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Bank of Ireland Global Markets

The Irish Property Review

A quarterly analysis of trends in the Irish property market

Market correction still underway

- Pace of mortgage slowdown has eased
- Prices still falling, but at reduced pace

The Irish housing market is still in the throes of a correction, although the pace of decline has slowed judging by the most recent figures on mortgage lending and house prices. Nevertheless, it may well be 2009 before more unequivocal signs of stability emerge, particularly in the wake of the ECB rate rise in July. This has put an additional strain on affordability, as variable mortgage rates had already drifted higher in response to the credit crunch. Affordability is forecast to improve next year, however, both in terms of mortgage repayment capacity and in relation to income relative to house prices. The probability of rate cuts by the ECB has also risen and the financial markets expect a quarter point reduction by mid-year.

The adverse impact of higher rates on the mortgage market has been exacerbated by a tightening of credit standards, as revealed in recent ECB surveys. Gross new mortgage lending has slowed, and fell by 13.4% in the year to the second quarter of 2008. The quarterly total of €7.6bn did represent an increase over Q1, nonetheless, where the annual rate of decline was 20%, and the number of new mortgages drawn also picked up, to 35,000 from under 29,000. The figure for house purchase alone was less impressive, although again showing a rise in the quarter. The pace of growth in the outstanding mortgage stock also continues to slow, to 9.6% in July, but the percentage change in recent months has stabilised around €1bn or 0.7%. On the basis of these figures, we remain comfortable with our previous forecast that mortgage lending growth will end the year at around 8%, and that gross lending will amount to €29bn, from €33.8bn in 2007.

Prices are also still falling, and the decline in July was the seventeenth consecutive monthly decline, taking prices back to November 2005 levels. The monthly fall was only 0.2% however, and the annual pace of decline again slowed, this time to 9.4% from 9.7%. On that basis, we project an 8% fall for the full year.

The supply response to falling prices has been substantial, which is ultimately supportive of the market: completions fell to under 28,000 in the first half of the year and still look set to reach 50,000 at best compared with 78,000 in 2007, which would be the lowest percentage addition to the housing stock since 1996. Moreover, leading indicators of housing starts imply that the first half of 2009 may be weaker still.

Sentiment and expectations can change, of course, but the current economic backdrop is clearly negative, given weak consumer confidence, a rise in unemployment and persistently high inflation, which is eroding real incomes. Inflation may have peaked however, given the recent fall in oil prices, and the market is now pricing in a rate cut by the ECB in the first half of 2009. This would be positive for the market, of course, and next year will also see house prices relative to income back to levels last seen prior to Ireland joining the euro, which may also provide support. Rental yields have also risen to their highest level since 2003, although the strong rise seen over the past few years has resulted in an increase in the supply of rental property, with concomitant pressure on rents.

Finally, to commercial property, where the market is re-pricing capital values in response to increased economic uncertainty and the credit crunch. We now expect a 16% decline in total returns in 2008, taking yields above 5%.

Dr. Dan McLaughlin.

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Prices down 9.4% in year to July

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45,000-50,000 in 2008

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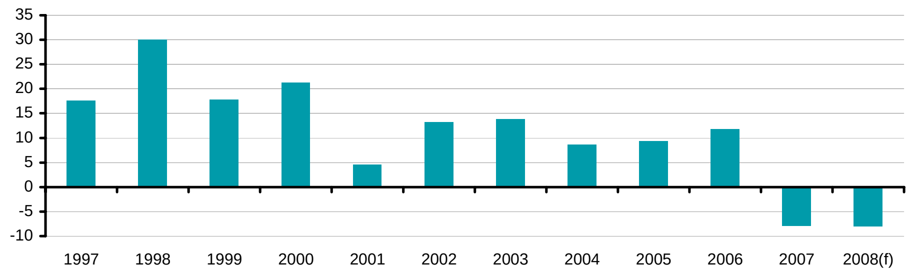
House Prices

Nominal price falls are unusual…

The Department of the Environment (DoE) publishes house price data back to the 1970s and average annual prices fell in only one year over that period, in 1987, and then by only 1.6%. CPI inflation in that year was relatively low at 3.2%, but had been much higher in the first half of the decade, with the result that house price increases did not always keep pace with general inflation. Real house prices (i.e. adjusting for CPI inflation) have therefore fallen more often than nominal prices over the past thirty-five years, and more recently, with marginal falls recorded in both 1991 and 1992.

