



The Irish Property Review

A quarterly analysis of trends in the Irish property market

Rapid supply response to weaker market

Economic Research Unit (01) 609 4613

- Prices back to early 2006 levels
- Rental yields up
- Affordability set to improve

The Irish housing market began to weaken in earnest in the second quarter of 2007, and since then the most striking feature of the correction is the speed of the supply response: completions in 2008 look set to reach 50,000 at best, compared with 78,000 in 2007 and a cyclical high of 88,000 in 2006. The fall in supply is negative for Irish economic activity but is ultimately supportive of house prices by bringing the market back into balance.

The demand for new mortgage lending has fallen, as evident from the data on gross mortgage lending, which fell by 15% in 2007, to €33.8bn, or by 19% for house purchase alone. Moreover, figures for the first quarter of 2008 show no change in the trend; gross lending fell an annual 20%, with loans for house purchase down by 29%. Consequently, we expect lending for the whole year to fall again, to €29bn, although the pace of decline is likely to bottom out in the second quarter. This will lead to a further deceleration in the growth of mortgage debt, nonetheless, which may end the year around 8% from the current 11.6%.

Yet the overall demand for housing does not appear to have changed materially, as private sector rents have risen by over 22% in the past three years, taking the gross rental yield to an estimated 4.1% in the first quarter. This implies that the marginal buyer is currently a renter in the face of the past deterioration in affordability and in response to uncertainty about the outlook for interest rates and house prices - the latter have fallen by 9% over the past twelve months, taking the price of the average Irish home back to levels existing in early 2006.

Sentiment and expectations play an important short-term role in the housing market and are difficult to predict. What can be said though is that affordability is set to improve in 2008 and 2009 (on the assumption that rates have peaked and incomes will continue to rise) and that any improvement would be greater if interest rates fall in 2008, as we expect. The Government has also cut the effective rate of stamp duty and provided a substantial fiscal incentive to first-time buyers, which should help, as does the fall in supply. The pace of price declines also appears to be slowing, judging by the first quarter data, perhaps signalling that we are nearer the bottom, although this is unlikely to be sufficient to prevent another 5% decline in 2008 as a whole.

Finally, the cyclical downturn in the Irish commercial property market is now pronounced, albeit not as sharp as seen in the UK; we now expect returns to fall by 5% in 2008 as yields adjust rapidly to the new economic environment.

Dr. Dan McLaughlin.
May 2008.

House Prices

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Prices have fallen for the past year, and are now back at early 2006 levels, although rents and rental yields have risen. Further modest declines in capital values are likely.

House Completions

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The 2007 outturn surprised some, but the trend is clearly weaker, with 50,000 completions seen in 2008.

Mortgage Lending

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The pace of mortgage growth has slowed since 2006, with gross new mortgage lending still falling.

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Affordability deteriorated, from 2005 through to 2007, but looks set to improve this year and next.

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The ECB has not moved, but weaker activity will prompt them to ease rates this year, by 0.5%.

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The cycle has clearly turned, with returns set to fall this year.

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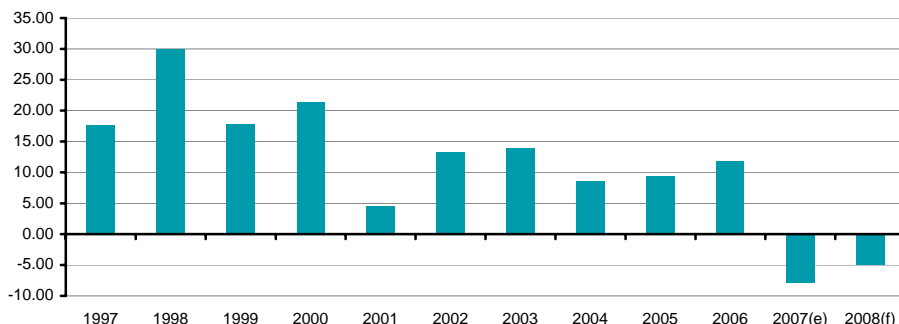
House Prices

Prices have fallen for the past year...

