

The Irish Property Review

A Quarterly Analysis – March 2007

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Summary

Market cools... |

The Irish housing market is cooling, as we expected, with price pressures abating, the growth in mortgage lending decelerating and house completions declining. Last year now looks more clearly like a cyclical peak for the market, in terms of growth, although we do not envisage an abrupt change in market conditions, delivering the 'soft landing' referred to previously – house price inflation will still be up on 2006, completions may well exceed 80,000 this year, gross mortgage lending for house purchases will again be around €25bn (comparable to the recent Irish Banker's Federation data of €40bn for 2006, which includes re-mortgages and top-ups), and the growth in the level of outstanding mortgage debt will still rise by around 20%.

House price inflation has certainly slowed, according to the permanent tsb / ESRI house price index. Prices nationally rose by 11.8% last year, but this reflects a surge in the early months of the year, with a deceleration evident from the summer – prices nationally rose by 0.8% in the fourth quarter, following a 2.8% increase in the third, and 4.2% in Q2. Indeed, prices rose by just 0.3% in the three months to January, although the annual change was still over 10%, with Dublin holding up better than the rest of the country – prices in the capital rose by 1% over the three months, and by 14.7% in the year.

The macro-economic backdrop has not materially changed of late; employment grew by 85,000 in the twelve months to November, accompanied by a similar growth in the labour supply, in turn augmented by substantial immigration. There has been a series of high profile redundancies over recent months but these layoffs are in line with the five year trend which has seen redundancies running at over 20,000 a year. The 2007 Budget also provided a substantial fiscal incentive for first time buyers, with a couple now allowed to offset €16,000 of mortgage interest against tax. On a €300,000 mortgage this would allow them to borrow an additional €25,000. Moreover, private sector rents rose by over 10% in the twelve months to February, which clearly implies that the overall demand for housing remains strong and that rental yields are beginning to rise.

...but rents
rise sharply.

Expectations of a reduction in stamp duty may be a factor in persuading some people to postpone purchase, expectations that are unlikely to be dampened in the current pre-Election period, but a more fundamental factor is affordability – we have been emphasising for some time that the tightening cycle would put pressure on house prices by raising the cost of servicing a mortgage relative to income. This ratio will rise to over 38% in 2007 according to our model, and to 39% in 2008, which means that house price inflation may fall short of income growth for a number of years, allowing incomes to ‘catch up’ to some degree on growth levels seen in house price inflation. Consequently, we reiterate our 3% house price inflation forecast for 2007; the market may receive some support in the second half of the year on the expectation that 4% may be the peak of the rate cycle.

The broader economic impact of higher rates may be limited however, as total interest payments on all household debt are low in Ireland – we estimate the figure at 7% of household disposable income in 2006.

On the mortgage side, we expect gross lending for house purchase in 2007 to be broadly unchanged on the 2006 estimate of €25.7bn, with a fall in the number of new mortgages offset by a further rise in the average size of a mortgage. This decline in volumes reflects our expectation of a fall in house completions, which we now expect to come in at 82,000, from our previous forecast of 85,000. This compares with 93,400 in 2006. Gross mortgage lending including re-mortgages and top-ups will also be broadly unchanged at just under €40bn.

Finally, the commercial property market performed very much in line with our forecast last year, with the return of 27.2% compared to our 28% projection. Again, though, the cycle has peaked, and we reiterate our 12% forecast return for 2007, as there appears to be little further scope for yield compression in the Irish market.