Consequently, the market's recent experience of nominal house price falls is a very unusual phenomenon. The DoE data, published quarterly, is not seasonally adjusted so is best looked at in terms of annual changes, and on that basis prices fell by an annual 4% in the third quarter of 2007, and by 2.3% in the fourth quarter, although leaving the annual average change still in positive territory, albeit marginally so.

House Price Inflation (%) (end-year)

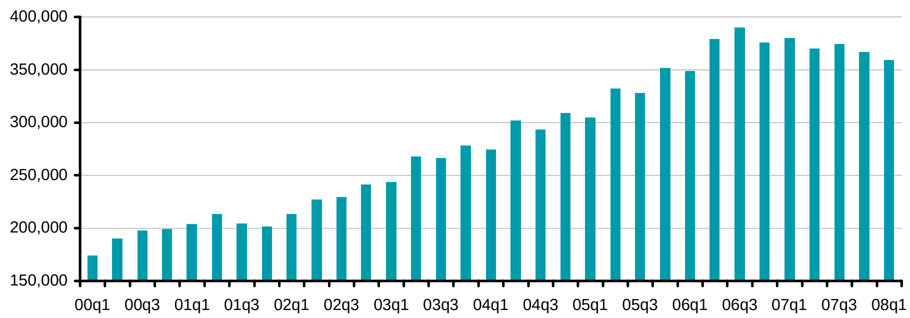


Permanent tsb / ESRI

…but started in 2007…

The pace of price decline accelerated further in the first quarter of 2008, however, to 5.4%, so it looks inevitable that this year will see the first negative reading in average annual house price inflation since 1987. The permanent tsb index is a more timely measure (and published monthly) and showed an average annual fall of 9.5% in the second quarter. This index peaked in January 2007 and recorded monthly price falls from March of that year, although the annual change did not turn negative until the third quarter, as per the DoE figures.

National House Prices (€)



DoE

The two indices also paint a similar picture in terms of relative performance, in that new house prices were slower to adjust to the weaker market than existing prices; existing house prices fell by 8.5% in the year to the fourth quarter of 2007 according to the permanent tsb index, against a 3.4% decline in new houses, and the DoE figures show that new houses actually rose marginally in price, against a decline in second-hand houses.

…new house prices slower to adjust…

This implies that builders and developers were slow to cut prices but this appears to have changed, with new houses down 6.1% from December 2007 to June 2008, against a 3.9% fall in existing house prices.

