



The Irish Property Review

A quarterly analysis of trends in the Irish property market

Further improvement in affordability, prices still falling

- First-time buyer demand picks up
- Lowest supply increase since 1988

The international downturn in the residential property market appears to be bottoming out in a number of countries, with the most recent data pointing to rising sales and some pick up in prices in the US and a more pronounced price rise in the UK. In the latter the commercial property market also appears to have bottomed, with positive returns recorded in the third quarter. One cannot say the same about Ireland, however, as the published data is still pointing to falling capital values in both the residential and commercial property markets.

The average mortgage rate on new loans has fallen sharply in the past year, to 2.65% from 5.5% and this alongside falling house prices has provided a substantial boost to affordability – the average new mortgage now costs €1,000 a month to service against over €1,600 a month a year ago – and this improvement looks set to continue into 2010. Our own affordability model forecasts that the cost of servicing a new mortgage will return to the long run average of 29% of income next year, following six years when it has been well above that norm. This should help to boost demand for mortgages, and new lending to first-time buyers has risen in the second and third quarters of this year, albeit from very weak levels in Q1. This has more than offset a substantial fall in investor interest in the market, resulting in an increase, albeit marginal, in gross mortgage lending for house purchase in Q3. Net mortgage lending has barely changed since the start of the year, however, with gross lending offset by redemptions, and the growth in net lending in 2009 as a whole is likely to be zero. A glance at the published rates quoted by mortgage lenders suggests that some have drawn back from the market.

Other factors will influence potential home buyers alongside affordability, including expectations about near-term price trends, potential tax changes affecting home ownership and uncertainty about employment and earnings prospects. The economic situation in Ireland certainly looks less bleak than it appeared six months ago and a global recovery appears to be underway, but the short-term economic outlook for Ireland remains far from clear. The published data on house prices also still shows a clear downward trend, albeit with smaller monthly declines in the third quarter than in Q2 and we expect a 15% fall in prices this year.

Rents too are still declining, implying excess supply in the housing market, but new house completions have plummeted to an estimated 27,000 this year, half the previous year's total. This would be the smallest supply total since 1994, and would add just 1.5% to the existing housing stock, the smallest incremental growth since 1988. Moreover, some 45% of supply in 2009 is one-off housing, largely built to demand so the supply for sale to the general market is lower still. The latest figures on proxy housing starts also point to a much smaller supply again in 2010, and we expect a total of some 16,000, which would add just 1.1% to the housing stock. This incremental supply is well below the 40,000 underlying annual demand identified by the ESRI, although actual demand in the short term appears to be well below that figure.

Finally, the Irish commercial property market recorded further falls in the third quarter, pushing yields to around 7% for prime Dublin rental locations and 8% for the office sector. These are high relative to the cost of funds and, as shown in the UK, this configuration eventually prompts a recovery although in Ireland's case expectations about further yield increases will possibly prevent this happening in the near term – we expect a 25% fall in returns in 2009 and a 10% fall next year.

Dr. Dan McLaughlin

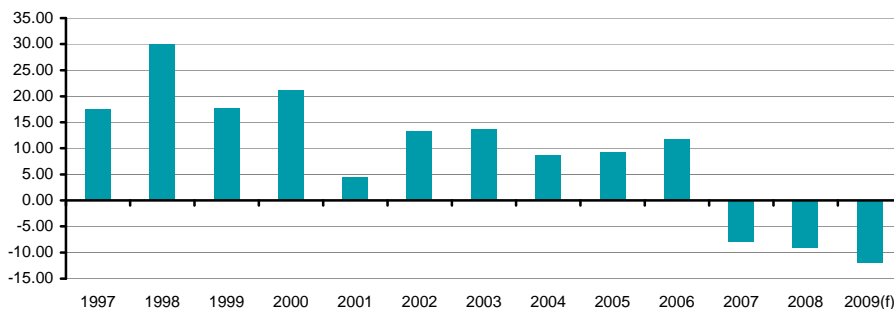
House Prices	Page 2
<hr/>	
15% fall in 2009	
House Completions	Page 4
<hr/>	
27,000 forecast this year	
Mortgage Lending	Page 6
<hr/>	
Demand rises from first-time buyers	
Affordability	Page 7
<hr/>	
Monthly cost of mortgage falls €563	
Interest Rates	Page 9
<hr/>	
ECB no hurry to tighten	
Commercial Property	Page 10
<hr/>	
25% fall in 2009	
Contacts	Page 12
<hr/>	

House Prices

DoE data shows mixed picture...

