



## THE IRISH HOUSING MARKET

### They think it's all over ... but it's not

- The Irish housing market remains in very good health, despite some fears.
- The housing market is being supported by a robust overall economic performance, particularly continued strong employment growth. This should support further high levels of net inward migration. Domestic demographic trends are also favourable.
- Thus, housing demand remains well underpinned. However, deteriorating affordability conditions are impacting on buyers' ability to realise their demand.
- Meantime, supply is increasing. Forward looking indicators point to record levels of output near term and only a moderate downtrend thereafter.
- Not surprisingly, the rate of house price inflation is moderating as the supply/demand balance adjusts.
- Further price moderation is anticipated as the market heads for the much anticipated soft landing. House price inflation could be in a 3-6% range by end 2007.
- Undoubtedly, though, the risks to the market have grown and require careful monitoring. These centre primarily around deteriorating affordability. Sentiment also plays a key role, particularly in the investor sector.
- The market also remains particularly vulnerable to government intervention and any proposed taxation changes should be well considered in terms of the impact they might have on the market.

*Dr Jenny Pollock*  
23 October 2006

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## COMMENTARY

# They think it's all over ... but it's not

The outlook for the Irish housing market is a subject that is never far from the minds of the general public as well as the government, the Central Bank, the IMF and indeed, those involved in other sectors of the economy who question if a housing market crash could occur and what impact it would have on the economy as a whole.

### ***Housing sector important to the Irish economy***

Average Irish house prices have almost doubled over the past six years while cumulative house completions have topped the 450,000 mark over the same period. The housing sector has directly accounted for one-fifth of the cumulative growth in real GDP of 36% since 2000. Construction employment now exceeds 260,000, representing 13% of the total workforce. Mortgage credit has more than doubled over the past three years and personal sector indebtedness now exceeds 150% of disposable income. Residential property related household wealth, however, has grown from €450 billion in 2003 to €700 billion in 2006.

### ***Risk of severe correction is low - Soft landing in sight***

Against the background of such an impressive record, many domestic and international commentators believe that the sector could, or indeed will, suffer a severe correction. While such a correction could have dire consequences for the economy, at least in the short term, the risks are low.

This latest report on the housing market remains quite optimistic on the outlook for the sector in 2007 and 2008. We do not envisage a hard landing or crash in either property prices or in construction output. We expect new peaks in output in 2006

with house completions set to reach 93,000 units, with only a moderate downtrend thereafter. More importantly, we also see the opportunity of a deceleration to moderate price gains over the medium term.

<b>Housing Market Forecasts</b>				
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Completions (DoEHLG Basis)	80,957	93,000	85,000	78,000
Prices % (End Year)	9.3	12	3-6	3-5

### ***Housing demand well underpinned***

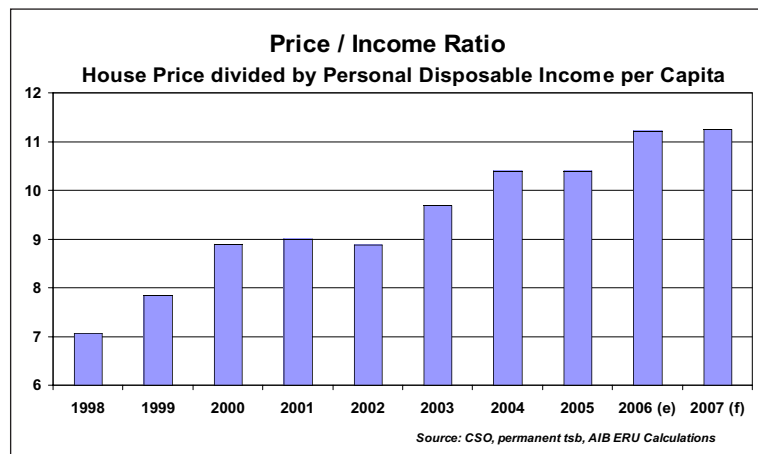
The Irish housing market remains well underpinned by demographic trends and by significant economic and social change. This is the key to the outlook. Employment growth has been remarkably robust, enabled by significant net immigration while the population continues to expand strongly. The level of demand from these and other sources has exerted considerable upward pressure on house prices in recent years. However, if prices get out of touch, the market will peg them back.

### ***Housing market not homogeneous***

It is important to remember that the housing market is not homogeneous. It is best seen as an interrelated series of sub-sectors that each have their own dynamics. Much has been made of the disappointing results at recent house auctions in the Dublin region. However, the Dublin auction market is not the Irish property market. Prices at the upper end of the second hand market in Dublin may have become too expensive in general and run into buyer resistance or affordability issues. However, this segment of the market is not representative of the first time buyers market or of other parts of the country. The greatest risk of overshoot in prices has always existed in the second hand market, where there are serious shortages of good quality family homes to meet demand. This is particularly true of major urban centres such as Dublin and Cork.

### ***Rate of price rises had become unsustainable***

In our last report, in April 2006, we said that high house price inflation running in double digits was unsustainable and that the deterioration in affordability would kill off some of the high level of demand that was then evident in the market. This view was based on the widening gap between house prices and personal disposable income. This ratio currently stands at over 11:1.



### ***Affordability continues to deteriorate as interest rates rise***

Of course, some financial institutions have continued to extend the terms of mortgages beyond 35 years, which has offset some of the deterioration in overall affordability. However, buyers have had to endure the ECB's unrelenting policy of raising interest rates. We have had five increases of 0.25% since December last, bringing the refinancing rate to 3.25%. Though not an historically high rate, potential buyers may not be too comforted by forecasts that the ECB will stop at 3.75%.

### ***Leading to more moderate house price inflation***

Looking ahead, more moderate growth in house prices of 3-5% is possible over the next few years. We see prices in the second hand market stalling over the winter period before recovering in the spring. Inflation in this sector could rise by 0-5% year-on-year by end 2007, down from 11% in 2006. As regards new house prices, this sector is somewhat stronger, but moderation to 5-7% could occur in 2007 from 13% in 2006.

Such rates of house price inflation would still exceed the projected rise in the CPI. However, with wage growth also expected to exceed the rise in consumer price inflation, this may be enough to stabilise the overall level of affordability. Furthermore, assuming that rents rise at least in line with inflation, this could be sufficient to keep investors in the market. Investors, though, must make an important adjustment in accepting that capital appreciation will be smaller in real terms than in the past few years.

***Any changes in property related taxes should be gradual so as not to unsettle the market***

It would appear that the property market is once again being unsettled by uncertainty about property related taxes. Thoughts of a general election have raised concerns on the selling side about the outlook for capital gains tax. On the buyers' side, recent speculation about possible changes to stamp duties may have persuaded some potential buyers to hold off until after the budget. Tax changes and overall government intervention in the property market have been disruptive in recent years. Though the current stamp duty regime is unnecessarily punitive, easing the burden at this stage would probably go straight into higher prices. This is an area that requires reform. However, it should be done on a gradual basis so as to minimise the effect on prices.

***Market now much closer to equilibrium***

We are now much closer to equilibrium in the housing market. Demand has been scaled back as affordability deteriorates, while supply has increased in both the new and second hand market. However, underlying demand still exceeds supply, with the latter constrained by planning and other restrictions, most notably in the Dublin region where there has been a marked decline in planning permissions. Overall, though, the market looks to be cooling towards the much sought after soft landing.



**John Beggs  
Chief Economist  
23 October 2006**

## Housing Output : New Peaks in Sight

*Output continues to be very firm in 2006*

In our last report (April 2006) we described the housing market as a 'hot house' in that output was continuing to rise, accompanied by accelerating price inflation. Building activity has continued to be very firm and looks set to hit new record levels again this year.

*Completions surged by 16.6% in Q4 2005 ...*

Output surged in the final quarter of last year. This, in part, probably reflected an acceleration of completions ahead of the expected ending of some tax based incentive schemes. Data from the Department of Environment, Heritage and Local Government (DoEHLG) show completions up some 3,800 in Q4 2005 to 26,563 units, an increase of 16.6% on year earlier levels. However, this understated the true underlying strength of house building activity towards the end of last year.

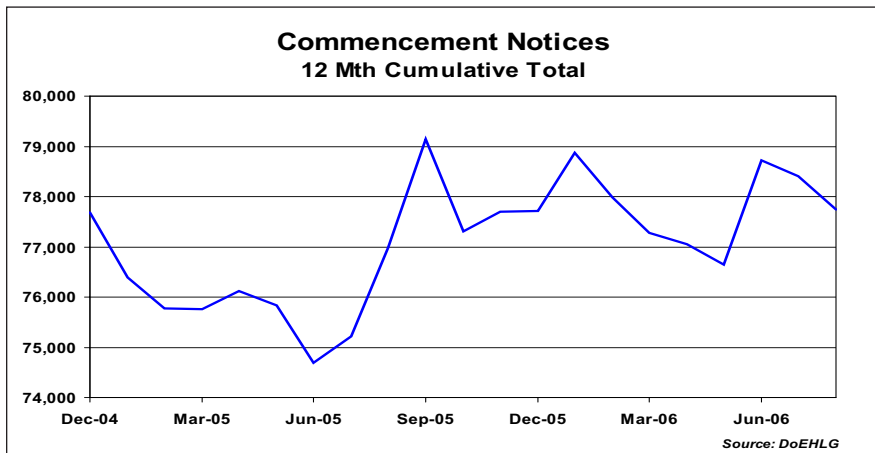
*... and have remained strong in 2006 to date*

The DoEHLG completions data are based on the connection of a property to the ESB network. The strength of construction activity was such that there was a much larger than usual number of dwellings (estimated by the CSO at an additional 5,200) awaiting connection at end 2005. The most recent figures show that there were 58,613 units completed in the first eight months of this year. This represents an increase of almost 11,000 or 23% on the same period in 2005. However, almost half of this increase reflects the carryover of the backlog in the provision of ESB connections from late 2005. Excluding this backlog, there was an increase in completions of around 5% year-on-year in the first eight months of 2006, reflecting the true underlying strength in house building activity.

Looking forward, with some slackening of demand and without the pressures to complete tax based schemes, there is unlikely to be quite the same surge in activity in the latter part of 2006 as there was last year. However, given the level of completions year to date, we still anticipate that completions will reach a record 93,000 this year compared to 80,957 units in 2005. (On a CSO basis, adjusted for the ESB backlog, completions would total 88,000 units in 2006 compared to 86,000 in 2005.)