The Irish housing market has clearly weakened in terms of buyer interest, and prices have fallen for the past twelve months. Rents, in contrast, have risen substantially, by 22% in the three years to March 2008, implying that the underlying demand for housing remains firm, but that the marginal buyer is currently a renter.

The timeliest source of data on house prices is the permanent tsb / ESRI index, published monthly, and that peaked in February 2007, with the average house price across the country recorded at €311,000, from around €85,000 ten years earlier. Prices started to fall in March 2007, with the monthly decline gaining momentum in the final quarter of the year to leave the annual decline in December at 7.3%.

House Price Inflation (%) (end-year)

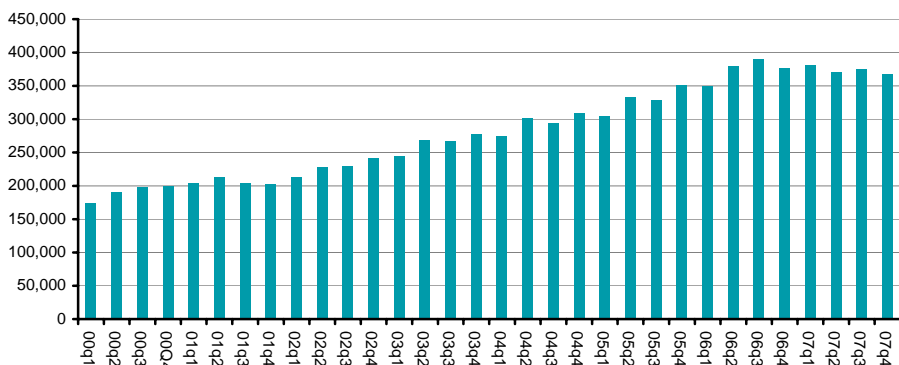


permanent tsb / ESRI

...and are now back at early 2006 levels...

Prices continued to fall in the first three months of 2008, albeit at a slower pace (averaging 0.7% per month against 1.3% in Q4), taking the price of the average home to €281,600 in March, and as such back to the levels existing in early 2006. Prices initially fell more rapidly in Dublin (by 7% in 2007 against 6.4% outside the capital) but this has changed in recent months, with prices in the capital declining by 1.8% in the three months to March (and by only 0.2% in March) against 2.8% in the rest of the country. Surprisingly, perhaps, the index also shows that the price of existing houses fell more sharply than new houses last year, by 9% against 4.1%, but this has changed year to date, with new prices down 1.3% and existing homes down 1.2%.

National House Prices (€)



DoE

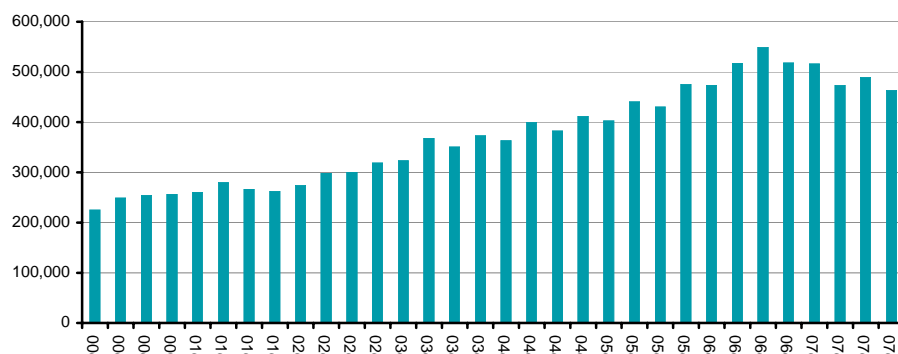
The other main source of information on Irish house price trends is the Department of the Environment (DoE), which collates data from all the mortgage lending institutions on a quarterly basis. The DoE house price figure is an unadjusted average for that quarter and as such can be strongly affected by seasonal factors and the housing mix. Nevertheless, the series shows house prices nationally also falling in the third and fourth quarters of 2007 (the latest data published), albeit at a more sedate pace than the permanent tsb / ESRI index; the annual fall in existing house prices in Q4 was 2.3%, although new house prices actually rose marginally, by 0.4%. The DoE data does differ in terms of Dublin prices, with existing house prices in the capital declining by 10.6% in 2007, a much wider divergence than in the permanent tsb / ESRI index, with new houses in Dublin down 4.4% in the latter source.