The most comprehensive source of figures on Irish house prices is supplied by the Department of the Environment (DoE), based on quarterly data from lending agencies. The figures are not adjusted for any change in the housing mix and a pronounced seasonal pattern is also evident, which can throw up surprising quarterly changes. House prices nationally actually rose in Q2, for example, according to the most recent DoE release, by 5.4%, albeit still leaving prices 12.1% down on the year, and 19% down from the peak. Dublin prices continued to fall, however, by 3.3%, and were 19% down on the previous year, with new house prices in the capital particularly weak: new homes in Dublin fell by 11.5% in Q2 following an 11.9% fall in Q1, to leave them 34% down on an annual basis and 40% below the peak level.

House Price Inflation (%) (end-year)

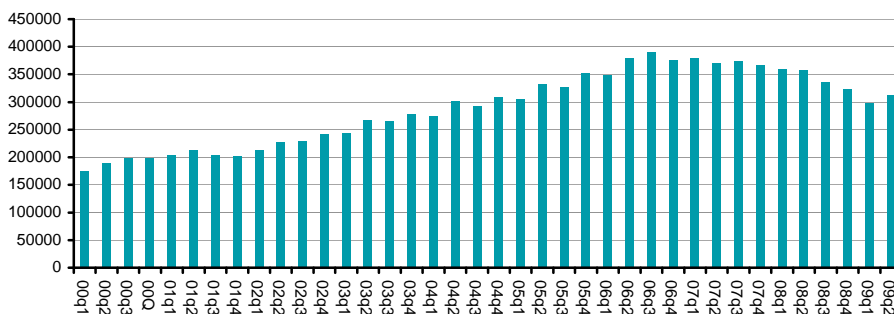


permanent tsb / ESRI

Other sources of price information have shown less of a variation between the capital and elsewhere, and a more substantial fall in the national figure from the peak. Daft.ie, for example, a website which captures asking prices, shows house prices 18.9% down in September on the previous year, and a 28% decline from the peak, defined as February 2007. The permanent tsb / ESRI index, also shows Irish house prices peaking in that month and the fall from the peak is also similar, at 26.6%.

...but other indices still showing consistent price falls...

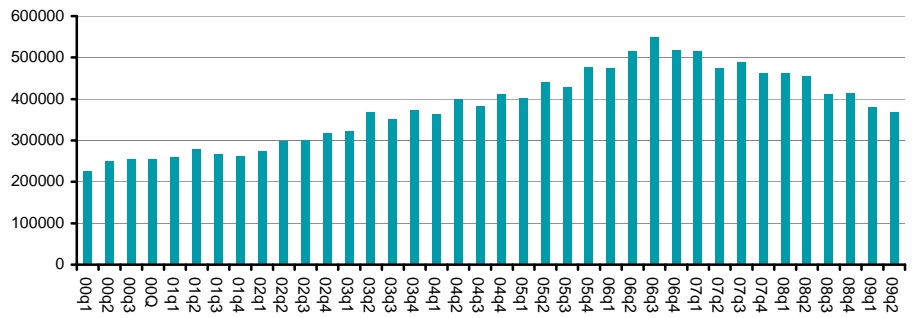
National House Prices (Euro)



DoE

The latter two indices are similar in that neither shows any sign that the market is bottoming but some slowing in the pace of price falls. The permanent tsb / ESRI index showed an average monthly fall of 1.2% in the third quarter, which represented a deceleration from Q2 (an average monthly fall of 1.6%), with the Daft.ie index reflecting a similar pattern – prices fell by 1.3% a month in Q3 against 2.1% in Q2.