…pace of price declines has slowed…

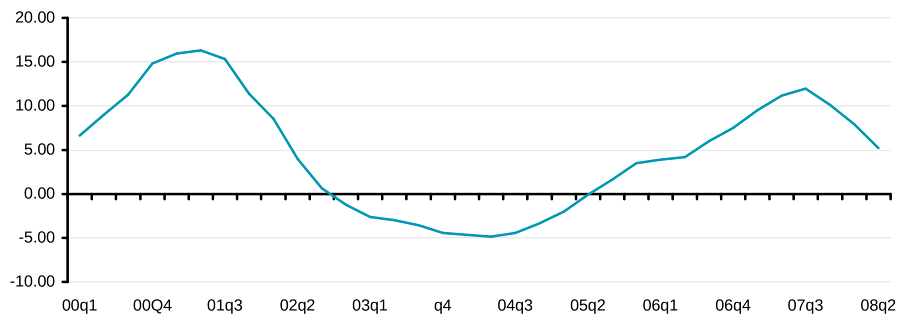
The outlook for prices for the remainder of the year and into 2009 is far from clear; particularly as sentiment and expectations play a significant role in short-term trends. Prices fell again in July, albeit by only 0.2%, and the annual pace of decline slowed to 9.4% from 9.7%, which perhaps hints at some signs of stability. Yet the economy is set to record flat growth in 2008 at best, compared with 6% in 2007, and the precipitous scale of the slowdown has contributed to a substantial fall in consumer confidence. Unemployment has also picked up and inflation has also remained stubbornly high, in large part due to a surge in oil and food prices earlier in the year. Indeed, high inflation not only eroded real incomes, but also persuaded the ECB to raise rates in July, despite what we now know to be negative eurozone growth in the second quarter. Mortgage rates for new borrowers had drifted higher ahead of this move anyway, reflecting the impact of the credit crunch on wholesale bank rates, but the ECB move means that affordability has deteriorated more than expected on our model, despite the fall in prices relative to income.

Oil prices have fallen in the past month, however, and the financial markets are now giving a high probability to a rate cut from the ECB by April 2009, which may boost affordability. An earlier rate move is possible if oil prices continue to fall but perhaps not this year, so borrowers are unlikely to see lower rates in the next few months, particularly as wholesale rates remain at very elevated levels.

…and supply response has been pronounced.

There has been a significant supply response to the fall in prices, nonetheless, and house completions in 2008 will be 50,000 at best, or 35% down on the previous year, with 2009 likely to see a further decline. This is ultimately supportive of prices. Rental yields have also picked up strongly and in the second quarter of 2008 were the highest since 2004, although the upturn in rents has encouraged more supply in that market, and annual rental growth has started to slow.

Private Sector Rent (% Change)



Central Statistics Office (CSO)

8% price fall forecast in 2008.

In summary, we may have to wait until the rate outlook becomes clearer in 2009 to see signs of an upturn in prices. By then, house prices relative to income will be at levels last seen before Ireland's membership of the euro, perhaps providing further support for the market. Near term, we expect prices to fall by 8% by end-2008, having fallen by 5% in the first six months of the year, which would take the average price of a house in Ireland back to levels seen in August 2005.

Second-hand Irish House Prices (Nationally)

		€ (000)	% change	year-over-year (%)
1998		134.5	31	
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

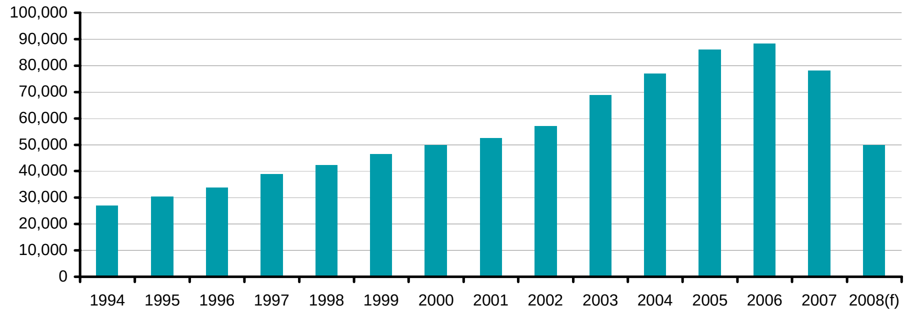
DoE estimates

House Completions

50,000 completions at best in 2008…

The leading indicators of housing supply have been signalling a sharp reduction in house completions for some time, and the hard data now confirms that 2008 is likely to see the lowest completions since 2000. Some 27,600 units were completed in the first half of the year according to the DoE, which is consistent with a full year figure of 45,000 - 50,000 in our view, against 78,000 in 2007. The higher end of the range would imply a 2.7% increase in the housing stock, the smallest percentage addition since 1995.