...although rents and rental yields have risen...

The scale of house price declines seen to date are modest relative to the decade-long appreciation, but might imply an excess of supply relative to demand. This argument would be easier to sustain if rents were static or falling, but rents nationally, as measured by the CSO, have risen steadily since early 2005, increasing by 3.5% in that year, by 7.2% in 2006, and by over 10% last year. This trend may have, in turn, boosted the supply of rental properties and the annual growth in rents has slowed, to 7.9% in Q1 and probably eased further in the second quarter, to around 4% judging by more timely market data, but the effect has been to boost rental yields, which we estimate at 4.1% in the first quarter, from a cycle low of 3.4% in the third quarter of 2006.

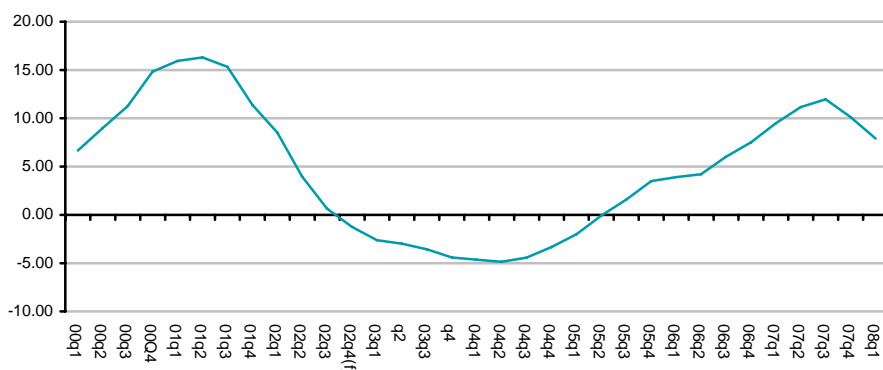
The pattern of falling house prices and rising rents suggests to us that potential buyers are currently renting, in part due to the deterioration in affordability and also reflecting a change in price expectations, with few, if any, expecting house prices to rise in the near term, and many expecting prices to be flat or to fall. Moreover, there is uncertainty over mortgage rates, given the rise in wholesale market rates and the absence of a clear signal from the ECB that the next move is down.

Dublin House Prices (€)



DoE

Private Sector Rent (% Change)



Central Statistics Office (CSO)

...further modest declines in capital values are likely.

We believe that interest rates will indeed fall in 2008 and this should boost affordability. House prices are also lower than they were, and new housing supply has been reduced which should also be ultimately supportive of the housing market, as will the recent fiscal measures taken by the Government to reduce the effective rate of stamp duty and to bolster tax relief for first-time buyers. Sentiment is difficult to predict nevertheless, and prices may drift lower near term before a bottom is reached, which may come in the third quarter if the ECB starts to cut rates, as we expect. Consequently, we forecast a modest fall in prices in 2008, of 5%, followed by unchanged prices in 2009.

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	Q1	379.9	1.1	9
	Q2	386.9	1.9	2.1
	Q3	374.4	-3.3	-4
	Q4	366.9	-2	-2.3

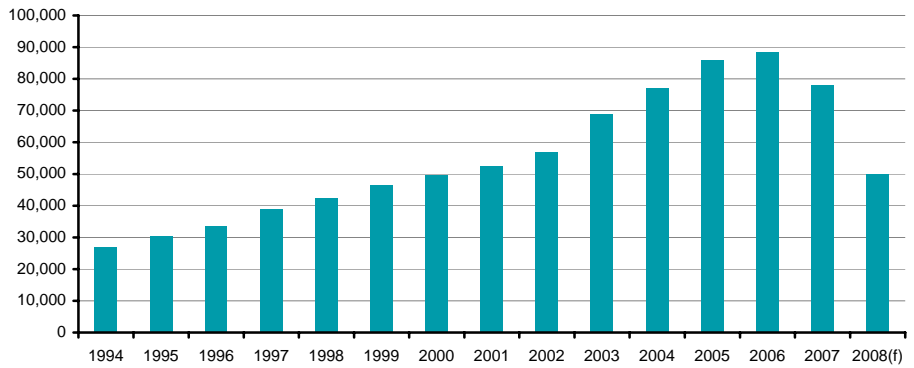
DoE estimates

House Completions

The 2007 outturn surprised some...