Dublin House Prices (Euro)



DoE

Second-Hand Irish House Prices (Nationally)

	€	% 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	348.8	-7.7	
2009 q1	297.2	-8.1	-17.3
2009 q2	313.4	5.4	-12.1

DoE estimates

...a 15% decline likely in 2009.

The permanent tsb / ESRI index fell by 12.7% in the ten months to October, and we now expect a 15% decline for the year as a whole. A deceleration in the pace of price declines is likely in the months ahead given the composition of the index – prices are included when the mortgage is drawn down, as opposed to when the housing transaction was agreed, and as such reflects price trends some months in arrears. Sentiment in the winter months and in early spring of 2009 was at its bleakest and has picked up somewhat since, in line with some better figures on the broader Irish macro economy. The pick up in mortgage lending to first time buyers in Q3 is also a positive sign as is the substantial improvement in affordability, but it may well take some time before the excess supply in the market is cleared.

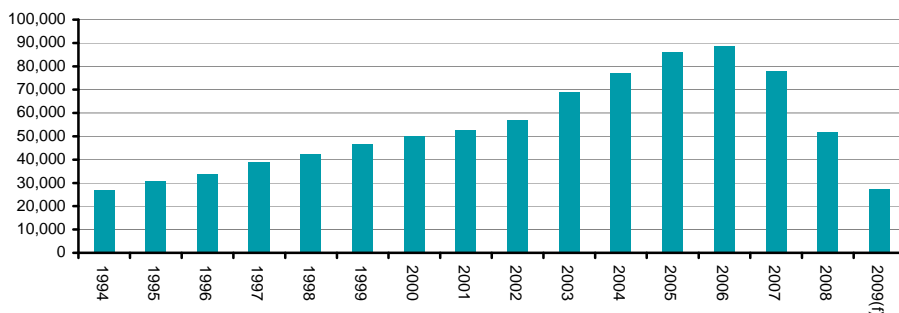
House Completions

Supply has fallen sharply...

The fact that house prices and private sector rents are still falling in Ireland implies that there is a substantial supply overhang in the market. Quantifying that excess is difficult in the absence of good figures on housing transactions, but what is clear is that the supply of new houses has slowed very sharply, with the consensus view anticipating a further substantial decline in 2010.

Data on house completions is published by the Department of the Environment (DoE) and figures are now available for the first ten months of the year. These show a total of 22,354, which compares with over 43,000 in the corresponding period of 2008. On that basis our own forecast for 2009 as a whole, of 25,000, looks marginally low and we now expect a figure in excess of 27,000. Our previous forecast was at the top of the published range and the consensus figure is now also moving higher having been below 20,000 a few months ago.

House Completions (Units)

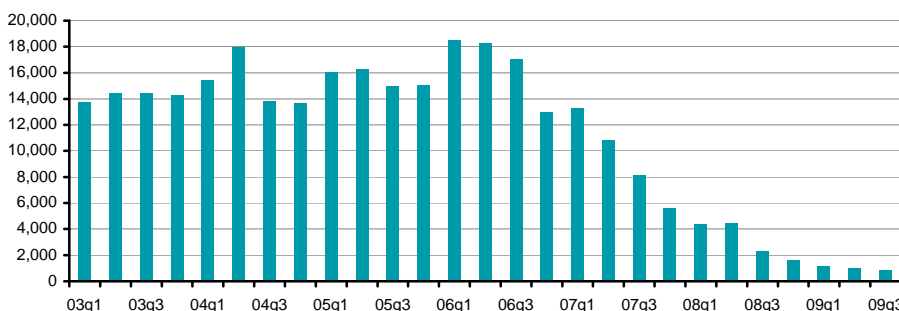


DoE

...with only 27,000 completions likely in 2009...