House Completions (Units)

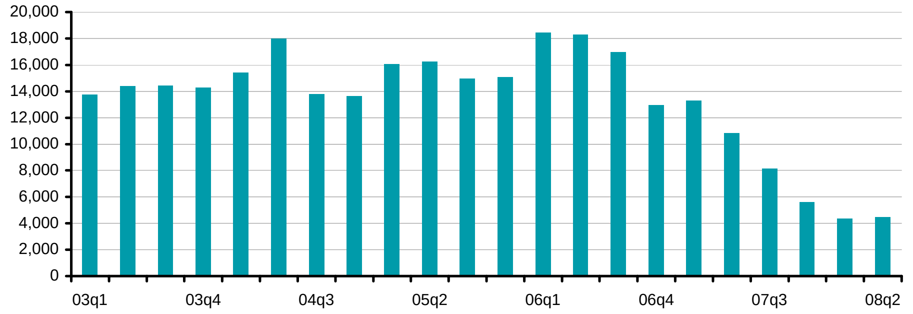


DoE

…which is supportive of house prices…

This rapid supply response is ultimately supportive of house prices, if negative for GDP growth in the short-term, but does not tell the full supply story as there is also a stock of unsold houses. Unfortunately, it is impossible to accurately capture this in Ireland as there is no data published on housing transactions. Some analysts use mortgage lending as a proxy for housing demand, but a proportion of houses are bought for cash, and this can be sizeable; house completions averaged 77,000 a year between 2003 and 2005, for example, at a time when prices were rising steadily, but loans for new property averaged only 44,000 a year or less than 60% of the total house completions.

New House Guarantee (Units)



DoE

…supply likely to fall again next year…

Bond registrations, a proxy for private sector housing starts excluding one-off developments, are still extremely weak; registrations amounted to 4,457 in the second quarter, a marginal increase on Q1 although still 59% down on the previous year. Commencement notices, another indicator of future completions, have also stabilised around 7,500 a quarter over the past nine months, although again this suggests that completions in 2009 may fall again, albeit not as precipitously as seen this year, and we forecast under 40,000 at this stage. This total would take the annual figure well below the 50,000 seen by the ESRI as medium term demand, although the actual outcome next year is still very dependent on how the market performs over the next six months.

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(f)	50,000	27,000

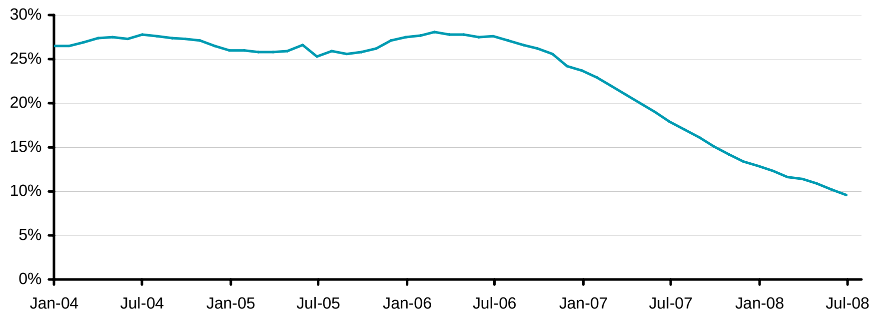
DoE

Mortgage Lending

Lending growth slowed to 9.6% in July…

Mortgage lending growth continues to slow across the euro area, reflecting a combination of weaker demand and constrained supply, with banks tightening credit standards in response to the credit crunch and expectations of an economic slowdown. The annual growth rate of mortgage lending slowed to 4.3% in the euro area as a whole in July, from a high of over 12% at the peak of the cycle, and the Irish experience has been similar, albeit from a higher base: annual mortgage growth in July was 9.6% from 10.2% in June and a cyclical peak of 28.1% in March 2006. The outstanding level of Irish mortgage debt is now €146bn.

Mortgage Lending (%)



Central Bank

The Central Bank publishes these figures on the stock of mortgage debt monthly, and data on gross mortgage lending is published by the Irish Banking Federation on a quarterly basis.