Dr. Dan McLaughlin

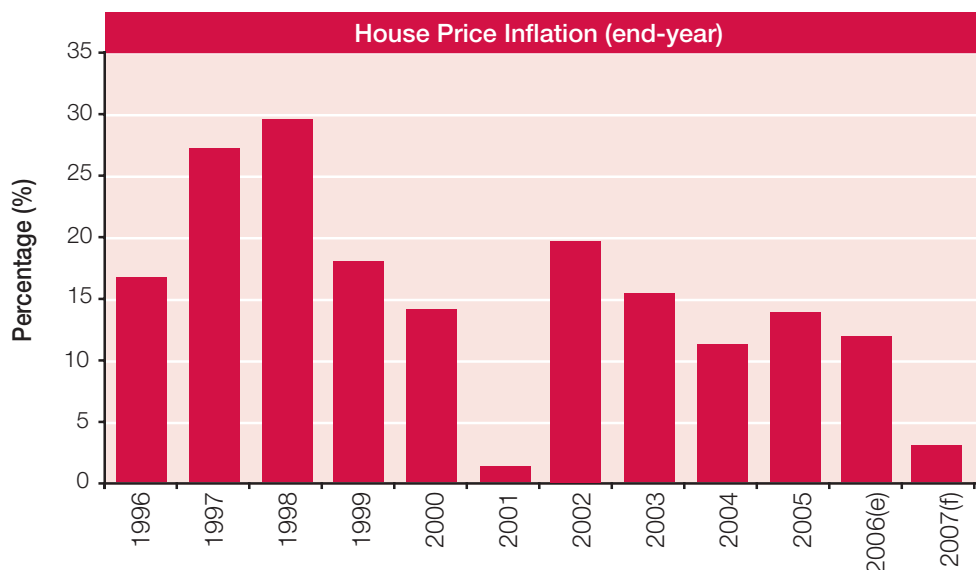
March 2007

House Prices

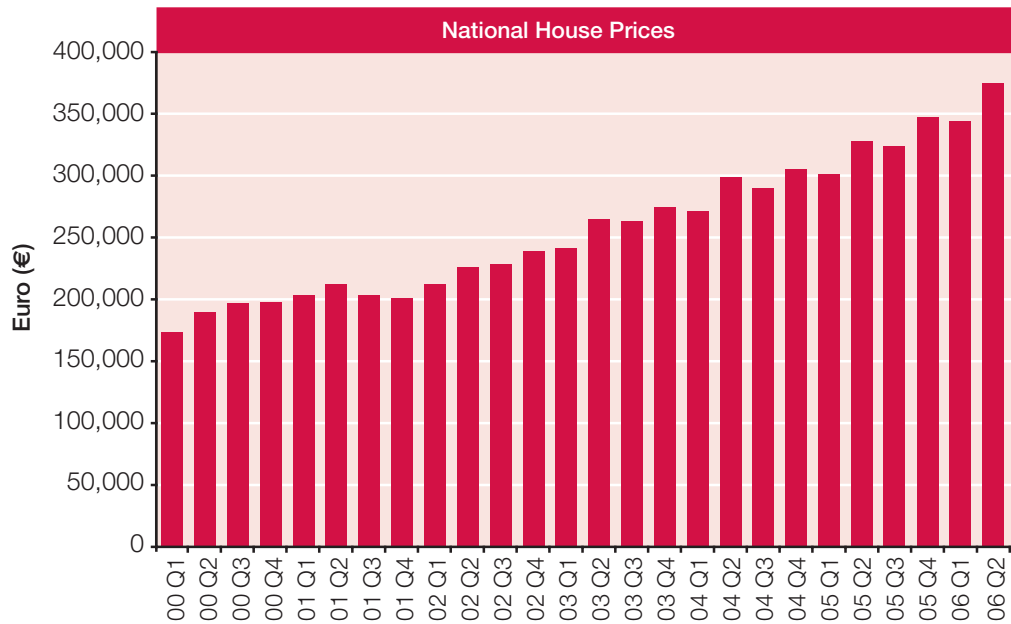
Prices rose by 11.8% in 2006...

House prices rose strongly in 2006, according to the permanent tsb / ESRI house price index, recording an annual increase of 11.8% nationally, following a gain of 9.3% in 2005. Prices in the capital outpaced the national average, rising by 15.9% last year. These double digit gains were largely due to a surge in prices from late 2005 to the summer of 2006, however, and the market appears to have cooled considerably of late, as we forecast some time ago, with prices nationally rising by just 0.3% in the three months to January 2007, and prices outside Dublin rising by 0.2%, against a 1% increase in the capital. Unfortunately, the price data from the Department of the Environment (DoE), which is the most comprehensive available, has yet to be published for the second half of 2006, which would perhaps confirm this trend but other evidence from estate agents provides some support.

The acceleration in prices in the early part of 2006 was perhaps surprising, given that house completions last year rose by 15% to over 93,000, but survey evidence from the Central Bank does show that competition in the mortgage market prompted an easing of credit standards by some lenders, with a rise in loan to value ratios, higher lending multiples and an extension of mortgage terms. The macro-economic backdrop was also supportive, of course, with over 6% growth in the economy last year, underpinned by buoyant household income, fuelled by employment growth which averaged 4.4%, or 87,000. One should also remember that the 2007 Budget provided a substantial boost to first time buyers, with a married couple now allowed to offset €16,000 of interest a year against tax, double the original €8,000, which means that a couple who could afford a €300,000 mortgage has the option to increase this by over €25,000 to keep the same net monthly payment.



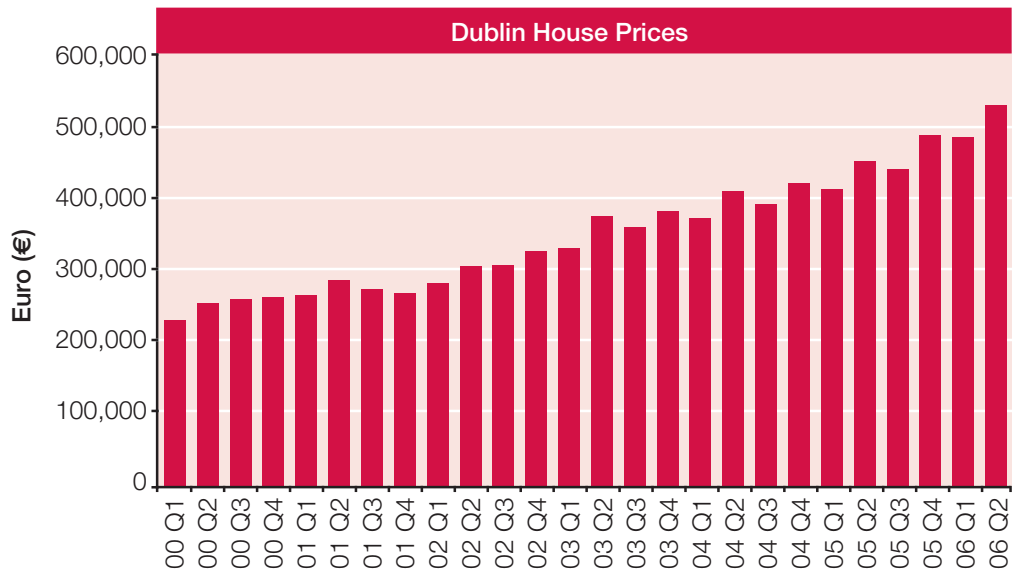
Source: Department of the Environment (DOE)