Irish housing supply reached a cyclical peak in 2006, with over 88,000 completions, but slowed last year; completions emerged at 78,000, equivalent to a 4.4% increase in the housing stock, from 5.2% in 2006. The 2007 outturn was stronger than most expected, as completions had slowed sharply in the third quarter, to 17,400, or 23% below the equivalent period in 2006. Completions rebounded in the fourth quarter, however, rising to 21,600, (or 20% down on an annual basis) leaving the annual total above the consensus forecast.

House Completions (Units)

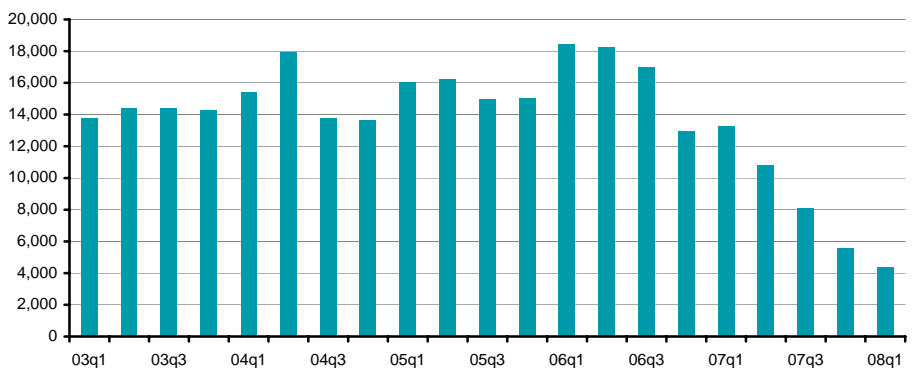


DoE

...but the trend is clearly weaker...

Forecasts of house completions are tentative in the Irish context because there are no published figures on housing starts. Much attention is given to Bond Registrations but these are taken out for insurance purposes by builders and developers and are not required by public sector contractors or on individual homes, the latter accounting for 25% of total completions in 2007. Nevertheless, registrations are a useful guide and we use them in our own forecasting models, albeit with adjustments. Registrations began to slow in the fourth quarter of 2006 and this trend became more apparent through 2007, with registrations at 5,600 in Q4, a 56% decline on the previous year. This pattern implied a further fall in house completions in the first quarter of 2008 and this duly emerged; completions were in line with our forecast at 14,000 and 30% down on an annual basis. Registrations have decelerated further in the first quarter, declining by 68% on the previous year, which implies a further supply contraction as the year unfolds, although the monthly data for April does suggest that registrations may be close to the bottom. This expectation is supported by data on house commencement notices, which are provided to local authorities by private sector contractors, showing a 50% fall in activity in the year to the fourth quarter of 2007, with only 7,600 notices. Data is only available for the first two months of 2008, and shows 5,500 notices and a similar percentage decline as in Q4 on an annual basis.

New House Guarantee (Units)



DoE

**...with 50,000 completions
forecast in 2008.**

Published data to April 2008 on completions put the figure at some 19,000. It seems clear then that completions will fall sharply in 2008 as a whole; we forecast a total of 50,000 which is in line with the consensus view, although the latter has been drifting lower. This figure is also around or below the most recent estimates of housing demand, which is put at some 50,000 by the ESRI and around 60,000 by the Irish Central Bank. The trend in planning permissions also suggests that supply may also be above 50,000 in the medium term; permissions amounted to 78,000 in 2007, down from over 93,000 in 2006 but showing a recovery in the second half of the year, with permissions up 9% on an annual basis in Q4.