This data shows that gross mortgage lending in Ireland peaked in the third quarter of 2006 at €11bn, and has been weaker since then, declining to €6.36bn in the first quarter of 2008 (the data is not adjusted for seasonal factors and tends to be higher in the second and third quarters). The second quarter did see a modest pick-up, to €7.6bn, and the annual pace of decline slowed to 13.4%, perhaps indicating that gross lending has bottomed out, although this conclusion must be tentative given the ECB rate rise in July.

…although gross mortgage lending picked up in Q2…

The headline gross lending figure includes re-mortgaging (i.e. borrowers switching lenders) and this market has been growing strongly, albeit at a slower pace in the second quarter. If one excludes this, lending fell at an annual 19% in the second quarter from 29% in Q1. The figures for house purchases alone shows a similar picture, with drawdowns of €4.7bn in the second quarter, up from €3.8bn in Q1, with the annual decline slowing to 20% from 29%.

...8% growth in mortgage stock forecast for 2008.

The IBF also provides details on the type of borrower and it reveals that investors are still prepared to take a longer view of housing prospects, with buy-to-let loans rising to €1.4bn in Q2 from €1.2bn in Q1, so reducing the annual pace of decline to 8%. Mortgage lending to first-time buyers also picked up to €1.5bn from €1.1bn in Q1, although this still left the Q2 figure 19% down on an annual basis. The appetite for existing mortgage holders to sell and move house has not improved, however, and although lending in this category did pick up in Q2, to €1.7bn from €1.5bn, it declines further on an annual basis, to 27%.

Mortgage Lending for House Purchase

	No. of Mortgages	Average Value (€000)	Total Market (€bn)
1998	61,407	74.7	4.5
1999	70,817	92.1	6.5
2000	74,258	102.4	7.6
2001	66,786	114.7	7.6
2002	79,292	136.5	10.8
2003	84,750	159.6	13.5
2004	98,709	171.5	16.9
2005	107,700	200	21.5
2006	111,250	229.2	25.5
2007	84,200	238	20.2
2008(f)	67,500	238	18

DoE estimates

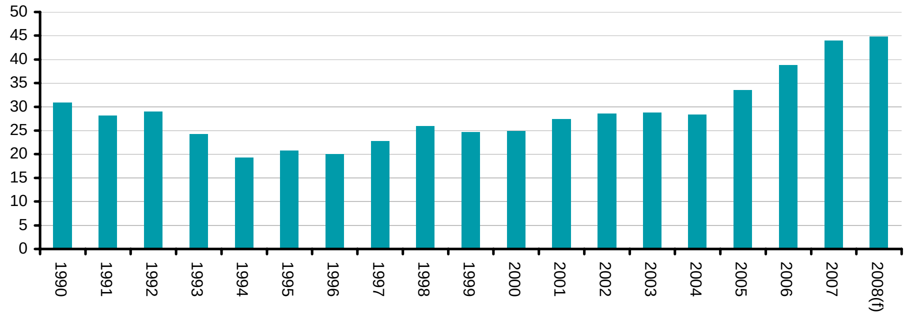
We had forecast total gross lending of some €29bn for the year as a whole, compared with €34bn in 2007, and the most recent data is supportive of this projection. Similarly, our 8% forecast for the growth in the outstanding mortgage stock in 2008 is also unchanged.

House prices have fallen relative to income…

There is no universally accepted definition of affordability when applied to the housing market, although all measures relate the price or cost of acquiring a house to some income measure.

One simple approach is to compare the price of housing to average income and on that measure affordability has certainly improved in Ireland over the past eighteen months, given the fall in house prices. In 2006, for example, the average Irish house cost €299,000 (according to the permanent tsb index), which was 7.5 times our measure of average earnings (just over €40,000 at that time). That ratio then declined to 7.2 in 2007, and is forecast to decline more rapidly in 2008, to 6.3, on the assumption that the average house price fall this year is around 9%. The ratio of house prices to income is then projected to fall further to 5.8 in 2009, which would take it back to the levels existing just prior to Ireland's entering European Monetary Union.