*Forward looking indicators point to further high output levels*

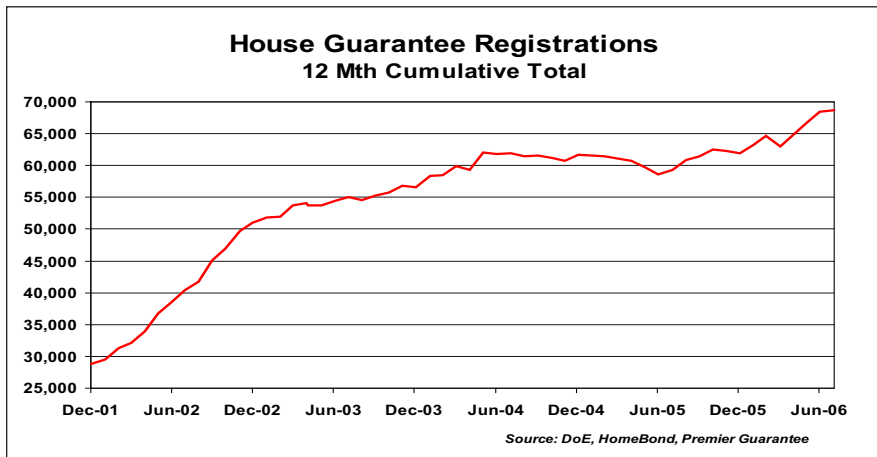
Forward looking indicators suggest that output will remain at elevated levels in 2007 and 2008. Commencement notices were issued for 54,518 units in the first eight months of 2006, virtually unchanged from the same period in



2005. Over its short history (the series only commenced at the beginning of 2004) the 12 month cumulative total of commencements has been confined to a 75,000 - 79,000 range. Commencement notices do not have to be issued for most local authority housing, of which there were some 8,900 units in progress in H1 2006.

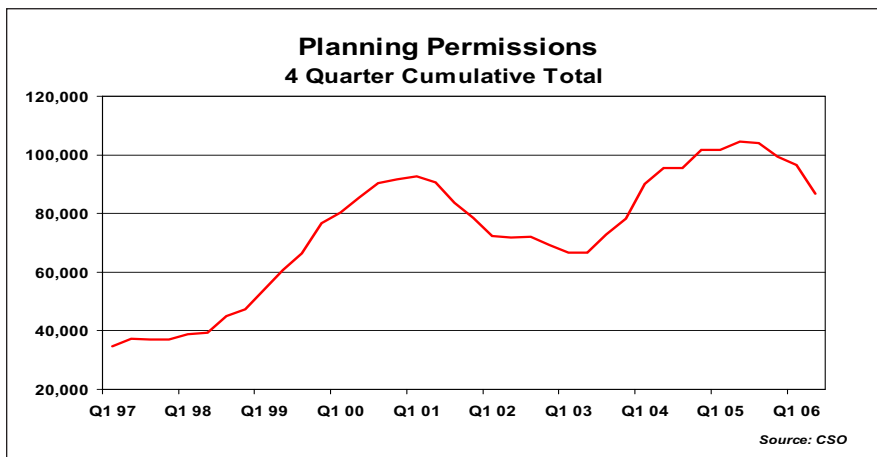
*Registrations rising to new highs*

Meanwhile, house registrations (which pre-date commencements) have been extremely strong. They were up 15.5% year-on-year in the first eight months of the year. As the monthly data can be volatile, we tend to focus on the cumulative 12 month total of registrations. This was stalled within a 59,000 - 62,000 range for much of 2004 and 2005. However, since then the trend has strengthened. Recent figures show the 12 month cumulative total at a record high of 68,640 in August this year.



*Though planning permissions are slowing ...*

Over a longer term horizon, though, planning permission data indicate that there could be a significant downturn in housing output. The number of permissions would appear to have peaked in the first half of last year and the rate of slowdown in permissions would appear to be accelerating. Permissions were down by 33% in Q2 this year following an 11% decline in Q1. As a result, the four quarter cumulative total of permissions has fallen to under 87,000, from a peak of over 104,000 in Q2 2005.

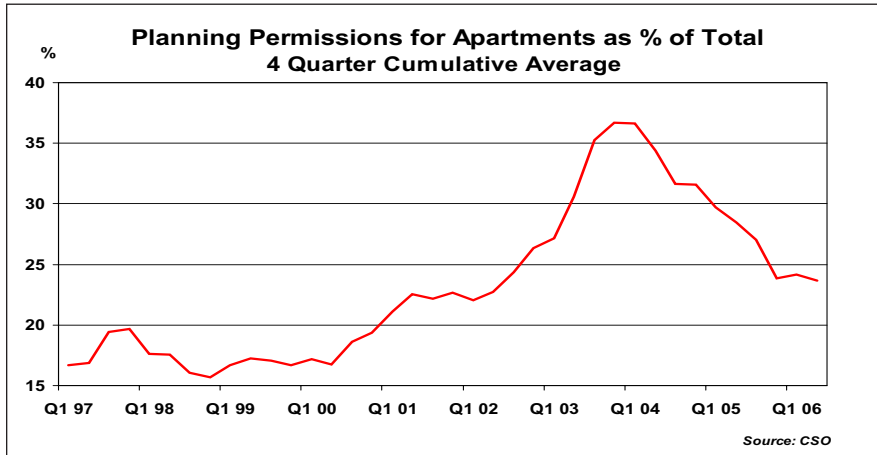


*... largely due to delays and refusals*

There has been some fall-off in the volume of planning applications, for the country as a whole, which were down 5.5% year-on-year for the four quarters to Q1 2006. However, the far larger decline in the number of permissions granted in this period highlights the impact of delays and refusals in the planning process.

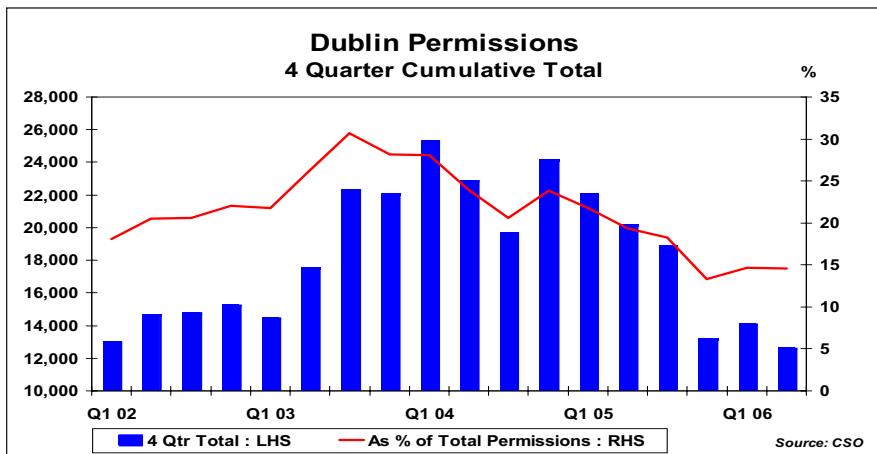
*Apartment developments a particular area of weakness*

The weakness in the planning permissions data comes primarily from two main sources, namely permissions in the Dublin area and for apartments in general. Permissions were granted for just over 20,000 apartments in the four quarters to Q2 2006, well down from the level of over 30,000 seen through 2004 and into 2005. An increasing number of delays have crept into the planning process for large apartment developments in particular. As a result, permissions for apartments represented only around 24% of total permissions in the four quarters to Q2 2006. This is well down from the peak of almost 37% in the periods to Q4 2004/Q1 2005.



*Low level of permissions for Dublin area*

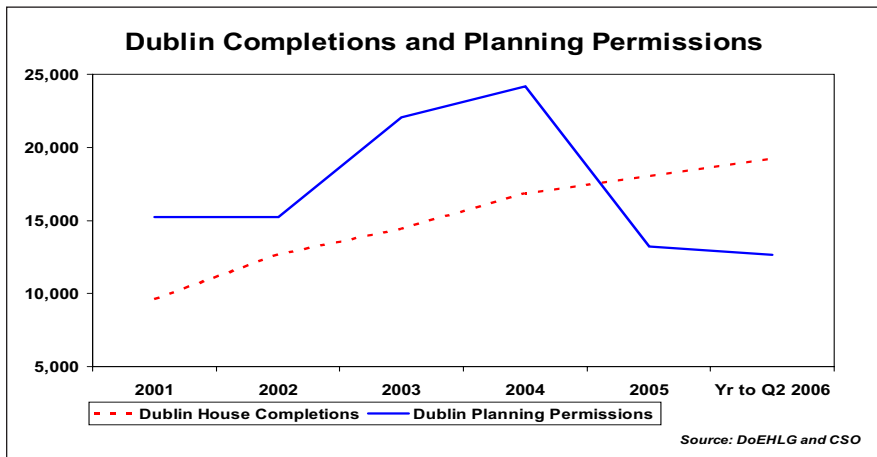
There has been no downturn in the volume of planning applications in the Dublin area. However, the delays being experienced in obtaining planning permissions, for apartment developments in particular, has resulted in a marked downturn in the number of permissions being granted for housing units within the Dublin area. Going forward, the difficulties in obtaining suitable development land may also weigh.



Permission was granted for only 12,644 units within the greater Dublin area in the year to Q2 2006. This is a decrease of some 37% on the year earlier levels and less than half the number in the four quarters to Q1 2004. Thus, while, according to the latest Census data, over 28.7% of the population lives within the greater Dublin area, the region accounts for less than 15% of total permissions.

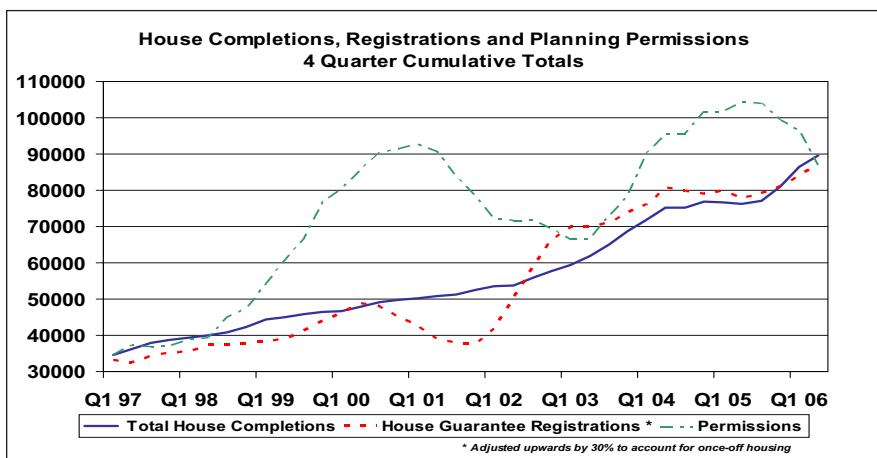
*Output is being constrained in the Dublin region*

The level of permissions being granted in Dublin has fallen well below the current level of output. In the four quarters to Q2 2006 permission was granted for only 12,644 new housing units in the greater Dublin area against a completions rate for the period of 19,192. Thus, it seems that the current supply shortage in the Dublin region will remain for some time.