Irish Housing Supply

	Housing Completions	New Home Registrations
1996	33700	23769
1997	38842	27080
1998	42349	29067
1999	46512	33852
2000	49812	34613
2001	52602	28845
2002	57695	51157
2003	68819	56859
2004	76954	60782
2005	86000	62284
2006	88400	66650
2007	78000	38352
2008(f)	50000	25000

DoE

Mortgage Lending

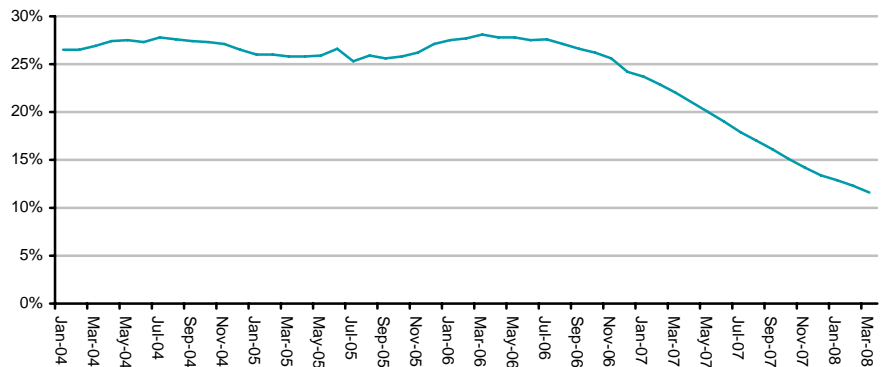
The pace of mortgage growth has slowed since 2006...

The pace of mortgage lending growth has slowed across Europe and Ireland is no exception; the annual change in euro-zone mortgage lending was 6.1% in March, about half the pace recorded at the peak of the cycle, and the Irish figure was 11.6%, down from 22.0% a year earlier and a cyclical high of 28% in the spring of 2006. Clearly, Irish lending growth is still substantially stronger than the European norm, but the trend represents a significant departure from recent Irish experiences, as the annual growth in mortgage lending has been above 20% since mid-2002. Moreover, a closer examination of the trend shows that the deceleration is not yet over, as the three-month annualised figure is running at under 8%.

The change in the mortgage stock depends on the flow of gross mortgage lending and redemptions, and information on the former is provided by the DoE, and more recently by the Irish Bankers Federation (IBF). The IBF figures showed the value of lending slowing sharply from late 2006, no doubt reflecting the impact of rising ECB rates, with the result that total gross mortgage lending in 2007 fell by 15% to €33.8bn from some €40bn in 2006. These figures include re-mortgaging and top-ups, so the figure for house purchase was lower, at €22.4bn, or 19% down on the previous year. The first-time buyer market held up best, with new loans down by 14%, followed by the buy-to-let sector (loans down by 18%), with the loans to existing house owners who moved house declining by 23%.

...with gross new mortgage lending still falling.

Mortgage Lending (%)



Central Bank

The data for the first quarter shows no sign of a rebound; gross lending emerged at €6.3bn, down 20% on an annual basis, the same percentage as in the fourth quarter. Loans for house purchase fell more sharply, by 29%, this time led by first-time buyers. The pace of decline may start to bottom out as the year unfolds but for 2008 as a whole we expect gross mortgage lending to fall to €29bn. This implies that the growth of mortgage stock will decelerate further, to 8%, but this may prove to be the cyclical low.

Mortgage Lending for House Purchase

	No. of Mortgages	Average Value (€000)	Total Market (€bn)
1998	61407	74.7	4.5
1999	70817	92.1	6.5
2000	74258	102.4	7.6
2001	66786	114.7	7.6
2002	79292	136.5	10.8
2003	84750	159.6	13.5
2004	98709	171.5	16.9
2005	107700	200	21.5
2006	111250	229.2	25.5
2007(e)	84600	238	20.2
2008(f)	67500	238	16

DoE estimates

Affordability

Affordability has deteriorated...