Source: DOE

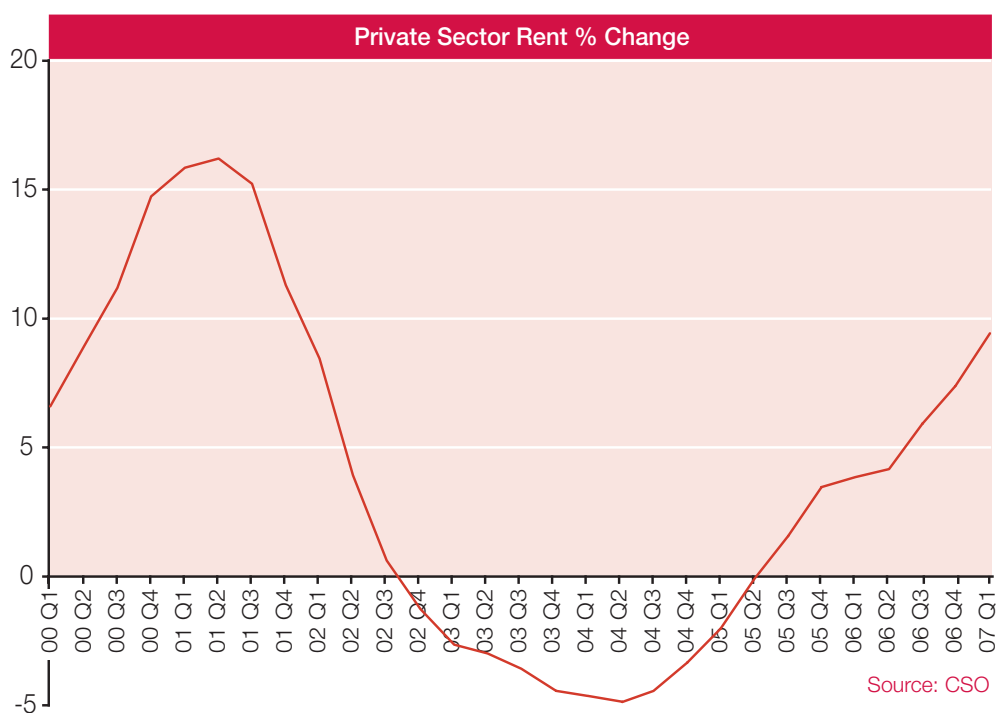
...but inflation has slowed appreciably of late.

Yet price inflation has clearly slowed of late although there has not been any material change in the labour market. Yes, there has been a series of high profile job loss announcements, but announced redundancies have been running at around 2,000 a month for the past five years with no marked change this year. Indeed, manufacturing employment actually rose in the second half of 2006, according to the Quarterly Household Survey. Moreover, the same survey showed further strong inflows of migrant workers, implying that overall immigration flows have remained firm. Private sector rents have also risen sharply of late, by 10.3% in the twelve months to February according to the CSO, which again would imply that demand for housing remains firm.



Source: DOE

We put the easing of price pressures down to two factors, one more short-term than the other. The more transitory influence came into the market in the latter months of 2006 and relates to expectations about a reduction in stamp duty on housing, a hope that has been given further oxygen in this current pre-General Election period. This may have persuaded some potential buyers to wait, perhaps also contributing to the rise in rents, although a reduction in stamp duty may well benefit sellers more than buyers.



Source: CSO

Second-hand Irish House Prices (Nationally)				
		€ (000)	% change	Year over year (%)
1998		134.5	31.0	
1999		163.3	21.4	
2000		190.6	16.7	
2001		206.1	8.2	
2002		227.8	10.5	
2003	Q1	243.6	1.1	14.2
	Q2	267.6	9.9	17.9
	Q3	266.4	-0.4	16.1
	Q4	277.8	4.3	15.3
2004	Q1	274.3	-1.3	12.6
	Q2	301.6	10.0	12.7
	Q3	293.1	-2.8	10.0
	Q4	308.9	5.4	11.2
2005	Q1	304.8	-1.3	11.1
	Q2	332.2	9.0	10.1
	Q3	327.9	-1.3	11.9
	Q4	351.5	7.2	13.8
2006	Q1	348.6	-0.8	14.4
		379.0	8.7	14.1

Source: DOE

Of more significance is our view of the impact of rising interest rates on affordability, a process we have discussed in previous 'Reviews'. As we pointed out some time ago, the cost of servicing a new mortgage relative to income has now reached levels which will impact on the market – our model puts the cost at 38.1% in 2007, on the assumption that ECB rates will rise to 4% over the next few months, and to 39.4% in 2008, as the full impact takes effect. Consequently, we reiterate our view that house price inflation will lag that of income growth for the next few years – we had forecast a 3% rise in house prices in 2007 and we remain comfortable with that view. Conditions in the economy would need to be very different to precipitate a substantial fall in prices in the aggregate, but the combination of higher rates and higher mortgages is finally impacting.