A 27,000 outturn for this year compares with just under 52,000 completions in 2008 and over 88,000 in the peak year of 2006, and would be the lowest absolute figure since 1994. However, one has to go back even further, to 1988, to find a lower percentage increase in the housing stock than the 1.5% recorded in 2009. Moreover, some 45% of completions year to date are individual houses, many built to order, implying around 11,000 completions for market sale.

New House Guarantee Registrations



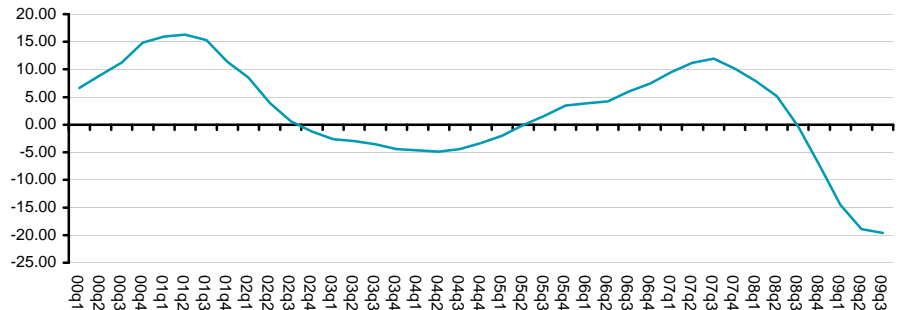
DoE

For 2010, the current consensus is that total completions will plunge to around 13,000, which would imply a figure of around 7,000 excluding individual house completions. This expectation is strongly coloured by data on Bond Registrations, a proxy for housing starts, which shows a total of only 828 in the third quarter of 2009, bringing the figure for the past nine months to just 2,945 from over 12,500 in 2008. Figures supplied to the

...and 16,000 next year.

local authorities on housing commencements are higher, albeit still pointing to a reduced supply in the coming quarters, with 2,403 commencements in the second quarter, from 2,461 in Q1. Planning permissions, although not a good guide to short term completions, have also slowed, to 27,000 in the first half of 2009 from 38,500 over the corresponding period of the previous year. Planning permissions for apartments rose in Q2, surprisingly, albeit well down on the figure a year earlier.

Private Sector Rent (% change)



Central Statistics Office (CSO)

The Bond Registration figures for October, if repeated over the next few months, imply that the series may be bottoming out, albeit at extremely low levels and would suggest that 2010 would see the low of the completions cycle. Our own forecast is for 16,000 completions next year, which would be the lowest total since 1991 and would represent only a 1.1% addition to the housing stock.

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
2009(e)	27,000	4,000

DoE

Mortgage Lending

Demand has risen from first-time buyers...

The Central Bank produces a quarterly survey of factors affecting the demand and supply of bank credit and that data shows that mortgage demand in Ireland was less depressed in the third quarter than the situation earlier in the year and relative to 2008. The figures on gross mortgage lending provide some quantitative support for this result, with loans for house purchase rising marginally in the third quarter from Q2, to €1.6bn. This is still substantially down from the previous year (58%) but also represents a pick up from what may transpire to have been a cycle low of €1.4bn in the first quarter of 2009.

The volume of gross lending for house purchase also picked up marginally in Q3, to 6,800 new mortgages, driven by first-time buyers; over 3,600 first time buyers drew down loans, from 3,200 in Q2 and 2,400 in the first quarter, offsetting a further fall in demand from buy-to-let investors and a small decline in the numbers moving house. Indeed, the value of buy-to-let mortgages taken out in the third quarter was 80% down on the previous year, with investors now accounting for less than 12% of total new lending for house purchases, with first-time buyers now half the total. Rental yields have recently fallen back below 4% (we estimate 3.87% for Q3) but are still well above the 3.3% recorded in the latter part of 2006, yet the relative lack of investor demand implies that the perceived risk of short-term capital loss is outweighing yield considerations.

...but gross lending still well down on 2008 levels...