*Permissions point to fall-off in output*

Nationally, the marked downturn in the level of permissions in recent quarters indicates that there could well be a significant fall in the level of housing output in the years ahead. Housing output cannot continue at the current rate of over 90,000 per annum if permission is only being granted for 87,000 new units.



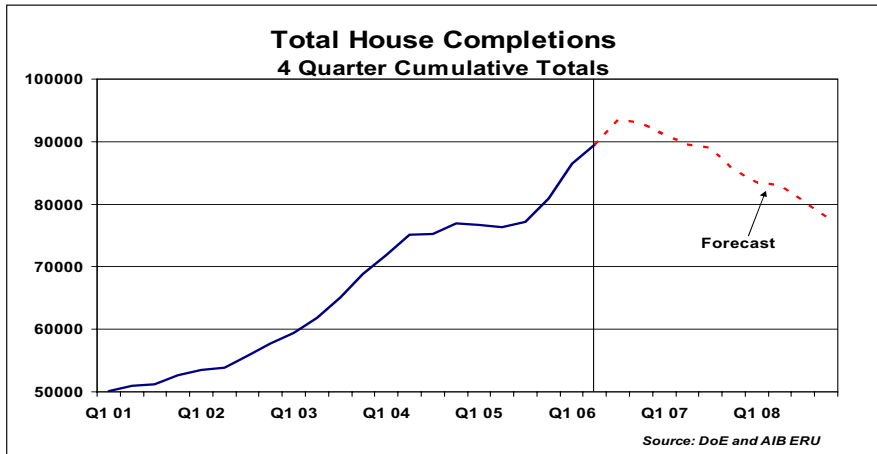
However, it may take some time for the downturn in permissions to be fully felt in output levels. In the period since Q1 1997, permission has been

*This may not be fully reflected in output in the near term ...*

granted for 720,000 new units, while completions have totalled less than 560,000 units. Of course, not all permissions translate into completions. However, there would appear to be a reasonable bank of permissioned land awaiting development that should provide a near term cushion to output from the recent downturn in permissions. Over the longer term, there would also appear to be a significant bank of development land awaiting permissioning which should provide a basis for ongoing supply.

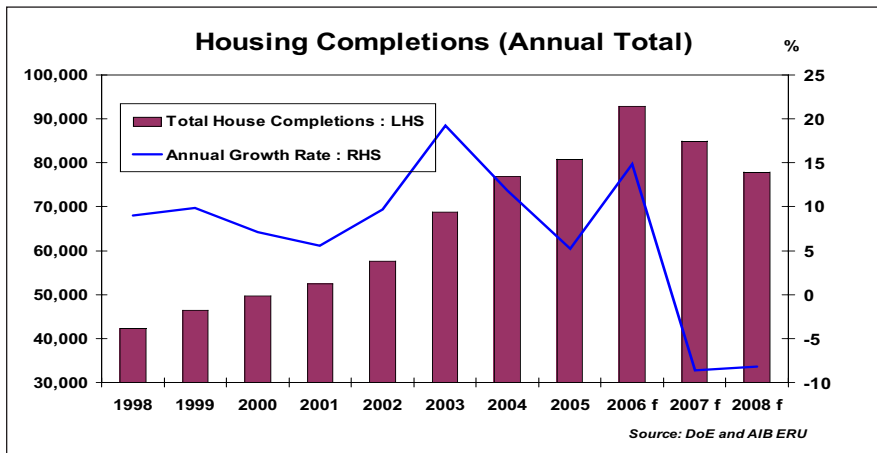
*... but level of completions to moderate ...*

**Thus, it seems likely that output will remain at elevated levels for some time. As we have noted above, given the level of completions year to date, it now seems likely that 2006 will prove to be another record year for output and we are expecting that completions will reach the 93,000 level (which incorporates the 5,200 backlog of completions from 2005).**



*... falling to 85,000 in 2007 and 78,000 in 2008*

**Given the recent strong completion data and the time lag between registration and completion, we are looking for output to remain very firm at least in the first half of 2007. However, it is unlikely that the housebuilding industry will ignore the deteriorating affordability conditions. Against such a background, we are forecasting some moderation in output in the latter part of next year, with the level of completions dropping to 85,000. A further modest decline in output levels to 78,000 is anticipated by end 2008.**



## Housing Demand : *Solid Support from Rising Population and Employment*

*New data from Census 2006*

**We have re-evaluated our demand model in the light of recent preliminary Census 2006 data. While the conclusions are only tentative, the preliminary Census figures would appear to confirm the trends we had previously identified.**

Housing demand can be considered in two ways, either from the perspective of the type of buyer (e.g. first time buyer, investor etc.) or in terms of the functional use of the property. The factors that drive functional housing demand can be broken into the following categories:

- Household formation, due to:
  - Changes in the size and structure of the existing resident population
  - Migration flows
  - Changes in headship
- Second, or otherwise vacant, homes
- Replacement of obsolete units

The publication next year of the household data from Census 2006 will enable us to make a better evaluation of the relative strengths of these components. However, in the meantime, we have made some adjustments to our previous estimates in the light of partial data available from Census 2006. The table below contains our revised estimates for the distribution of housing output between these demand categories.

<b>Estimated Distribution of House Completions to Satisfy Functional Housing Demand</b>						
<b>Year to April</b>	<b>Avg 1996-2002</b>	<b>Avg 2002 - 2006 Previous Estimate</b>	<b>2006 (e) Latest Estimate</b>	<b>2006 (e)</b>	<b>2007 (f)</b>	<b>2008 (f)</b>
Household Formation	27,450	53,700	51,300	66,100	70,000	61,800
<i>of which :</i>						
- Population Growth						
<i>due to:</i>						
Resident Population	12,550	16,900	16,500	16,300	16,300	16,300
New Net Inward Migration	13,650	17,500	17,800	25,800	27,700	24,000
- Changes in Headship	1,250	19,300	17,000	24,000	26,000	21,500
Vacant Properties	10,800	10,500	14,000	11,500	10,800	8,600
Replacement of Obsolete Units	6,500	8,300	8,300	8,800	9,200	9,600
<b>Completions</b>	<b>44,750</b>	<b>72,500</b>	<b>73,600</b>	<b>86,400</b>	<b>90,000*</b>	<b>80,000</b>

\* This includes 5,200 units effectively completed in the previous period but not connected to the ESB network

Source : AIB ERU. 1996 - 2002 period based on study of Census data. Estimates for 2002- 2006 include data from the preliminary Census 2006. Data for 2007 and 2008 are AIB ERU best estimates

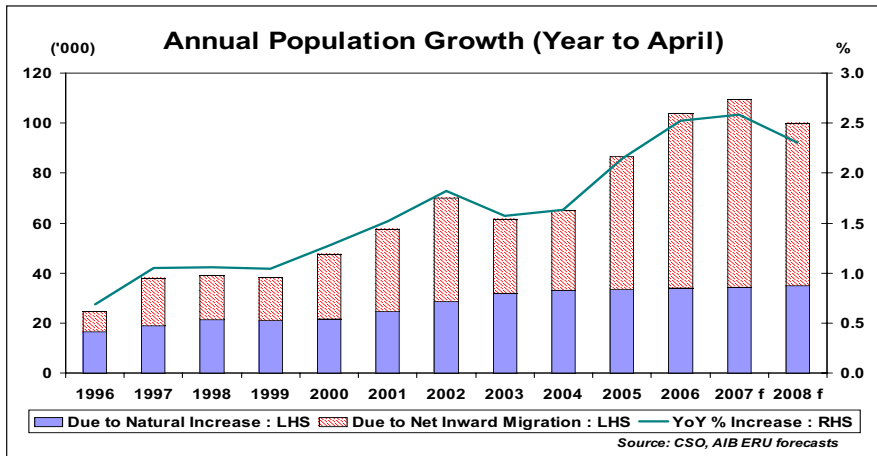
**Note: The data in this table are for the year to April and thus differ somewhat from calendar year figures used in other sections of this report**

**Population Growth and Migration Flows**

*Population growth major driver of demand*

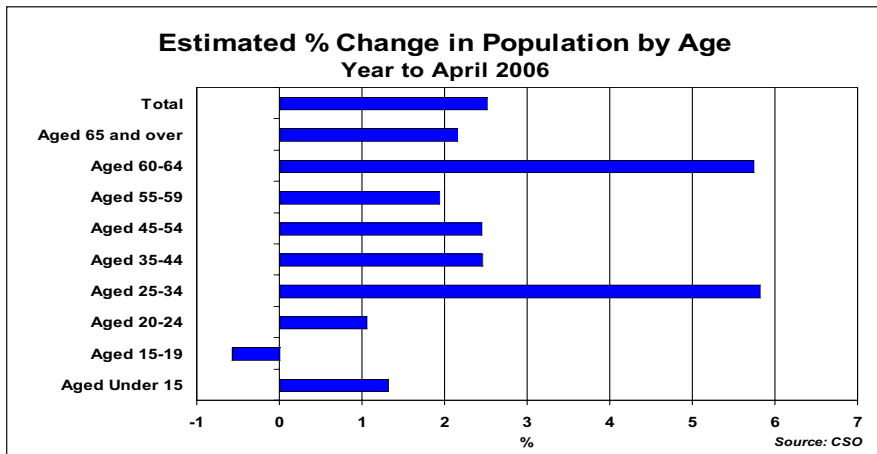
The main driver of functional demand remains the strong population growth, which is being driven by high levels of net inward migration. Preliminary results from Census 2006 put the population of Ireland at April 2006 at 4,234,925. This is an increase of 317,7122 (+8.1%) from the previous Census in April 2002. Of this total population growth, almost 60% is due to net inward migration, with migration overtaking natural increase as the main driver of population growth from 2003 onwards.