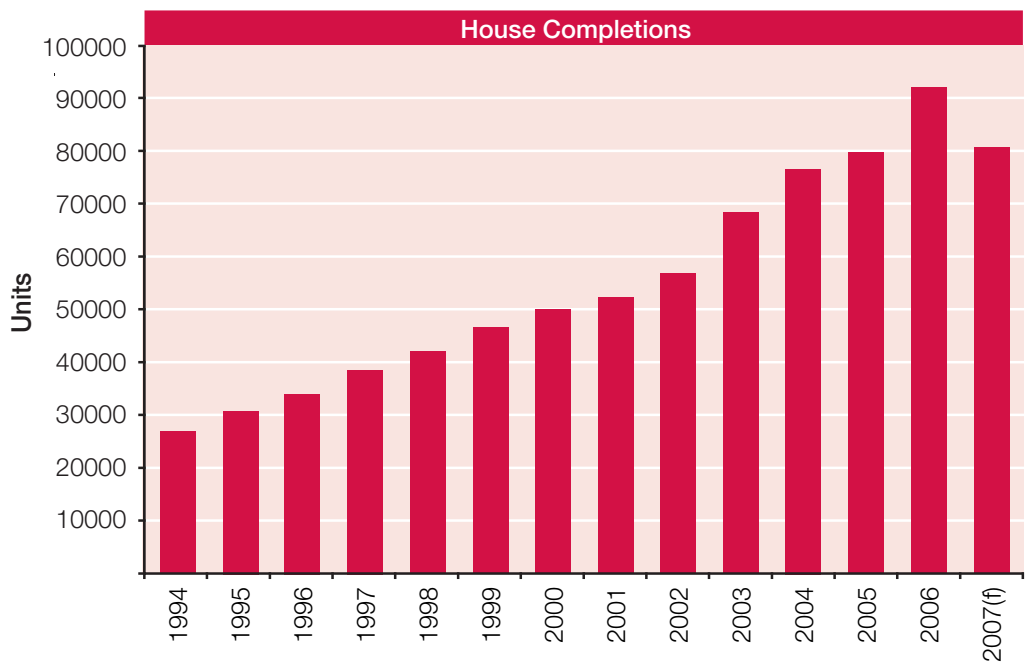
Expectations are also important in the housing market, be it in terms of prices, economic conditions, employment prospects and the interest rate outlook. Sellers of property appear to be adjusting to the new market realities with evidence pointing to a reduction in asking prices, the latter reflecting expectations of further double-digit price inflation, expectations that are no longer appropriate. Sentiment on the buyers side may improve later in the year if it becomes clearer that 4% will prove the peak of the rate cycle.

House Completions

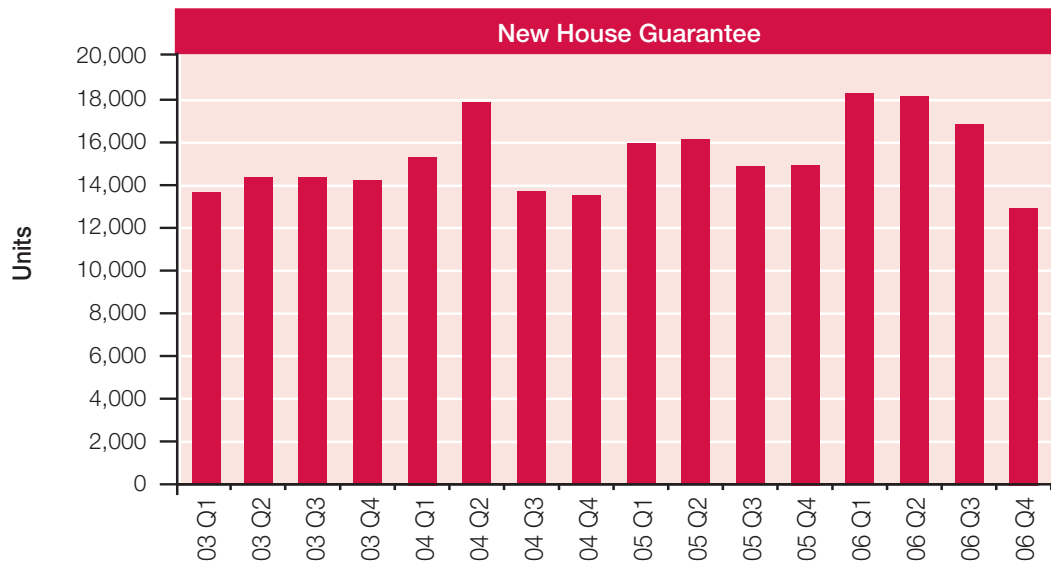
Another record last year...

In our previous 'Review' we noted that housing completions had consistently surprised to the upside in recent years and revised up our forecast for 2006 to 95,000. In the event, the official figure put total completions at 93,419, a new annual record, and equivalent to a 5.6% addition to the total housing stock. Indeed, the housing stock has risen by 40% over the past decade and by 26% in the past five years alone, which implies that the planning process, often cited as a major constraint, cannot be too much of a barrier to supply, in the aggregate at least.

Looking at the composition of that supply perhaps a surprising feature is the continued importance of individual house construction, as opposed to housing developments, with the former accounting for just under 25% of the total. The number of apartments has risen to over 22% of completions in recent years, with 2006 seeing a slight decline in the share held by apartments, to 21.4%.