Total gross mortgage lending in the third quarter was broadly unchanged from Q2, reflecting a fall in top-up mortgage lending and a decline in re-mortgaging – the latter was 74% down on the previous year. For 2009 as a whole we now expect total gross mortgage lending of under €9bn compared with €23bn last year and a cycle high of €40bn in 2006.

Mortgage Lending for House Purchase

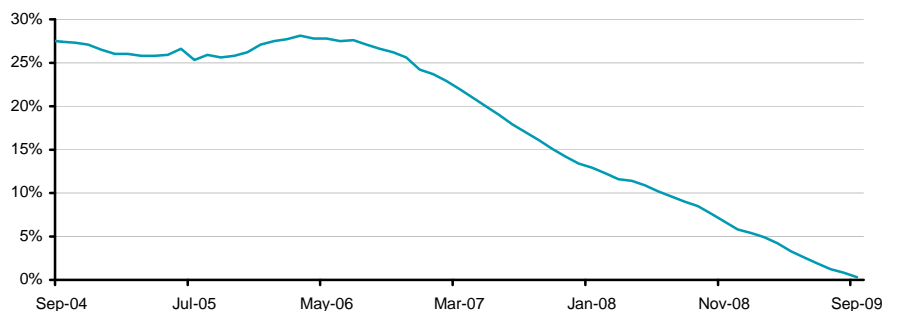
	No. of Mortgages	Average Value (€000)	Total Market (€bn)
2003	97,817	159	15.6
2004	108,225	186	20.1
2005	110,495	220	24.4
2006	110,790	251	27.8
2007	84,195	267	22.5
2008	53,616	271	14.5
2009(f)	24,300	239	5.8

IBF

...with net lending flat this year.

The Central Bank’s monthly data on net mortgage lending implies that gross lending is being offset by redemptions, as the stock of outstanding mortgage debt has barely changed since the start of the year. Net mortgage lending has grown marginally on an annual basis in September but may well end the year flat relative to December 2008. A glance at the published mortgage rates on offer from lenders in the Irish market implies that a number of institutions that were aggressively seeking to supply credit have pulled back from the market.

Mortgage Lending (%) YOY Growth



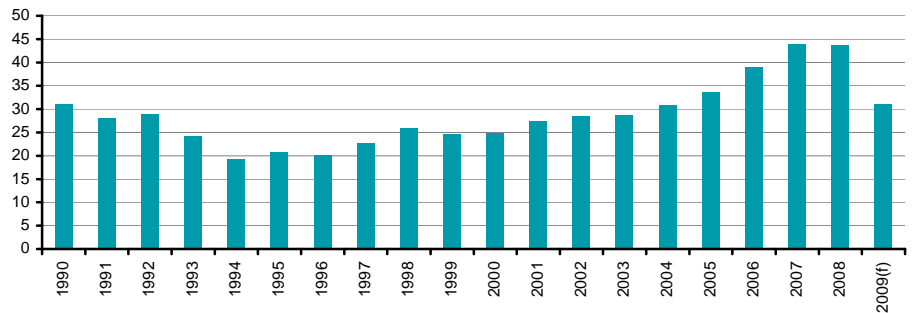
Central Bank

Affordability

The monthly payment on a mortgage has fallen by €563...

The average interest rate on a new mortgage in the third quarter of 2008 was 5.5% according to the Central Bank, which on a €262,000 mortgage (the average for the quarter) gives a monthly repayment of €1,608, assuming a 25-year term. By the third quarter of 2009, in contrast, the mortgage rate had fallen to 2.65% which reduces the payment to just under €1,200 a month. House prices have also fallen over the same period, however, with the result that the average new mortgage for house purchase in Q3 was also lower, at €229,000, giving a monthly payment of €1,045, a reduction of €563 a month or €6,750 a year.

Affordability (%)



Economic Research Unit (ERU)

The example illustrates that existing mortgage holders have benefited substantially from the ECB’s monetary easing and that potential house purchasers have seen a significant improvement in affordability. Our affordability model attempts to capture the latter concept in a formal way by looking at the average mortgage cost of a new 25-year mortgage through time and expressing this in relation to average income.