*60% of population growth due to migration flows*



*Growth amongst 25-35 year olds particularly strong*

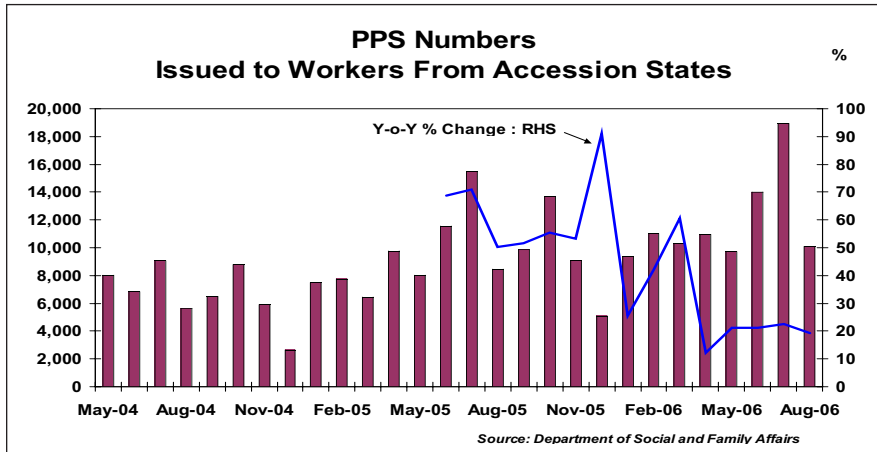
As a result of continued strong migration flows, the overall population grew by an estimated 2.5% in the year to April 2006. Crucially for household formation, population growth in the key 25-35 cohort has been particularly strong, at some 5.8% in the year to April 2006. (The DoEHLG report that 63% of first time buyers in 2005 were aged between 26 and 35.)



*PPS data indicate further strong inward migration*

The strength of population growth in this key age cohort again owes much to migration flows with, it is estimated, over 50% of immigrants in the year to April 2006 aged between 25 and 44. These migration flows look set to remain a strong driver of population growth. PPS data from the Department of Social and Family Affairs show that the rate of PPS numbers being issued

to those from the EU-10 Accession States continues to grow. While, in recent months, there has been some slowdown in the rate of increase in PPS numbers issued to migrants from the EU-10 States, they are still growing at around 20% per annum.



In addition to the almost 95,000 PPS numbers issued to EU-10 migrants in the year to August 2006, it shouldn't be forgotten that there were an additional 30,000 PPS numbers issued to migrants from other EU states over the same period. There was, though, a slight drop in the number of new work permits issued to workers from outside the EU (down 1,000 to 17,049) due to a drop in the number of renewals. All in all, though, there is strong evidence of a continued high level of net inward migration.

*Some restriction on workers from Bulgaria and Romania likely*

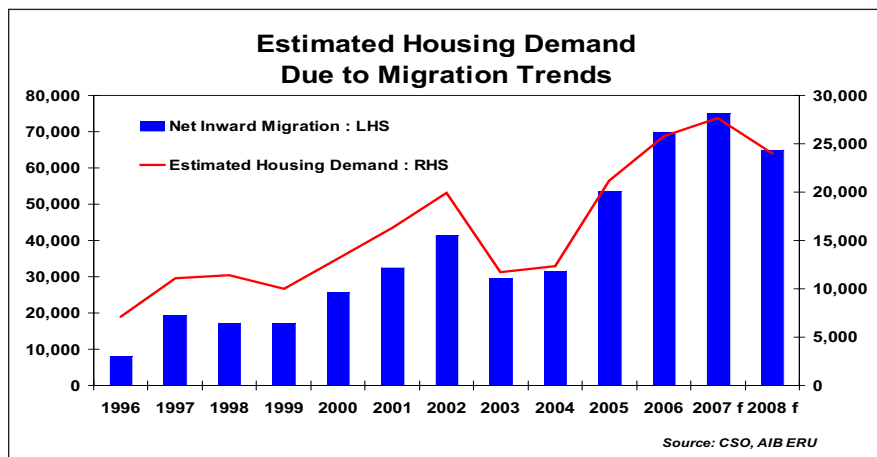
Looking ahead, it remains to be seen whether the government will place any restrictions on workers from Bulgaria and Romania, after these two countries join the EU in January 2007. Some restrictions are quite possible, given increased concerns about whether the Irish economy and society can continue to sustain the current high levels of inward migration. It is also possible that there could be exceptionally strong inflows from Bulgaria and Romania if no restrictions were imposed due to the relative low level of wealth and incomes in these countries.

However, whether or not restrictions are placed on Bulgarian and Romanian workers, it seems likely that there will be further high levels of net inward migration, primarily from the existing EU-10 Accession States, given the favourable employment experience of those already here. The CSO estimate that of the 90,000 non-Irish nationals entering the labour force over the last two years all but 6,000 have found employment.

*Record net immigration of 75,000 in year to April 2007*

Accordingly, we have increased our forecast for net inward migration flows for the years to April 2007 and 2008 to 75,000 and 65,000, respectively. This compares with 69,900 in 2006. These immigrants require housing, whether in the rental sector or as owner occupiers. On the basis of these flows, and assuming the same headship rates for the new migrant population as for the existing population (see below for a discussion of headship

changes) net inward migration could account for 27,700 (31%) of the 90,000 houses that we expect will be completed in the year to April 2007. Migration flows could account for another 24,000 completions in the year to April 2008. This compares to our estimate of migration demand for 25,800 housing units in the year to April 2006.



Meanwhile, growth amongst the population already resident in the country is likely to account for around a further 16,300 completions in both the years to April 2007 and 2008.

*Immigration supported by employment*

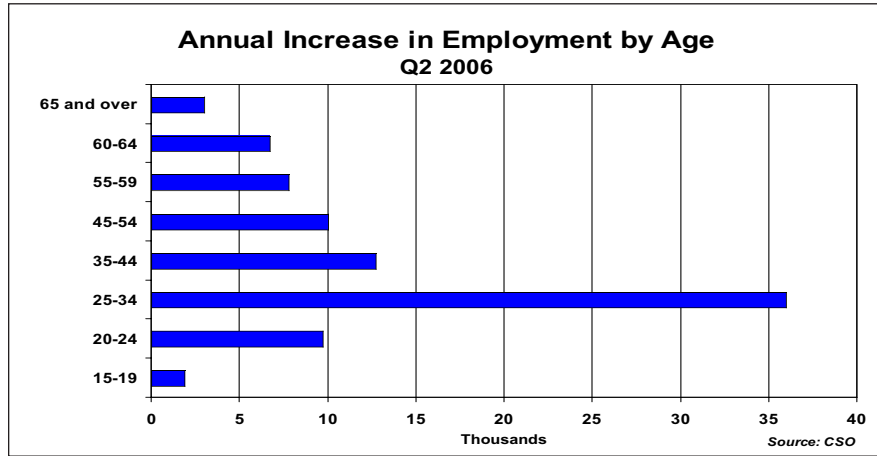
Our forecasts of continuing high levels of net inward migration are dependent on the maintenance of current favourable employment prospects. The most recent data from the CSO show that total employment rose by 4.6%, or by 87,800, in the second quarter of this year compared with the same period of 2005, bringing total employment to over 2 million for the first time. This was the fifth successive quarter where the annual growth in employment has exceeded 4.5%.

The current phase of high rates of employment expansion started around the middle of 2004 and has coincided with the significant inflow of migrant workers from the EU-10 Member States. Of the cumulative rise in total employment of 181,000 over the past two years, non-Irish national workers accounted for 46% of this total.

Importantly, for household formation, job creation in Ireland is being driven by increased employment in the 25-34 age group (again in large part reflecting migrant flows). This is the key cohort in terms of household formation. In the year to Q2 2006, out of 87,800 jobs created, 36,000 (or over 40%) were in this key age group.

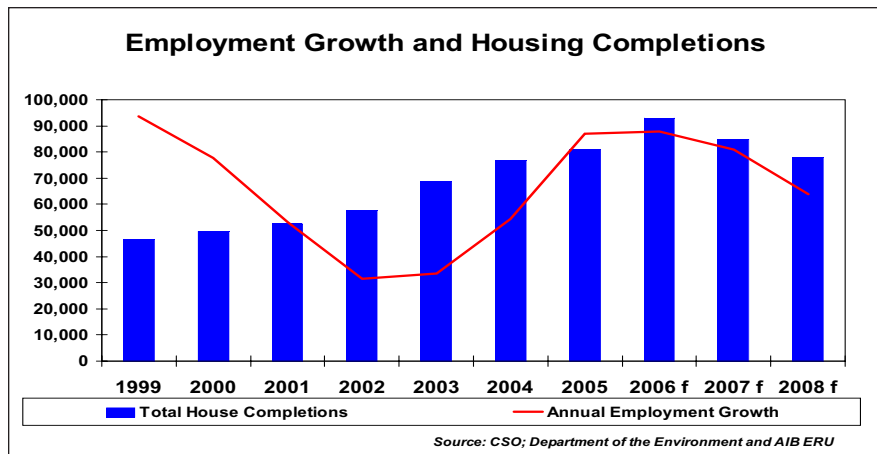
*Employment prospects remain favourable*

The prospects for employment in Ireland remain very favourable. Further job creation is envisaged in most of the main categories of employment in 2007. Furthermore, prospects for the manufacturing sector are also improving. The annual rate of employment growth could, therefore, remain very high over the balance of 2006 and 2007.



*Employment prospects a key driver of private housing demand*

Looking to 2007, some slowdown is anticipated in construction employment as housing output stabilises. Other sectors of the economy could also experience more moderate growth. Demand for employment, though, remains high in the services sector, including the traditional public sector areas of health and education, and we expect service sector employment to continue to expand at a fast pace in 2007 and beyond.



Overall, therefore, employment could continue to expand at an annual rate of around 4% in 2007 and 3% in 2008, thus providing a sound base for economic growth and, more specifically, supporting household formation over that period.

*Robust domestic economy supports continued strong labour market*

This strong labour market outlook is supported by our expectation of a continuation of robust Irish economic growth in 2007 and 2008. Ireland's economic performance remains both exceptionally buoyant and resilient with real GDP expected to grow by about 6% in 2006. A slightly lower rate of growth of 5.5% is forecast for 2007, reflecting an expected downturn in the global economy. Such a performance would represent the continuation of a remarkable period of steady and sustained growth in real GDP since the ending of the Celtic Tiger period in 2000. Furthermore, the outlook beyond 2007 may not be as gloomy as often predicted. We are forecasting GDP growth of 4.5% in 2008.

A number of factors should underpin economic growth in the short term including expansionary fiscal policy, the lagged effects of a very low interest rate regime, maturing SSIA related expenditure and strong growth in several regions, especially the pick up in activity in the eurozone and UK economies.