Source: DOE



Source: DOE

...but lower total expected in 2007.

The majority of the 20,000 apartments built last year were in Dublin (11,500) but total house completions in the capital were under 21% of the total, and falls were recorded in South Dublin. House buyers employed in the capital have sought housing further ahead, and other counties in Leinster have seen substantial increases in supply. Kildare, for example, saw completions rise by 34% last year, with strong increases also recorded in Kilkenny (29%), Laois (25%), Longford (37%) and Offaly (33%). Supply in Meath fell, however, by 3.5%, and as did completions in Wicklow which plunged 16%.

Last year may well prove to have been the peak in terms of total completions, as the available indicators generally point to a lower total in 2007. Certainly, the pace of completions slowed anyway in the second half of 2006, with the 27,000 recorded in the final quarter up just 1.5% on the previous year. Moreover, other data that act as a proxy for housing starts (there are no official statistics), imply a further deceleration in the coming months. New House Guarantees (which excludes once-off and public sector developments) fell very sharply in the final quarter of last year, declining by 14% year-over-year, and the available data for the early part of 2007 imply an even steeper correction. This implies total completions of some 36,000 in the first half of the year, on our own models, which would be some 18% below the corresponding total in 2006. The number of planning permissions has also fallen sharply, with the total over the first nine months of 2006 amounting to 62,500 against over 78,000 in the first three quarters of 2005. The number of commencement notices in 2006 was also down on the same period of 2005, albeit this time only marginally.

The conclusion is inescapable; completions will be lower in 2007, although the data on employment in construction would not point to a sharp contract in construction output overall. We had anticipated a completion decline in 2007, to 85,000, but in the light of the most recent data we are revising the forecast down to 82,000 and the risks appear to be on the downside.

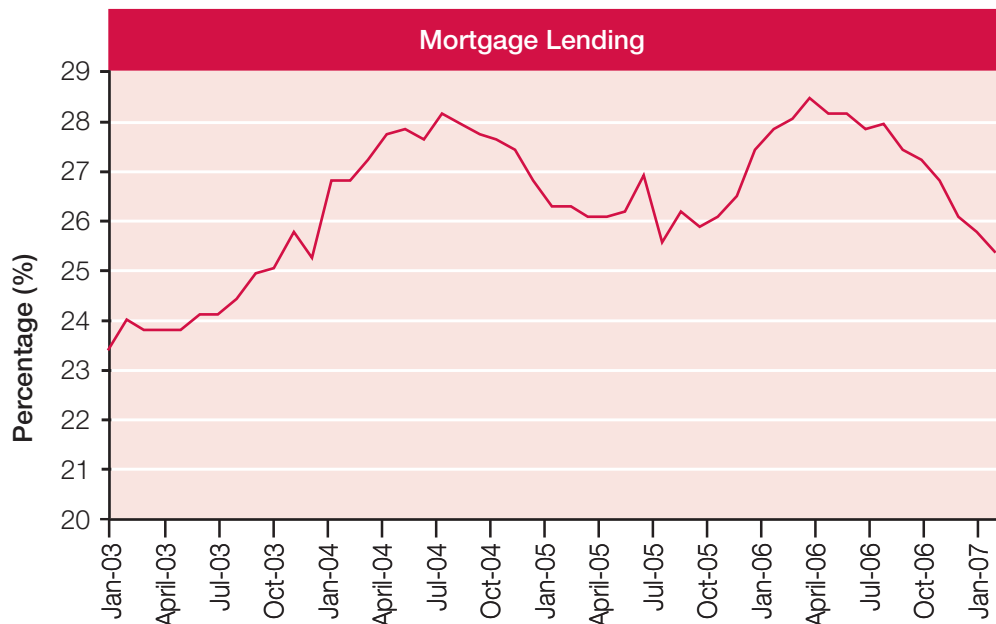
Irish Housing Supply		
	Housing Completions	New Home Registrations
1996	33,700	23,769
1997	38,842	27,080
1998	42,349	29,067
1999	46,512	33,852
2000	49,812	34,613
2001	52,602	28,845
2002	57,695	51,157
2003	68,819	56,859
2004	76,954	60,782
2005	81,000	62,284
2006	93,400	66,650
2007(f)	82,000	56,000

Source: DOE

Mortgage Lending

Momentum peaked last March...

The most timely data on lending in the mortgage market is reported by the Central Bank, although it is a net figure (i.e. it is the difference between all gross mortgage lending minus redemptions), and therefore provides no information in terms of the numbers taking out mortgage loans or the average size of such loans. Nevertheless, it captures the change in the size of the outstanding mortgage stock and on that basis the Irish mortgage market reached peak momentum in March 2006, when the annual growth in mortgage debt rose to 28.1%, a record high. Since then, the pace of debt accumulation has decelerated, albeit mildly, slowing to 25.5% at end-year, with the outstanding level of mortgage debt standing at €111bn, or €123bn if one adjusts for mortgage securitisation, which takes loans off banks' balance sheets. January saw a further slowing, to 25%, reinforcing the view that higher rates are finally impacting on the demand for loans.



