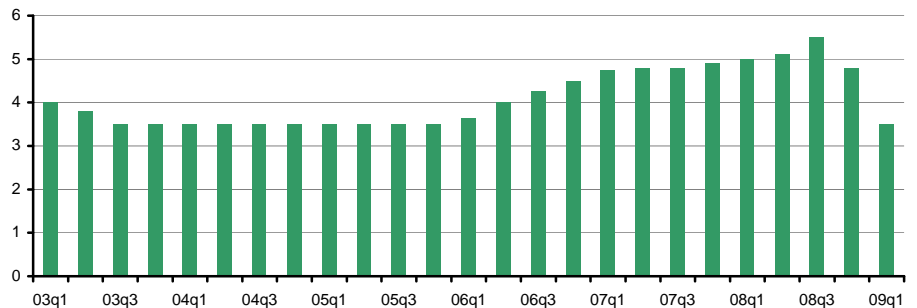
Interest Rates

We may be at cycle low...

The ECB's quarter point cut in official rates in May brought the repo rate to a new cycle low of 1%. This is also an historic low for euro (and Irish) rates and compares with a cycle high of 4.25% as recently as last October. Existing mortgage holders on a floating rate loan have therefore seen a massive reduction in their borrowing costs: a household with a €250,000 twenty-five year mortgage, for example, on an average tracker rate, has seen gross payments fall from €1,535 a month to €1,090, a saving of over €5,300 a year. For new borrowers the cost of servicing a mortgage has also fallen sharply as wholesale money market rates (the cost of funds for a bank) have also declined, with 3-month cash now around 1.1% from over 5% last September, at the height of the credit crunch.

Interest rates tend to follow the economic cycle and the ECB has cut rates aggressively, if belatedly, in the face of the worst European recession in post-war history. This plunge in euro area output and the resulting rise in unemployment have put downward pressure on prices, and the ECB believes that inflation will remain below its 2% target for some time, thus allowing it to cut rates to such unprecedented levels.

Mortgage Rate (%)



Central Bank of Ireland

...and fixed rate offers may rise.

There are some signs that the worst is over, however, both in Europe and in the broader global economy, and we feel that any further rate cuts are unlikely. If so, the next move in the repo rate will be up, although this is unlikely to happen for some time in the absence of a much sharper economic recovery than currently expected.

Longer term interest rates have already started to rise, nonetheless in anticipation of monetary tightening down the road: 3-year rates are now around 2.3% from a low of 2%, and 5-year rates are now just under 3% again, having been below 2.75%.

The market may have reacted too aggressively on the timing of a rate rise by the ECB but in the absence of a reversal of such recent moves, fixed rates on offer to retail borrowers may well rise.

Commercial Property

The market is now re-pricing aggressively...

The Irish commercial property market was much slower to re-price to the new economic and financial environment than the UK, no doubt largely due to the size of retail property funds in the latter economy, prompting a much larger volume of transactions even accounting for the scale of the respective economies. Property returns started to fall in the third quarter of 2007 in the UK, according to the IPD index, or immediately after the onset of the credit crunch, but negative returns in Ireland did not emerge until the second quarter of 2008, and then only -2.8%.

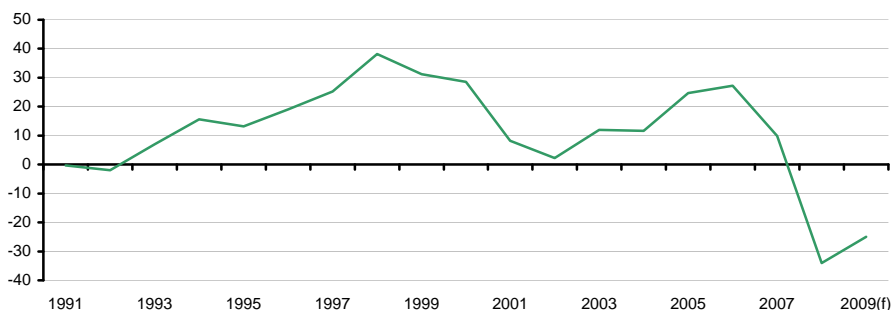
Since then the index has captured a much sharper rise in Irish yields, albeit against limited transactions, with a 13.9% fall in returns in Q3 2008 followed by a 16.5% plunge in Q4 to bring the total return in 2008 to -34%, the first negative figure since 1992. Capital values fell by 37% in 2008, according to the index.

Data for the first quarter of 2009 shows a continuation of the negative trend, albeit at a much slower pace: returns fell by 9.3% in Q1, with capital values down by 10.4%. The retail sector has seen the sharpest fall in returns, having been the best performer over recent years but it marginally outperformed in Q1, with returns falling by 9% against 9.6% in the office sector and 9.3% in industrial space.

...with returns set to fall 25%.

The yield on property has now risen to 7.4% according to IPD, which compares favourably with the risk-free rate return (proxied by 10-year Government bond yields of 5.8%) and the cost of funds (five year swap rates are currently around 3%, albeit up to 2.75%). At some point this is likely to attract investors but confidence is low amid expectations of further capital falls. Despite some signs of stabilisation the Irish economy, too, is set to contract sharply this year, and next, at least according to the consensus. Consequently, we expect returns to continue to decline through 2009, albeit at a diminishing pace, with a 25% fall for the year as a whole.

Commercial Property Returns



SCS/IPD

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