*(For more details of our outlook on the Irish economy see our **Irish Economic Outlook, October 2006**. This is available online at [www.aibeconomicresearch.com](http://www.aibeconomicresearch.com).)*

### **Headship**

*In our view, changing social structures ....*

We remain of the view that there has been a significant increase in headship rates (i.e. the percentage of adults in any age group that head up households) in recent years, supported by the robust labour market and overall confidence in the economy. There would also appear to be a strong demand for housing reflecting changing social structures (increased divorce, separation, one parent families etc) and an increased willingness by young people to take on debt to set up households on their own.

*... are leading to significant increase in headship rates*

We are estimating that, over the 2002-2006 period, some 17,000 per annum of completions went to satisfy increased headship rates. In the year to April 2006, increased headship may have accounted for as many as 24,000 housing completions.

*Some substantiation of this view from preliminary Census data*

The preliminary Census 2006 data appear to substantiate our view of increased headship, though only on the basis of a lot of, at this stage, unverifiable assumptions. The preliminary Census report notes that 1.5 million census forms were delivered to households and communal establishments. If we assume that this 1.5m is an exact measure of the number of establishments identified, and also assume some increase in the number of communal establishments but assume no increase in the number of temporary homes (i.e. mobile homes etc), then the preliminary Census data would point to an increase of some 205,000 in the number of households in permanent accommodation since the 2002 Census. Of this increase, 137,000 can be accounted for by population growth and migration flows. This would leave a balance of 68,000 (17,000 per annum) additional households created due to headship changes over the 2002-2006 period.

We must again emphasise that these numbers are based on rounded partial preliminary Census data and we await the publication of the final Census report for more detailed data. Indeed, even if our estimates should prove to be accurate, the extent to which demand from increased headship has been satisfied could be even greater than headline numbers imply if, as we suspect, the overall headship data hide two contrasting underlying trends.

Over 50% of immigrants in the 2002-2006 period were in the 25-44 age group. It is quite possible that a number of young single people amongst the immigrant community chose to share accommodation for economic reasons.

Any such communal household, of three persons or more, would serve to reduce overall headship rates (i.e. reduce the number of adults that are heads of household). If this were indeed the case, it implies, that within the indigenous population, and possibly elsewhere within the migrant population, there is an offsetting increase in the number of smaller family units being created to accommodate the social changes referred to above.

*Irish headship rates remain low ...*

As we have emphasised many times before, Irish headship rates remain low. (In 2002, only 46% of over 20s were heads of households in Ireland compared to 55% in England and Wales.) Thus, looking forward, we expect that there will continue to be an increase in headship rates as the Irish market slowly adapts to changing social structures.

*... implying unrealised housing demand*

Of, course, the ability to realise this housing demand to satisfy increased headship rates relies on the ability of first time buyers, in particular, to enter the market. As we discuss in detail elsewhere, affordability is deteriorating. As a result, first time buyers are increasingly being priced out of the market. However, if, as we anticipate, this results in a significant moderation in the rate of house price inflation, the deterioration in affordability should moderate over the course of 2007. This is even more likely in that, by that stage, we envisage that interest rates will have peaked. This will help to support first time buyer demand allowing for a further increase in headship rates.

*Further increase in headship envisaged*

Thus, we are guesstimating that headship changes will account for somewhere in the region of 26,000 housing units in the year to April 2007, and a further 21,500 units in the year to April 2008.

### **Replacement of Obsolete Units**

*Low replacement rate due to young age of stock*

The internationally accepted norm is for an annual replacement rate of obsolete housing of between 6 and 7 units per 1,000 of the housing stock. We, however, in our demand model assume a slightly lower replacement rate of 5 per 1000. This is on the basis of the relatively young average age of the Irish housing stock, reflecting the rapid expansion in house building activity in recent years.

### **Second (or Otherwise Vacant) Properties**

*Large number of second homes in holiday areas*

Based on the above analysis, it would appear that there was an increase of some 56,000 second homes or otherwise vacant properties in the 2002 - 2006 period. We have tried to identify the areas of the country where these vacant properties may lie. In order to do this, we have looked at house completions between Census dates alongside the increase in population that the Census surveys identified. In some of the main holiday areas there were considerably more houses completed between April 2002 and April 2006 than warranted by the increase in population. Most notable is County Sligo

where there were 4,634 completions but the population increased by only 2,663. This is a completions to population increase ratio of 1.7. The next highest ratio was in Kerry at 1.5, followed by Mayo and Donegal at 1.4.

<b>Completions as a Proportion of the Increase in Population</b>			
<b>1996-2002</b>		<b>2002-2006</b>	
Leitrim	3.70	Sligo	1.74
Longford	2.49	Kerry	1.52
Monaghan	2.07	Mayo	1.40
Sligo	1.90	Donegal	1.36
Mayo	1.71	Limerick	1.35
Donegal	1.70	Waterford	1.33
Kerry	1.45	Leitrim	1.09
Tipperary	1.29	Tipperary	1.05
Roscommon	1.27	Longford	1.02
Limerick	1.10	Dublin	1.02
Cork	1.08	Clare	1.00
Waterford	1.06	Louth	0.97
Cavan	1.03	Monaghan	0.96
Clare	0.90	Cork	0.94
Wexford	0.89	Roscommon	0.93
Carlow	0.89	Carlow	0.91
Louth	0.89	Westmeath	0.89
Kilkenny	0.89	Galway	0.88
Galway	0.89	Cavan	0.87
Dublin	0.88	Wexford	0.77
Offaly	0.85	Offaly	0.74
Westmeath	0.83	Kilkenny	0.73
Wicklow	0.70	Wicklow	0.72
Laois	0.67	Laois	0.69
Kildare	0.48	Kildare	0.62
Meath	0.43	Meath	0.50
<b>TOTAL</b>	<b>0.92</b>	<b>TOTAL</b>	<b>0.93</b>

*Sources: CSO, DoEHLG*

These ratios are considerably smaller than in the 1996-2002 period when, in some of the main holiday areas, completions to population increase ratios of over 2 were recorded (Leitrim 3.7; Longford 2.5; Monaghan 2.1 and Sligo 1.9). However, while the phasing out of tax based holiday schemes has dented the holiday homes market, it would appear that there was a considerable amount of holiday home construction over the 2002-2006 period.

*Affordability and absence of tax based schemes to weigh on holiday homes sector*

Apart from traditional holiday homes, vacant properties could be city homes no longer used by students and kept for occasional visits, investments for capital appreciation only, or investment properties that have proved difficult to rent due to location.

Looking ahead, affordability issues and the absence of tax based schemes are likely to weigh heavily on the second homes market. However, SSIA flows should provide some support in the near term. Thus, we are guesstimating that the increase in the number of second (or otherwise vacant) homes will edge lower to 10,800 in the year to April 2007, from

11,500 in the year to April 2006, with the number then decreasing further to 8,600 for the year to April 2008.

*Census enumerators identified more vacant properties*

The number of vacant properties is particularly difficult to quantify. Here we are deriving it as a residual from the number of completions and the number of properties accounted for by other factors. On this basis, we have estimated an increase of some 56,000 in the number of vacant properties between the 2002 and 2006 Census reports.

The preliminary Census 2006 report, though, notes that enumerators identified 275,000 vacant properties, an increase of 105,000 on the number at the time of Census 2002. Yet again we emphasise that these are preliminary figures and we await the definitive data from the final Census report. However, the data imply that there may have been a significantly higher number of new properties in habitable condition at April 2006 than indicated from completions data.

*Possible overhang of vacant properties*

We already know that there were 5,000 properties effectively completed at end 2005 but, due to delays, not connected to the ESB network. What these figures hint at, though, is that there may have been a considerably larger number of new properties than this in habitable condition, at April 2006 than have been recorded as completions in the DoEHLG data.

Should this prove to be correct, the reasons for this phenomenon remain unclear. It may be that the stock of properties completed, or near completed, at April 2006 and awaiting an ESB connection was higher than estimated. It is possible that property developers were holding on to stock in the hope of achieving a higher price. An alternative explanation would be housing stock in completed developments awaiting the next phase of release.

### **Alternative Scenario**

*Alternatively, little or no growth in headship ...*

However, it would seem that these factors cannot fully explain the discrepancy of over 50,000 additional properties apparently standing vacant, over and above the number that we have guesstimated in our functional demand model. An alternative scenario would be that, as happened ahead of the release of Census 2002 data, we have over-estimated headship demand. (It shouldn't be forgotten that the number of households remains unclear awaiting the detailed Census 2006 report.)

*... implying pent-up headship demand*

If this were the case and, as a result, headship demand was some 50,000 lower in the 2002 - 2006 period, this would imply virtually no change in headship in the period. Such an outcome would have implications for demand, and thus for pricing, in that it significantly raises the level of unrealised potential demand from headship changes. However, anecdotal evidence supports our view that there has been some significant increase in headship rates over the 2002 - 2006 period but we await Census 2006 for clarification on this point.

## Buyer Demand : Risks are Increasing

While the functional demand for housing is well underpinned, as outlined in the previous section, the risks to the market would appear to be growing. These risks are best viewed from the perspective of those buying property, be they first time buyers, existing homeowners wanting to trade up or down or to acquire a second holiday type home or be they investors purchasing with the intention of letting the property. Thus, this section focuses on the key issues of affordability and other factors that determine a buyers (or sellers) attitude towards the market, against the current trend of rising interest rates, combined with recent strong price increases.