Source: CENTRAL BANK

The Department of the Environment (DoE) is another source of data on mortgage lending, this time providing quarterly figures on gross new lending for house purchases. Unfortunately, the most recent available data only covers the first half of last year, but using these figures alongside the Central Bank data leads us to believe that gross lending for house purchases amounted to €25.7bn in 2006, a 19% advance on the previous year. The number of new mortgages rose by 16% in the first half of the year, but we estimate a rise for the whole year at around 10%, on the assumption that activity slowed in H2.

Nevertheless, this still implies over 118,000 new mortgages for house purchases, a new record. This volume figure alongside the total amount lent implies an average new mortgage of €216,000 in 2006, an 8% increase on the previous year.

...with 20%
growth seen this
year.

The DoE data does not capture equity release, nor indeed, re-mortgaging, and the Irish Banking Federation (IBF) has attempted to capture this by conducting a survey of its own members, which account for over 95% of mortgage lending. The IBF data is likely to become a standard reference for the mortgage market in the future. On that basis, gross lending amounted to some €40bn in 2006, a 17% rise on the previous year. That source also shows a slowdown in the second half of the year, this time pronounced, with the value of loans in Q4 unchanged from the previous year.

The trend in mortgage lending therefore seems well established, and we expect the stock of outstanding mortgages to rise by around 20% this year, still strong by international standards but the slowest pace of growth in Ireland since 2001. In terms of gross lending for house purchases, this translates into a gross flow of €25.6bn, the same figure as in 2006, with a 7% decline in new mortgage numbers offset by a similar increase in the average mortgage size.

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	200.0	21.5
2006(e)	118618	216.4	25.7
2007(f)	109880	233.2	25.6

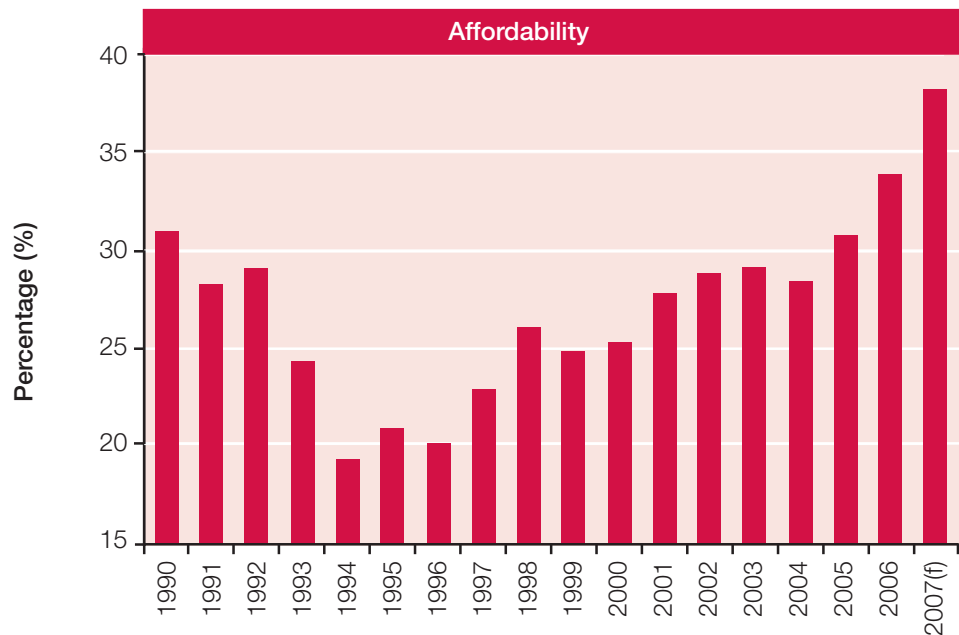
Source: DOE estimates

Affordability

New mortgage costs 33.8% on income in 2006...

Affordability, a concept first popularised by this 'Review', has now become commonplace in any analysis of the Irish housing market. The concept – the cost of servicing a mortgage relative to income – is attractive as it takes account of interest rates, the growth in household income, and the change in the size of mortgages, which in turn is related to house price inflation. Through most of the 1990's, affordability was extremely benign and therefore not much discussed as falling interest rates and rising incomes offset the impact of rising house prices. The last few years have been different however, with a rising interest rate environment playing out alongside further increases in mortgage size, and combining to more than offset the steady upward move in average incomes.

The change became most apparent in 2006 when mortgage rates rose as the ECB embarked on its tightening cycle. The average new mortgage for house purchase also rose, to an estimated €216,000, from €200,000 a year earlier. Average earnings increased, of course, by just under 5%, to €40,000, but the result was that the first-year cost of servicing the average new mortgage (assuming a 25-year term) rose to 33.8% of earnings, against 30.7% the previous year and a thirty year average of 28%.