Affordability (%)



Economic Research Unit (ERU)

…so boosting affordability on some measures…

This concept of affordability ignores the cost and availability of mortgage finance, however, and these certainly change through time. Some models assume a constant loan to value ratio of, say, 90%, which then only allows changes in the mortgage rate to affect affordability. On that basis, affordability deteriorated in 2007, reflecting higher mortgage rates, but has improved in 2008, despite a further rise in borrowing costs, reflecting the fall in house prices and hence the assumed average new mortgage.

...but affordability has deteriorated on our model.

A third approach, and one we have used, is to allow for changes in the loan to value ratio by using data on the actual size of a new mortgage, using published figures on gross lending. The IBF data is the new industry standard on the latter and produces a higher figure for the average new mortgage than previous DoE figures, which has the effect of giving a bigger deterioration in affordability than previously indicated in our model. The average new mortgage is now seen to cost 43.9% of income to service in 2007, from 38.8% in 2006, rising to 44.7% in 2008. The model assumes a 25-year repayment mortgage and in practice many borrowers have taken out longer term debt so the impact is not as pronounced as implied here. Affordability also looks set to improve on our model in 2009 as in the other variants, nevertheless, on the basis that the loan to value ratio will decline. We have also assumed a half point cut in the ECB repo, which helps to take the affordability measure back down to 44.7%.

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 (f)	44.7

ERU

Interest Rate Outlook

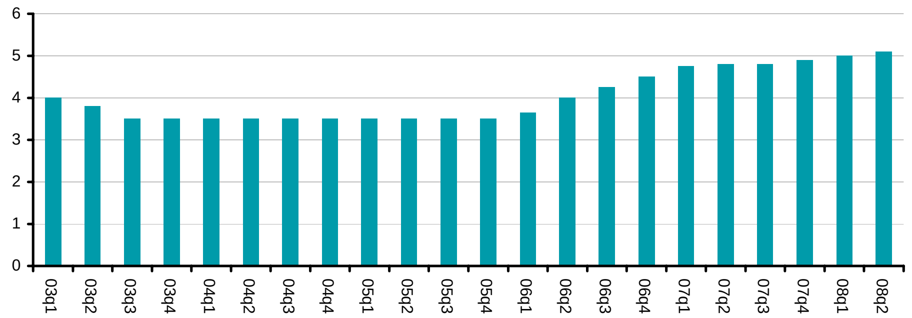
Higher inflation prompted an ECB rate rise…

Tracker mortgages have proved popular with new Irish mortgage borrowers in recent years, with the interest rate linked to the ECB's repo rate. The margin paid by borrowers over the repo rate is fixed at the outset, depending on market conditions and the loan to value, and all such borrowers have therefore faced a quarter point rise of late, following the ECB's decision to raise rates in early July to 4.25% from 4.0%.

In fact, the average mortgage rate paid on new loans had drifted higher prior to the ECB decision, reflecting the impact of the credit crunch on wholesale money market rates. It was 5.23% in June according to the Central Bank from around 5% in the spring, and the ECB's decision no doubt pushed this average higher again in July and August.

The decision by the ECB in June to flag a rate rise was a surprise given the economic outlook. It has been clear for some time that the pace of economic activity in the euro area is slowing, and it was recently confirmed that GDP fell in the second quarter of the year, with output declining in Germany, France and Italy. Business and consumer sentiment indices also point to further weakness and on past evidence one might expect rates to have been cut against that backdrop, as in the US and UK, rather than raised.

Mortgage Rate (%)



Central Statistics Office (CSO)

Euro area inflation has risen sharply in 2008, however, reaching 4% in July, (albeit primarily due to higher oil and food prices) and the ECB fears that households will now expect inflation to remain above the Bank's 2% target, and adjust wage demands accordingly. Hence, the decision to raise rates even though the ECB also admits that there are downside risks to growth.