### Stretched Price/Income Ratios

*Price/income ratio currently over 11 times*

As house prices continue to rise sharply, the ratio of price to income is becoming ever more stretched (the income measure used here is personal disposable income per capita i.e. total personal income after tax divided by the population aged 15 or over). This ratio has now risen to over 11 compared to something just over 7 in 1998. In itself, this increase in the price/income ratio does not present a threat to the housing market. However, as we have pointed out before, **the more stretched the price/income ratio becomes, the greater the potential for correction if other affordability conditions deteriorate significantly - such as is happening at the moment from higher interest rates.**

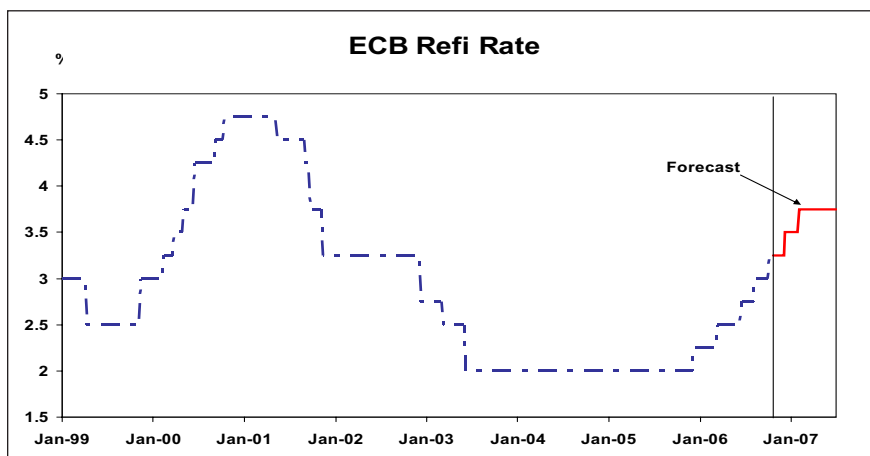


### Interest Rates

*Refi rate up 1.25% from low ...*

*... with more to come*

The ECB hiked rates by 0.25% to 3.25% on 5th October. This was the fifth consecutive 0.25% move since the tightening cycle began in December last year, bringing rates up from their low of 2.0%. Recent hawkish rhetoric suggests that the ECB believes that there is sufficient economic momentum and perceived inflation risks to persuade it to raise rates again in December, bringing the official refi rate to 3.5% at end 2006. A further increase to 3.75% in early 2007 is also possible, with rates expected to stay on hold thereafter.



**Repayment Affordability - Existing Mortgage Holders**

*Higher rates pushing up costs for existing mortgage holders*

Increases in interest rates have a direct impact on existing mortgage holders. Indications are that most of these are not yet experiencing any real difficulties in making repayments. However, if interest rates continue to rise, pressures on those at the margin, struggling to make repayments, will only intensify. Official interest rates have already been hiked by 1.25%, with a distinct possibility of at least another 0.5% to come.

For illustrative purposes, we consider the impact that the 1.25% increase in mortgage rates to date would have had on a typical tracker mortgage. We estimate that it has added some €65 to the monthly repayments per €100,000 borrowed for a 20 year mortgage and €74 for a 35 year mortgage.

*For a loan with €275,000 outstanding, additional monthly cost of ...*

On the assumption that interest rates rise by a further 0.5%, to peak at 3.75%, this would increase the repayment cost on a 20 year mortgage by an additional €27 for every €100,000 outstanding, bringing the cumulative additional cost to €92. On, for example, an outstanding mortgage of €275,000 (over 20 years) this implies an additional monthly repayment of €253 per month. In total, the repayment burden will then have increased by 16% since December 2005.

*... €253 for 20 year loan ...*

<b>Impact on Mortgage Repayments Of Interest Rate Increases</b>					
<b>Additional Monthly Mortgage Repayment per €100,000 outstanding</b>					
	<u>Due To 1.25% Increase in Rates to Date</u>		<u>Further Increase of 0.5% Cumulative</u>		
	Repayment Cost	Increase in Burden	Additional Cost	Repayment Cost	Increase in Burden
	€	%	€	€	%
<b>20 Year Mortgage</b>	65	12	27	92	16
<b>35 Year Mortgage</b>	74	19	31	105	27
<b>Interest Only</b>	104	40	42	146	56

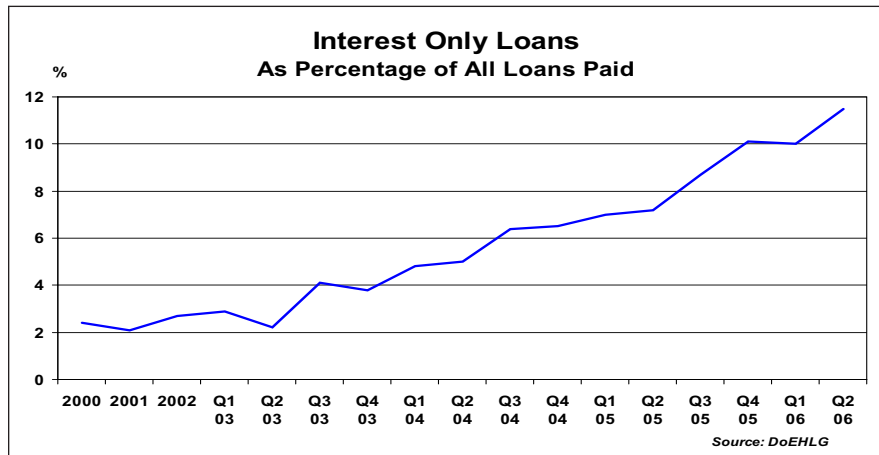
... €290 over 35 years

For a 35 year mortgage, the additional cost of another 0.5% increase in rates would be €31 per month, making a cumulative additional cost of €105. This represents an increase in the repayment burden of almost 27% and it puts the cost of a outstanding loan of €275,000 (on a 35 year basis) up by in total almost €290 since December 2005.

Increased number of interest only loans ...

However, the most significant increase in repayment costs comes for those on interest only mortgages. There has been a significant increase in the number opting for interest only mortgages in recent years and these now account for some 11.5% of new mortgages. For these interest only mortgages, the effect of the 1.25% increase in the mortgage rate to date is to increase the cost of repayments by some €104 per month per €100,000 borrowed.

... for which interest impact is greater ...



... with an additional €400 per month on €275,000 outstanding (+56%)

Then, should rates increase by a further 0.5%, to peak at 3.75%, it would cost an interest only mortgage holder an additional €146 per month per €100,000 outstanding, or a cumulative increase of €146. Overall, under these circumstances, the mortgage burden will have increased by 56%. In this instance, for an outstanding mortgage loan of €275,000, monthly repayments will have gone up by some €400 since December last year.

Thus, the greatest risk from these increases in mortgage repayments is to those who had opted for an interest only mortgage as a means of increasing the overall amount that it would be possible to borrow. For some of these, the increase in repayments from higher mortgage costs could prove unduly onerous. A large number of holders of interest only mortgages are investors who may not have the same degree of long term commitment to the market as some other property owners.

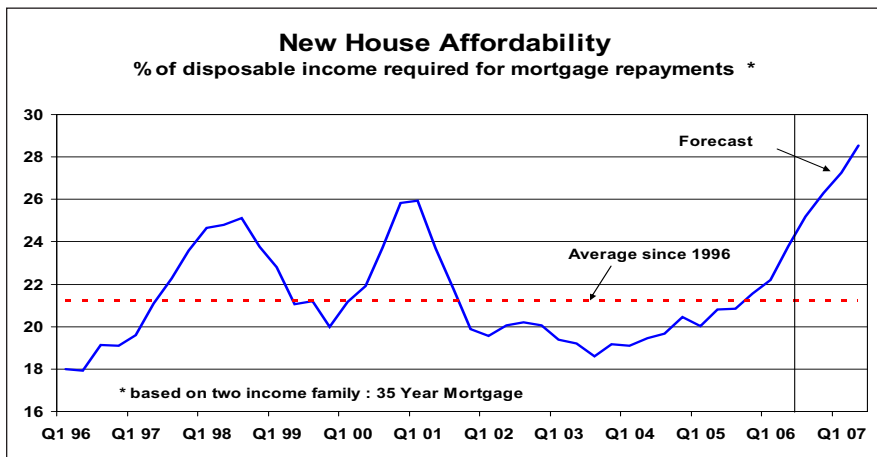
**Repayment Affordability - New Mortgages**

Meanwhile, the combination of rising interest rates and sharply higher prices is leading to a significant deterioration in new mortgage affordability. It may be possible that disposable income will receive a boost in Budget 2007, over

and above the indexation of bands and credits assumed in these calculations. However, even if this were the case, it would have little impact on overall affordability given the dominant impact on affordability of strong house price increases and rising interest rates.

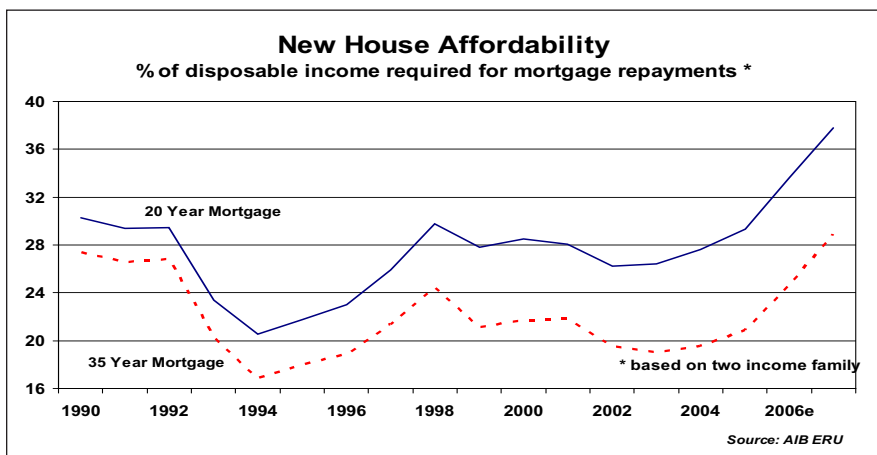
*Significant deterioration in new mortgage affordability ...*

For those looking to take out a new 35 year mortgage, affordability conditions are approaching the worst that they have been over the past 10 years. For example, for a couple on average incomes, taking out a 90% mortgage on an "average" new house, mortgage repayments accounted for 25% of disposable income in Q3 this year. This is up from a trough of 19% in 2003 and above the average for the last 10 years of 21%. With both interest rates and house prices expected to rise yet further, by Q2 2007 a similar mortgage could take approaching 29% of disposable income.



*... removing improvement seen from move from 20 to 35 year loans*

Such a move would serve to wipe out the improvement in affordability that has arisen from the move to longer term mortgages. At almost 29% of disposable income in Q2 2007, repayment affordability on a 35 year mortgage is close to the upper end of the range seen on 20 year mortgages over the 1990-2005 period. Some lending institutions are now offering 40 year loans which will ease affordability conditions somewhat for those eligible for these products. However, the scope to continue improving affordability through new products is becoming increasingly limited.



**Loan Affordability - New Mortgages**

*Higher rates curtail amount that can be borrowed*

By driving up the level of mortgage repayments, the rising trend in interest rates is curtailing the amount that can be borrowed - at a time when house prices are rising.

Banks typically stress test the ability to repay by adding 2% to the prevailing mortgage rate. The banks then generally require that repayments, including this loading, should then be no more than around 35% - 40% of disposable income.