...highlighting the improvement in affordability...

On that basis the model shows an average figure of 29.3% from 1975 to 2008, implying that a mortgage and by implication residential property was very affordable in the 1990’s (the index fell below 20% at one stage and finished the decade at 24.3%), but became much less affordable from 2006 to 2008, when the index rose above 40%.

Affordability

	Mortgage Cost (% of average earnings)
1995	20.7
1996	19.8
1997	22.4
1998	25.5
1999	24.3
2000	24.9
2001	27.4
2002	28.5
2003	28.7
2004	30.8
2005	33.6
2006	38.8
2007	43.9
2008	43.6
2009(e)	31.0
2010	29.2

Economic Research Unit (ERU)

Affordability has improved substantially in 2009, as the example illustrates with the fall in interest rates and the fall in mortgage size offsetting a decline in incomes – we project a figure of 31% for the year as a whole, taking the average affordability measure back to levels recorded in 2004. A further improvement is also likely in 2010, despite another

fall in average incomes, as the full year effect of lower rates feeds through (the last ECB cut was in May 2009) on the assumption that rates are unchanged for most or all of the coming year. On that basis the affordability index declines to 29.2%, or to the average of the past thirty-five years.

...but other factors weigh.

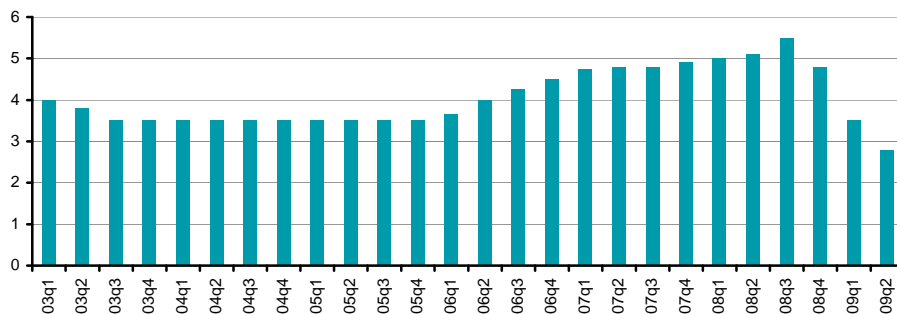
One might expect this improvement in affordability to boost demand for mortgages and residential property, but in practice other factors are also important for would-be buyers, including expectations of house price changes, uncertainty about employment and earnings and views on the likelihood of tax changes impacting on the housing market. Although gross lending for house purchase did rise in Q3 the move was marginal and it would appear that as yet these other factors are weighing heavily, despite the affordability boost.

Interest Rates

The economic situation is improving...

The global recession is over and with recovery underway a number of central banks have started to tighten monetary policy – the Reserve Bank of Australia, for example, has raised rates three times in the last two months. The major central banks, however, including the ECB, are still signalling that it is too early to raise rates, given the fall in economic activity and the degree of uncertainty surrounding the shape of recovery.

Mortgage Rate (%)



Central Bank of Ireland

...but ECB in no hurry to raise rates.

The euro area as a whole returned to growth in the third quarter of 2009, thereby formally signalling an end to recession and the ECB has revised up its forecasts for economic growth next year. Yet President Trichet has continued to stress that the road ahead may be ‘bumpy’ and that caution and prudence is required in terms of any policy change. Consumer prices in the euro area have fallen, although a return to positive inflation readings is likely over the next few months, the inflation rate over the next few years is widely expected to remain below the ECB target level and as such consistent with low rates.

The ECB cut the repo rate to 1% in May and since then money market rates have fallen sharply; 3-month cash is now trading at under 0.7% from 1.30% in early May and over 4% twelve months ago. Longer dated interest rates – which help determine fixed rates as offered in the retail market – have actually risen marginally since May, in contrast, with 3-year rates at 2.20% from a low of 2% following the ECB cut.