The term affordability has a number of interpretations in relation to the housing market, but we define it in terms of servicing a mortgage relative to average income. This is straightforward in principle but less so in practice, given definitional and data issues. There is no official Irish data on average earnings, for example, gross or net, and tax relief on mortgages varies through time and across groups of buyers (first-time buyers currently receive a substantial fiscal incentive relative to other borrowers). Our own model takes the cost of an average new 25-year repayment mortgage and compares it to average gross income, which is derived from data on total employees and aggregate wages and salaries. In 2007, for example, the mortgage cost was €1,364 a month, which amounts to 38.9% of our income estimate of €42,100.

This compares with an average ratio over the past thirty years of 28.5% but one doubts if a mean reversion model is appropriate in this case, as the trend is likely to be upward through time, given a change in lender's attitude to mortgage debt, the decline in the tax burden in Ireland, the trend to longer maturity loans, and membership of the euro, which represented a regime shift in terms of Irish interest rates.

Affordability (%)



Economic Research Unit (ERU)

...from 2005 through to 2007...

Nonetheless, the model does provide some insights as it picked up a clear deterioration in affordability in the period 2005-2007, reflecting higher interest rates and a rise in the average size of a new mortgage. As such, it provided a clue that the housing market was likely to slow. Consequently, it is interesting to note that affordability now looks set to improve in both 2008 and 2009 which should provide some support for mortgage demand. The initial catalyst for the improvement is simply higher incomes, as earnings in Ireland are forecast to rise by 4.9% this year and 4.5% next. The increase in the average new mortgage for house purchase is also set to slow in 2008, following a 6% plus rise in 2007, and we are projecting a half point cut in interest rates in the second half of this year, which will have a full impact in 2009. Consequently, the model shows affordability improving to 37.1% in 2008 and 35% in the following year.

...but looks set to improve this year and next.

In practice, the trend towards longer mortgage terms means that the model now overstates the first year repayment burden. For example, if one assumes a 30-year mortgage, the repayment burden in 2008 would be 34% and not 37.1%. Similarly, the burden would be lower still for first-time buyers, as a married couple can offset €20,000 a year in mortgage interest against the standard (20%) tax rate.

Affordability

	Mortgage Cost (% of average earnings)
1995	21
1996	20.2
1997	23.1
1998	26.2
1999	24.7
2000	25.3
2001	27.7
2002	28.6
2003	28.6
2004	28
2005	30.5
2006	35.5
2007 (e)	38.9
2008 (f)	37.1

ERU

Interest Rate Outlook

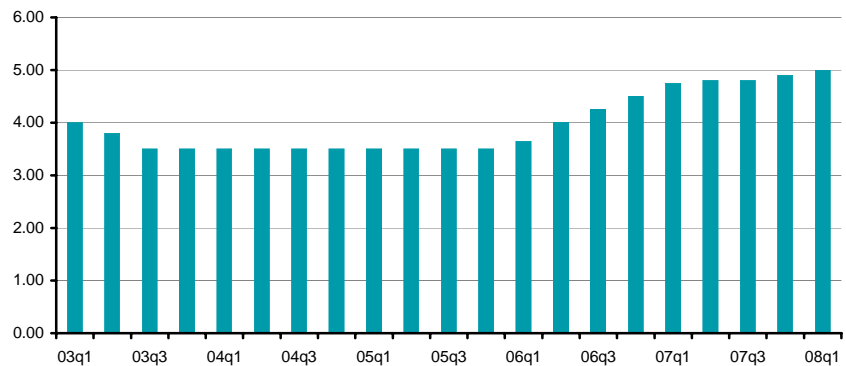
The ECB has not moved...