*€51,250 joint income required to buy €275,000 property in December 2005 ...*

We estimate that, towards the end of 2005 (before the first interest rate hike of the current cycle) a working couple would have needed a combined income of €51,250 to get a 95%, 35 year mortgage on a €275,000 property (the national average) if restricted to borrowing no more than 35% of their total disposable income (based on the prevailing average mortgage rates).

*... would only fund property priced at €241,000 now*

However, since then, official interest rates have been hiked by 0.25% on five separate occasions. Thus, on the basis of a 1.25% increase in mortgage rates, to stay within a 35% of disposable income restriction, the same income would only be able to purchase a property priced at €241,000. To buy a property priced at €275,000, their combined income would need to rise to €60,205 (+17.5%). Unfortunately, at the same time rising house prices would have pushed the price of the same property up to €305,000. In this instance, the couple's combined income would need to rise to €69,750 (+36%) in order for the applicant to satisfy the assumed lending criteria.

*Alternatively, require income of €69,750 to buy same property now*

<b>Estimated Income Requirement to Purchase Property Within Lending Criteria *</b>			
	<b>Q4 05</b>	<b>Oct 06</b>	<b>Q2 07</b>
Income required to Purchase €275,000 Property	€51,250	€60,250	€64,000
Property Value Purchasable on Income of €51,250	€275,000	€241,000	€229,000
<b>Same Property</b>			
Price :	€275,000	€305,000	€315,000
Income Required :	€51,250	€69,750	€78,000
* Dual Income Couple, restricted to borrowing no more than 35% of disposable income			

*By Q2 2007, would only be able to buy €229,000 property if no increase in income ...*

It is quite possible that official rates could rise by a further 0.5% before peaking at 3.75% in Q1 next year. Assuming a similar increase in mortgage rates, the couple on a combined income of €51,250 would only be able to buy a property priced at €229,000 (within our assumed lending criteria). In order to purchase a €275,000 property the couple's income would have to

*... and could need €78,000 income for same property*

rise to €64,000 (+23%). Rising house prices could, though, by then have pushed the cost of this same property up to €315,000. In order to purchase this property and still stay within our assumed lending criteria would involve an increase in the couple's combined income to €78,000 (+52%).

Alternatively, of course, the couple could raise the finance for the property by increasing the size of their deposit. The lending institution would then in turn reduce its loan to value ratio.

### **Taxation and Political Uncertainty**

*Some speculation of changes in stamp duty*

Apart from affordability issues, potential buyers are faced with potential political and taxation risks. These centre on two issues, changes in the stamp duty regime in the budget and uncertainty about future expected taxation after the next general election in 2007.

*Any decrease risks pushing up house prices*

There has been some speculation that stamp duty rates may be lowered or the bands increased in Budget 2007. Such a move, should it occur, may do little more than push up prices, as was the case when stamp duty for first time buyers on second hand properties valued at less than €317,500 was abolished in Budget 2005. Though stamp duty rates are unnecessarily high, it may not be appropriate to tackle this issue at this stage.

*Speculation may be dampening demand*

It may well be, though, that anticipation that the government could make some reduction in stamp duty costs is already impacting on the market. The lack of demand evident in recent auction results, in part, appears to reflect a reluctance to purchase properties giving rise to high stamp duty costs ahead of any possible changes in the regime.

*Market eyeing risk that change in government could see higher capital taxes*

On the other hand, the current high level of supply in the second hand market could reflect a desire to realise profits ahead of the next general election. There are some concerns that any change in government could, in particular, result in higher rates for capital taxes.

*Policy changes need to be well considered*

**On both these issues, any changes need to be well considered. House price rises need to moderate and stabilise. Thus, the government should avoid any measures that might threaten this.**

### **First Time Buyers**

*First time buyers vulnerable to deteriorating affordability ...*

First time buyers are particularly vulnerable to deteriorating affordability conditions. Undoubtedly increased income requirements and the higher level of mortgage repayments must be impacting on the ability of some first time buyer couples (and even more some single people) to either raise or service a mortgage loan. Indeed, there is some evidence that first time buyers may be finding it harder to raise a mortgage. However, as yet, there is no very strong evidence that first time buyers are being priced out of the market in

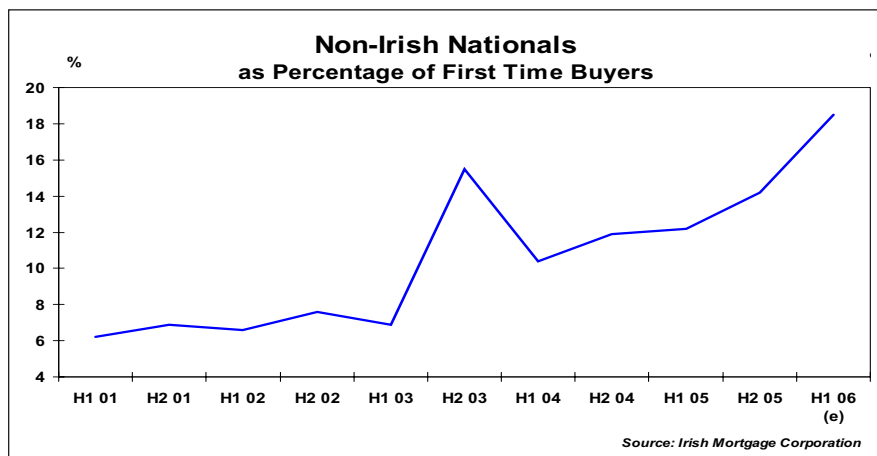
any substantial way. Data on mortgage drawdowns from the Irish Bankers Federation show some slight decrease in the proportion of first time buyers to 33.5% in Q2 2006 (if loans for re-mortgage and top-ups are excluded). This compares to 34.0% in Q1 this year and 34.3% on average in 2005.

Furthermore, Sherry Fitzgerald report that first time buyers accounted for 34% of purchases of second-hand properties in the first nine months of 2006, down from 36% in the same period of 2005. Douglas Newman Good, meanwhile, see a fall in the percentage of purchasers who were first time buyers to 36% in Q3 2006 from 45% in Q2 this year.

However, in absolute terms, there was no decrease in the number of first time buyer mortgages in H1 2006. It may be that parents are increasingly helping their children with deposits to help alleviate the affordability pressures and allow them to enter the property market. This may be one factor behind the increased level of top-up mortgages in the period.

*Increased number of non-Irish national buyers*

Demand from first time buyers is being supported by an increasing number of non-Irish nationals buying property. The Irish Mortgage Corporation has reported that non-Irish nationals accounted for 18.5% of first time buyer purchases in the first six months of 2006. This is up from just 6.2% in H1 2001 and is far greater than the proportion of non-Irish nationals in the workforce, where they represent under 11% of total employment.



Interestingly, though, some 37% of non-Irish national purchasers in Q1 2006 were from Asia, with those from the UK (21%) the next largest group of purchasers. This no doubt reflects the fact that a large number of workers from Asia find employment in the relatively well paid, health sector. Workers from the UK are distributed evenly over all sectors of the economy, but can also be expected to have relatively well paid employment.

It would appear that, as yet, the large influx of workers from the EU-10 Accession States have not been substantial purchasers of property. The Irish Mortgage Corporation data indicate that those from the EU as a whole (excluding the UK) represented only 17% of non-Irish national first time buyers. Meanwhile, this group represent some 54% of non-Irish nationals in

employment. There has been anecdotal evidence of those from the EU-10 Accession States committing to the housing market. However, the deteriorating affordability conditions may well make it increasingly difficult for many of these often lower paid workers to enter the property ladder.

### Existing Owners

*Increased mortgage repayment costs for existing owners*

Existing home owners have to bear the cost of increased mortgage repayments due to higher interest rates. For those on variable or tracker rates, the increases have already to a large extent been felt. For those who had fixed their rates, the impact of recent interest rate increases will only become apparent when the period of fixing comes to an end.

Awareness of the mortgage repayment burden, plus increased ease of switching, has led to an increase in the amount of re-mortgaging. Between 2004 and 2005, there was an increase of 40% in the number of re-mortgage loans and re-mortgages accounted for some 13% of new mortgage drawdowns in Q2 2006. This is up from 9% in 2003 and 10% in 2004.

Meanwhile, affordability considerations could also impact on those wanting to either trade up or down the property ladder. However, the data from the Irish Bankers Federation show no evidence to date that this is significantly curtailing activity in the sector, with little change in the proportion of "movers" as a percentage of total new mortgages.

### Investment Sector

*For investors with interest only loans, interest burden could increase by 56% ...*

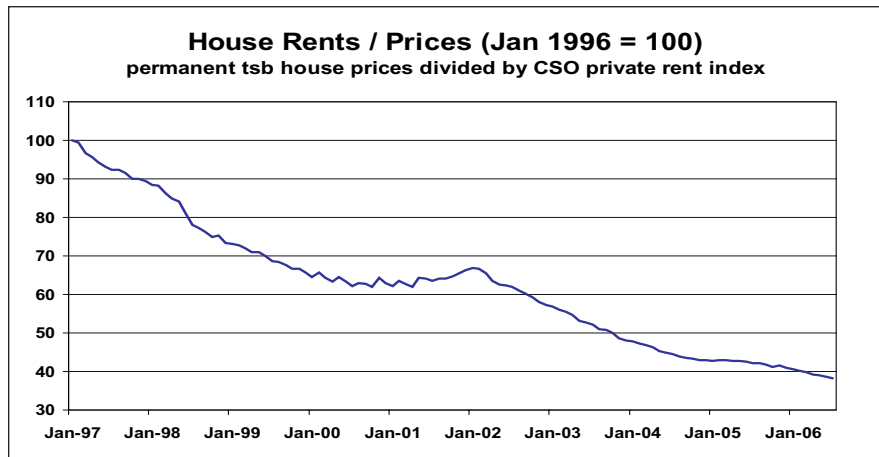
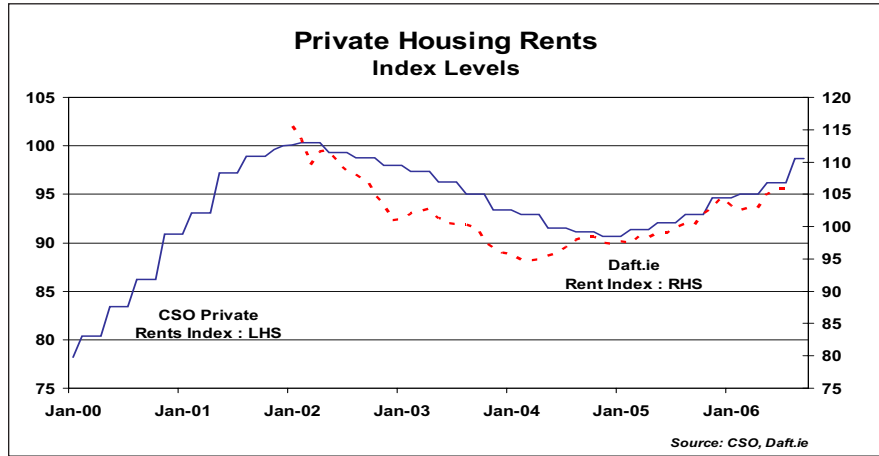
Those investors with interest only loans are particularly vulnerable to the current cycle of rising interest rates. As we estimated earlier, their repayment burden has already increased by 40% since end 2005. If, as we expect, interest rates rise by another 0.5% before they peak at 3.75%, this would give a cumulative additional interest burden of 56%. Even for those properties financed through a 20 year term loan, the monthly repayment burden could increase by in total over 16% from the level at end 2005.