This pattern reflects the market’s view that the ECB will start to tighten policy within the next year, although the expected timing of such a move does change, reflecting the economic data and ECB rhetoric. At the time of writing the market has pushed the first ECB rate rise further out, to the third quarter of 2010, having previously priced in a rise in the second quarter. New mortgage borrowers have the option to fix their rates for a number of years which offers certainty, but at a higher initial cost than floating rates, reflecting the market expectation that rates will move higher.

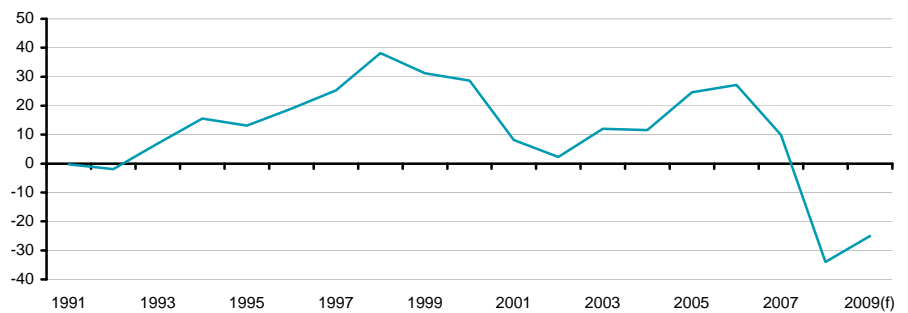
Commercial Property

The UK market has bottomed...

In recent editions of *The Irish Property Review* we have contrasted the performance of the Irish and UK commercial property markets, noting that the UK re-priced earlier than Ireland in the initial stages of the downturn, in part reflecting a plunge in transactions in the Irish market and the influence of retail property funds on the UK market. The latter also appears to have bottomed out earlier than Ireland, with returns turning positive again in the third quarter, according to the IPD index.

The same cannot be said about the Irish commercial property market, with negative returns again recorded for the seventh consecutive quarter in Q3. Moreover, the decline in the three months to September, at 6.7%, was larger than the Q2 fall of 6.1%, although substantially lower than a year earlier, with the result that the annual pace of decline slowed to -34% from -39% in Q2. Capital values fell by 8.5% in the third quarter, taking the decline from the peak of the cycle to 53%.

Commercial Property Returns



SCS/IPD

...but Irish returns still falling...

The retail sector was the star performer in the commercial property boom and it has generally underperformed in the downturn, reflecting a sharp fall in Irish consumer spending and a substantial increase in actual and planned supply, although the scale of the latter has been trimmed back. Yields have risen markedly and are now approaching 7% in Ireland's prime city centre locations, from under 3% at the peak. The total return on retail property fell by 6.5% in the third quarter, following an 8.3% decline in Q2, leaving the annual decline at 37%.

The office sector has also experienced an effective doubling of yields, from under 4% in the prime Dublin locations to around 8% now, following a 6.8% fall in returns and 8.7% fall in capital values in Q3, bringing the fall in the past year to 36%. The take-up of office space in Dublin has picked up since the first quarter according to CBRE, albeit from very low levels, although the vacancy rate is put at 22% from a cycle low of 12%. The industrial sector also had a similar capital decline in Q3 (8.5%) and a total return fall of 6.4%.

**...yields now high relative
to cost of funds.**

Yields are now high relative to the cost of borrowing and the risk-free rate of return (measured by 10-year Government bond yields around 4.70%) and this configuration is usually a catalyst for eventual recovery as is evident in the UK. The availability of credit is another issue, however, as are expectations about the near-term trend in yields. The Irish economic situation has certainly improved over recent months, but the timing and shape of recovery is still far from clear, which means that we may not see a cyclical turning point in the near-term; we expect a further decline in returns in Q4, albeit at a slower pace, bringing the total decline in 2009 to 25%, followed by a 10% fall in 2011.

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