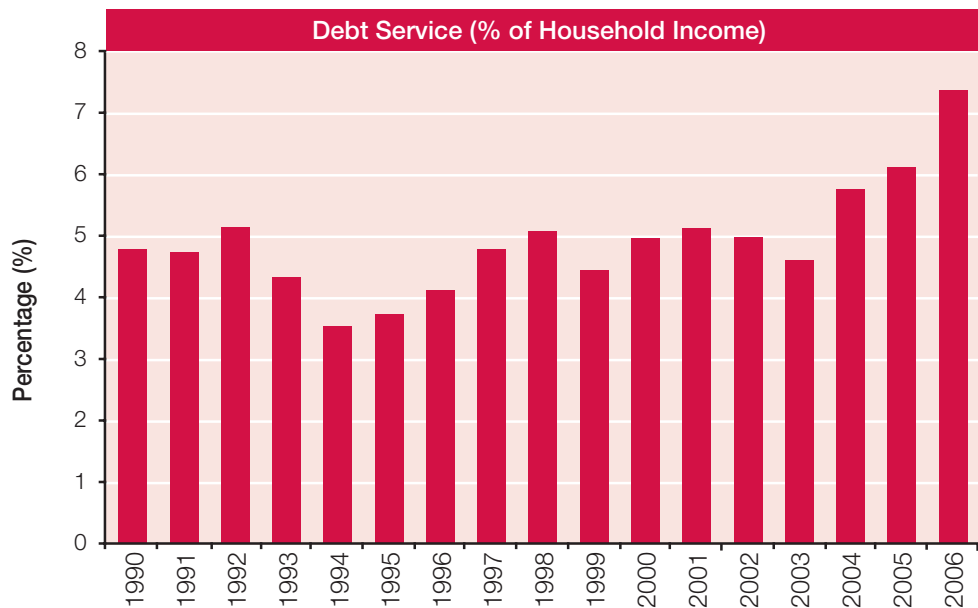


Source: Economic Research Unit (ERU)

...rising to over 38% this year.

Clearly then, affordability deteriorated last year, but not to levels that might seriously impact the market, particularly as survey results from the Central Bank indicated that some lenders eased mortgage credit conditions – loan to values ratios rose, as did income multiples, and mortgage terms were extended. These changes cannot be repeated every year, and affordability is likely to deteriorate further in 2007 and 2008, reflecting the full impact of rising mortgage rates, which we assume will reach 5% in the second half of this year.

The increase in the size of new mortgages will also slow, and earnings will continue to rise by around 5% per year, but the result is that the cost of servicing a new mortgage rises to 38.1% of income in 2007 and then 39.4% in 2008. This level of servicing was last seen in the early and mid-1980's, when interest rates were over 15%, and can be expected to have an impact on the market. Affordability will therefore have to be rebuilt which will eventually happen when the interest rate cycle turns, but in the short-term the growth in average income is likely to outpace house price inflation.



Source: Central Statistics Office (CSO)

From a broader economic perspective, one should note that there are far more savers than borrowers, and that aggregate interest payment on debt is still relatively low; we estimate that the cost of servicing residential mortgages and non-mortgage personal debt amounted to 7% of household disposable income in 2006.

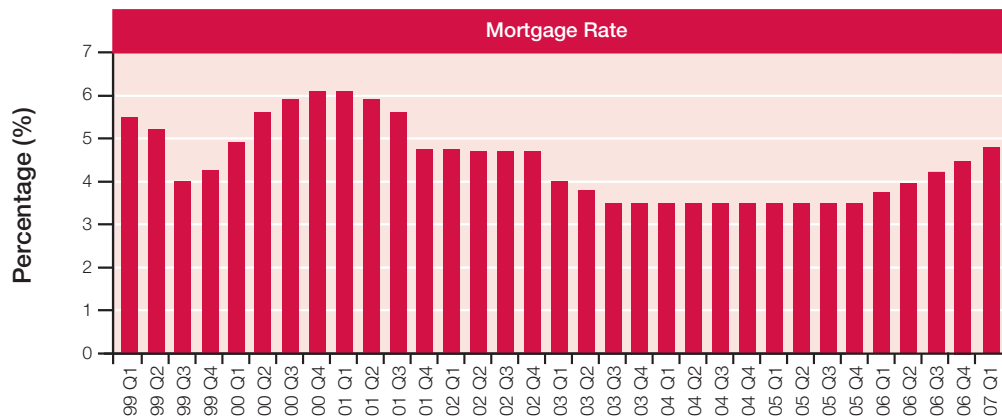
Affordability	
	Mortgage Cost (% of average earnings)
1995	21.0
1996	20.2
1997	23.1
1998	26.2
1999	24.7
2000	25.3
2001	27.1
2002	28.6
2003	29.0
2004	28.3
2005	30.7
2006	33.8
2007	38.1

Source: ERU

Interest Rate Outlook

ECB to raise rates again...

The ECB commenced the current tightening cycle in late 2005, when rates were at 2%, and the most recent increase brought official rates to 3.75%. This resulted in a similar increase in mortgage rates for most Irish borrowers, as the vast majority of Irish outstanding mortgages are on variable rates, with tracker mortgages (which have a constant margin over the ECB rate) increasingly popular. Unfortunately for such borrowers, rates look set to rise further, but 4% may well prove to be the peak of the cycle.



Source: Central Statistics Office (CSO)

The prime factor behind the move to higher rates is the pick-up in the economic performance of the euro area; GDP growth was 2.75% in 2006, from 1.4% in 2005, and the best performance in six years. Moreover, economic growth was particularly strong in the final quarter of 2006, implying strong momentum in the early part of this year, leading forecasters to revise up projections for 2007 – the ECB now expects euro area growth of 2.5% compared to a forecast of 2.2% made in December.

...but 4%
may be peak.