The ECB last changed interest rates in June 2007, the quarter point move bringing the repo rate to 4% and the cumulative increase in the tightening cycle to 2 percentage points. Since then we have seen the onset of the credit-crunch, a sharp slowdown and possible recession in the US and interest rate reductions by the Federal Reserve and the Bank of England. Rates in the US have fallen to 2% from 5.25%, while the reduction in the UK has been three quarters of a point, taking rates there to 5%. The euro-zone economy has also started to slow, and the consensus growth forecast now projects GDP growth of 1.6% in 2008, from 2.6% last year, followed by another year of sub-trend growth in 2009. This should put downward pressure on inflation and hence prompt the ECB to lower rates, just as it did during the last cyclical slowdown in 2001-2003, when rates fell from 4.75% to 2%. This expectation was certainly well entrenched in the financial markets in the early part of the year, but in the past month expectations have changed markedly, and the market is no longer expecting any rate cut. This change in sentiment largely reflects the rhetoric emanating from the ECB, where council members are concerned about the recent acceleration in inflation, which reached 3.6% in March before falling to 3.3% in April. Yet, inflation was 3.1% when the ECB started to cut rates in May 2001, showing that their rate decisions are based on their forecast for economic activity and inflation some eighteen months forward. Consequently, we still believe that the repo rate will fall in 2008, in response to a steady slowdown in economic activity, and retain our forecast of a half-point reduction, albeit pushing the first cut in to the third quarter.

...but weaker activity will prompt them to ease.

For mortgage lenders, the cost of funding mortgage rates is not the repo rate, however, but wholesale market rates, which have risen sharply despite the unchanged ECB policy rate. Consequently, the past few months has seen an upward drift in the average mortgage rate paid by new borrowers. Central Bank data shows that this was 5.05% in March, from 4.9% in September. The elevated level of wholesale rates is expected to unwind somewhat over time but it has been a slow process so any material reduction in rates would probably require an ECB rate move.

Mortgage Rate (%)



Central Statistics Office (CSO)

Commercial Property

The cycle has clearly turned...

The returns on most asset classes tend to be cyclical and that is particularly true in commercial property, given the lags inherent on the supply side. In the Irish case, the market peaked in terms of momentum in September 2006, with annual returns of over 30% on the IPD index, and has slowed since then, albeit at a modest pace for most of 2007. This was to be expected, given that the prospect of further yield compression seemed low last year, funding costs had risen and the yield on alternative investments (equity, bonds) had also moved higher.

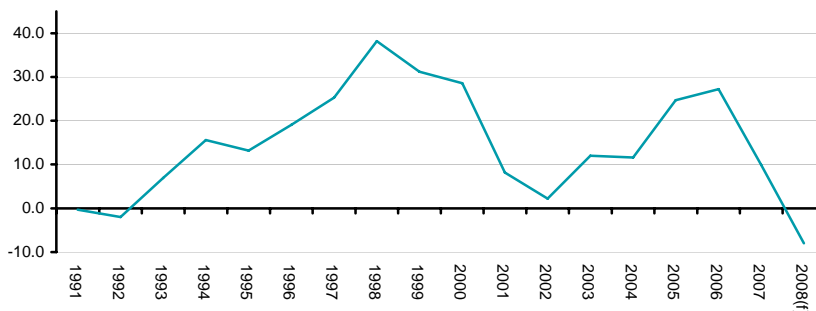
Each cycle carries its own unique features and in this case the credit crunch has emerged as a key overlay, hitting investor confidence and impacting the funding of transactions, via the supply and price of funds. The impact was far less pronounced in Ireland than the UK in the fourth quarter of last year, it has to be said, as returns here in the quarter were positive, albeit at only 1%, the weakest since March 2003. This left the annual return on Irish commercial property at 9.9%, compared with 27.2% in 2006, following capital growth of 5.8% and income growth of 3.9%.

The first quarter of 2008 has seen a much more pronounced re-pricing however, with yields moving higher across the board, led by the retail sector. Capital growth fell by 3.6% in the quarter in that sector, and by 3.4% in the office sector, so contributing to a 2.8% negative return for the former and a 2.4% decline in the latter. Industrial proved the exception, with a modest positive return (0.4%) thanks to an upturn in income growth.

...with returns set to fall this year.

This still left the annual return for Irish commercial property in positive territory, at 4.9%, but it seems inevitable now that yields will rise further in the coming quarters, so pushing the total returns into negative territory – we forecast a 5% decline on the IPD index for the year as a whole. Sentiment in the retail sector is likely to remain subdued given the deceleration evident in consumer spending and the office market may also see yields move drift higher, although a number of large financial institutions are publicly seeking new head-office space.

Commercial Property Returns



SCS/IPD

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