…but lower rates now predicted by the market.

These downside risks may now be materialising, according to ECB President Trichet, and the recent fall in commodity prices, notably oil, raises the probability that inflation peaked in July, with the prospect of a sharp deceleration in 2009. Consequently, market expectations regarding the likely path of ECB rates have shifted appreciably in the past month: a rate cut by April 2009 is now given a high probability, whereas another rate rise was previously expected.

The ECB is unlikely to start cutting rates in the next few months, however, as inflation is still uncomfortably high, but a further rate rise looks unlikely too, in the absence of a fresh spike in oil. The expectation that the next ECB move is down has had an impact nonetheless, in that the wholesale cost of borrowing fixed cash for longer periods has fallen. 3-year cash now costs 4.70% from a high of 5.4% in June, although this compares with 3.80% in January. The result has been some lower fixed rate offers in the retail market.

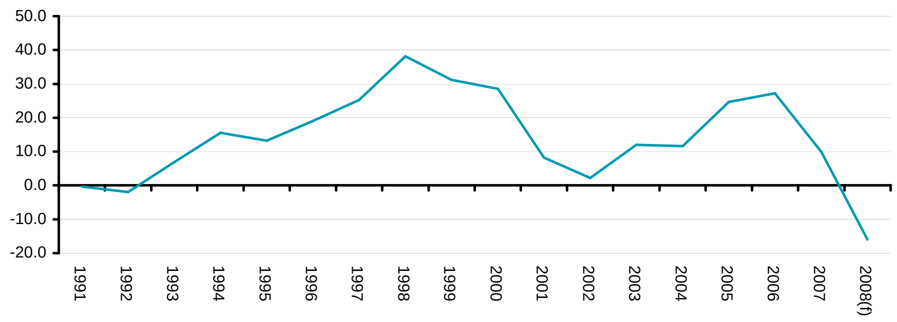
Irish yields now moving sharply higher…

The credit crunch is now over a year old and had an immediate impact on UK commercial property. Transactions stalled and yields were re-priced higher, resulting in large capital falls in the latter part of 2007 and into 2008. The Irish market response was much slower and capital values continued to rise in the second half of 2007, albeit by only 1% in the final quarter. It was clear though that the cycle was turning, given that short and longer term rates had risen and the economy was set to slow, leaving aside any impact from the credit crunch. Consequently, we forecast negative returns in 2008.

In the event our forecast is proving too optimistic as the market is now re-pricing more aggressively than most anticipated, in the face of uncertainty about the near-term economic outlook and a tightening of credit standards across the European banking sector.

The yield adjustment has been most pronounced in the retail sector, the star performer over the past decade. Capital values fell by over 8% in that sector in the second quarter according to the IPD index and this followed a 3.6% decline in Q1. This dragged the Q2 return to -7.3% and left the annual return in negative territory for the first time since 1992.

Commercial Property Returns



SCS/IPD

…and 16% decline in returns predicted for 2008.

The office sector faired only marginally better, with a 6.3% negative return in Q2, reducing the annual return to -4.5%. The annual return on industrial property remains positive at 3.2%, but quarterly returns in Q2 were negative, helping to pull the total property return in the quarter to -6.2%.

Sentiment in the sector is poor, although the aggressive re-pricing of commercial assets has pulled the yield up to 4.6% from 4.0% in late 2007. Yields are now higher than the risk-free rate of return (proxied by the 10-year Government bond yield) which has fallen from 5% to 4.50%. 5-year swap yields, a proxy for funding costs, have also fallen from the highs to 4.70% from 5.20% earlier in the year. These trends, if sustained, will ultimately be positive for the market but yields may have to rise above 5% to find support levels. On that basis, we now expect total returns for 2008 to decline by 16%.

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