The amount of money circulating in the euro area has also risen at a pace which is of a concern to the Bank, adding to the arguments for raising rates again. Yet inflation remains well behaved and is forecast by the ECB to be around 2% over the next two years, and bank lending growth appears to be slowing, particularly in relation to mortgage borrowing. On that basis, we doubt if rates will rise above 4%, particularly if the US economy continues to grow at a sub-trend rate, prompting rate cuts in the US, although it has to be said that the rate risks in Europe are probably on the upside.

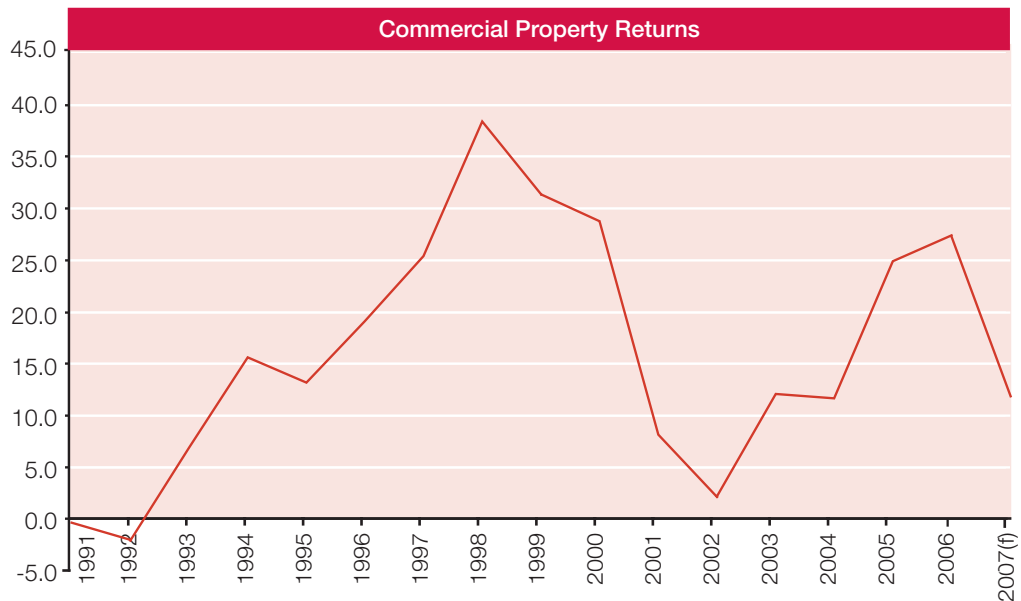
Risk-averse borrowers may be tempted to fix to protect themselves from an upside surprise, but a fix for three or four years at this stage of the cycle also means that borrowers will not benefit if the rate cycle turns in 2008 or 2009.

Commercial Property

Cycle peak in 2006...

The past few years have seen international commercial property returns soar. Demand from financial institutions and private investors have driven down yields, so returns have been dominated by capital appreciation. Last year may have marked a cyclical peak in this process, however, as property yields are now low relative to the risk-free rate of return (proxied by the yield on long term government bonds), notably in Ireland, and as a result returns may be less spectacular in 2007, albeit still in double digits.

The latest IPD/SCS index confirms that 2006 was an extremely buoyant year for commercial property in Ireland, with total returns of 27.2% compared with 24.3% the preceding year, and the best return since 2000. The outturn was also very close to our 28% forecast, and the sectoral split was also in line with our expectations, with the office sector (27.6% return) outperforming retail (26.7%), for the first time in six years.



Source: SCS/IPD

...with 12%
returns seen in
2007.

The office sector is more cyclical than retail because business spending is more volatile than that of the consumer, reflecting global trends in corporate confidence. The world economy has experienced an unprecedented global boom in the past three years, and the corporate sector has rarely if ever been as healthy, particularly in the service sector, which in turn has driven demand for office space. Employment in the service sector has risen sharply in recent years, notably in financial, business and professional services and the take-up of office space was at record levels last year in the Dublin market. Vacancy rates fell further as a result, declining to under 11%, and lower still in the City Centre. Rents have picked up as a result, rising by 3.8% in the year to the fourth quarter of 2006 according to IPD. Yet, this is still dwarfed by capital growth of 21.7%, and the equivalent yield on the office sector in Ireland is now under 4.5%.

The equivalent yield in the retail sector ended the year even lower, at 3.3%, following a capital gain of 22.8% in 2006. Retail growth did pick up through the year, however, notably in the fourth quarter to give an annual rise of 7.1%. Demand from prime retail space remains strong, underpinned by buoyant consumer spending, which saw the value of retail sales excluding cars rise by 6.9% in 2006. Moreover, retail spending re-accelerated in the final quarter, pointing to a strong performance in 2007. Supply has also risen however, and this year will see new shopping centres in Dublin, extensions to a number of existing centres in and around the capital, and the opening of a number of new retail developments throughout the country.

A number of significant new industrial schemes are also due for completion in 2007, as demand in that sector has also been strong, particularly in areas with easy access to the motorway network. The sector returned over 25% last year, the best performance since 1999, and the equivalent yield is still a relatively attractive 5.9%, implying some prospect for further yield compression.

The potential for such compression appears limited in the other two sectors however, although the weight of money chasing assets in the retail and office sectors may well drive yields a little lower. Consequently, we reiterate our view that returns will decelerate to 12% in 2007, with rental growth and the prospect of such growth becoming a more important issue.

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