*... only partly offset by the continuing recovery in rental incomes*

This additional repayment burden is only partly being offset by rising rental incomes. According to the CSO's private rental component of the consumer price index, rental levels were up 6.2% in the year to September 2006. Daft.ie report a similar 6% increase in rental levels in the year to July. The level of rental incomes, though, has yet to regain its 2002 peak.

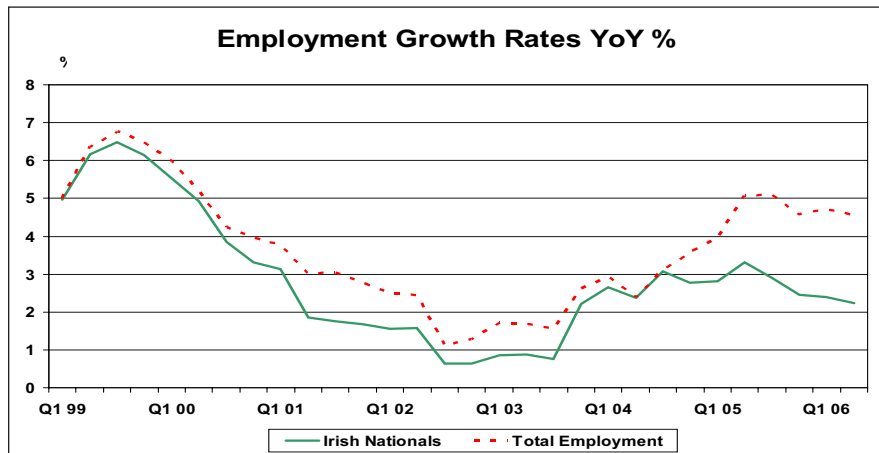
*Price appreciation eroding rental return*

Meanwhile, for new investors, the level of possible rental return is being continually eroded by the strong level of price appreciation. In most instances, rental yields no longer cover mortgage repayment costs. Daft.ie estimate the average rental yield in Ireland at 3.27%, well below prevailing interest rates. Thus, the decision to buy or to hold on to investment property is on the basis of expected capital appreciation only.



Rental demand should remain firm

However, the continuing strong level of net inward migration and strong job creation by the non-Irish nationals argues for strong demand for rental properties. The current strong level of employment growth in the Irish economy of some 4.5% is largely being driven by growth in non-Irish nationals in the workforce. Employment growth by Irish nationals is running at just above 2% per annum. As we have noted above, while there is evidence of increased numbers of non-Irish nationals purchasing property, as yet, the large influx of workers from the EU-10 Accession States have not



been substantial purchasers of property. Provided, as we anticipate, the Irish economy continues to attract high levels of net inward migration, there is likely to be strong demand for rental properties, providing fundamental support to the investment sector.

Thus, **while the investment sector is particularly vulnerable to any significant deterioration in sentiment towards the property sector, the sector remains well underpinned.** Indeed, evidence, as yet, is that investors, by and large, remain committed to the market. Indeed, the data on mortgage drawdowns from the Irish Bankers Federation would give no indication of any downturn in investor interest with investors taking a consistent share of the market over the year and a half to Q2 2006.

*Some hints of cooling investor sentiment ...*

There are, though, some hints from data from estate agents that investor sentiment may be cooling somewhat but there are no signs that investors are withdrawing from the market in any substantial way. Sherry Fitzgerald report that investors represented 29% of vendors in the first nine months of 2006, up just slightly from 28% of vendors in the same period last year. Douglas Newman Good, meanwhile, have seen the percentage of sellers who are investors rising to 33.5% in Q3 2006, from 25% in Q2 this year.

*... but, property owning culture*

However, despite some evidence that sentiment amongst investors may be cooling, the strong price performance of recent years has left many investors with a large safety cushion. Meanwhile, Ireland has a property owning culture without a strong appetite for personal equity investment. Thus, while a higher return can be obtained on some stock investments, property may well remain the main vehicle of investment for many. That being said, **if investors decide to take profits or to hold off from purchasing, in the belief that the property boom is over for the meantime, this could have serious consequences for the market as a whole. Thus, as ever, we maintain a close watch on the investment sector in particular.**

*Sector requires careful monitoring*

### **Second (Non-Investment) Homes**

*Similarly, second homes market vulnerable after recent rate hikes*

The second home market would also appear to be particularly vulnerable to any significant deterioration in market sentiment. As a marginal investment, rather than a housing necessity, increased mortgage repayment costs may become an issue for some second home owners, especially if expectations of capital appreciation dissipate.

The unwinding of tax based holiday home schemes is already acting as a dampener on this segment of the market. Increased planning restrictions on holiday developments can also be expected to impact. Looking forward, we not only expect holiday homes to be less of a driver of the market than they have been to date but there is also a risk that affordability issues could lead to some selling, adding to overall pressures on the housing market.

## Prices : *Cooling to a Soft Landing*

*In April we warned that house price inflation had to moderate*

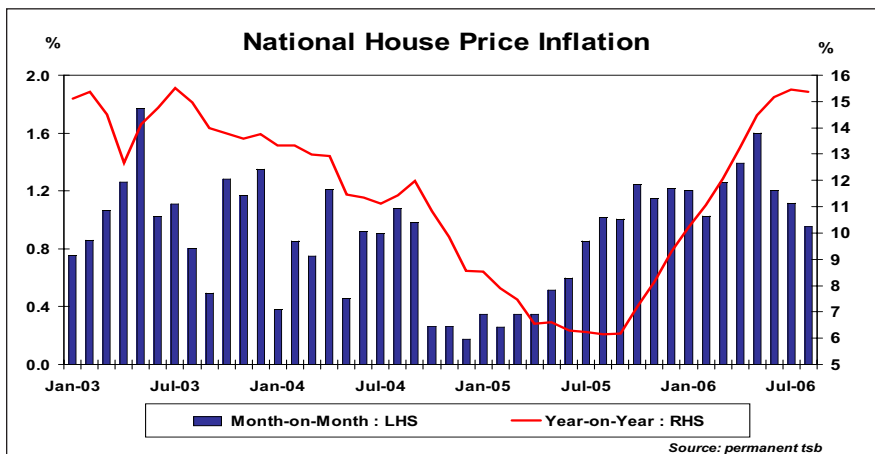
In our last report in April this year we expressed the view that the rate of house price rises was unsustainable and that house price inflation had to moderate. Thus, we are not surprised at the recent indications that the housing market is cooling, especially as affordability conditions deteriorate.

Recently there has been considerable media speculation about the health of the housing market. Undoubtedly, some of the heat has come out of the market. As yet, though, house price inflation remains high. We, however, expect a significant decrease in the annual inflation rate. The crucial question is whether we are heading for a soft or a hard landing. **Overall, we remain of the view that the market is on course for a soft landing. This, though, does not preclude modest price falls on a month-on-month basis in some sectors of the market.**

*Annual rate remains very high ...*

The media speculation about the health of the housing market has been spurred by recent poor Dublin auction reports, suggesting that the large number of properties on offer is impacting on demand and thus on prices. However, as yet, there are no hard data to indicate the extent to which this is impacting on the market as a whole and how, nationally, house prices are responding to the high levels of supply as the autumn selling season gets under way.

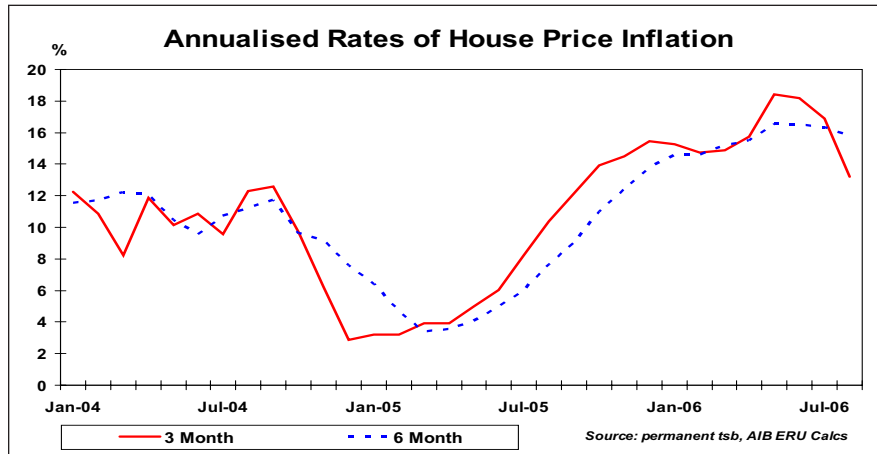
Indeed, the most recent permanent tsb house price data, which are for August, show the annual rate of house price inflation still running at over 15% per annum. This is hardly surprising after 13 consecutive months of price increase of 1% or above. The annual inflation rate in August of 15.4% is unchanged from its July peak. This is a sharp jump from the rate of 9.3% in December last year and September 2005's low of 6.2%.



*... but some moderation in house price increases over the summer months ...*

We may have to wait some while before it becomes clear to what extent prices are responding to the high levels of supply in the autumn selling season and to the deteriorating affordability conditions. However, the permanent tsb data indicate that there was already some moderation in the monthly rate of house price increases over the slack summer months.

According to permanent tsb, Irish house prices rose by on average 1.1% per month in the July/July/August period, a marked decrease on the previous three months in which prices rose by, on average, over 1.4% per month. On an annualised basis, prices were increasing at 18.4% in the three months to May. For the three months to August this annualised rate fell to 13.9%. There has also been a (more modest) decline in the 6 month annualised rate to 16.1% in August from 16.6% for the six months to May.

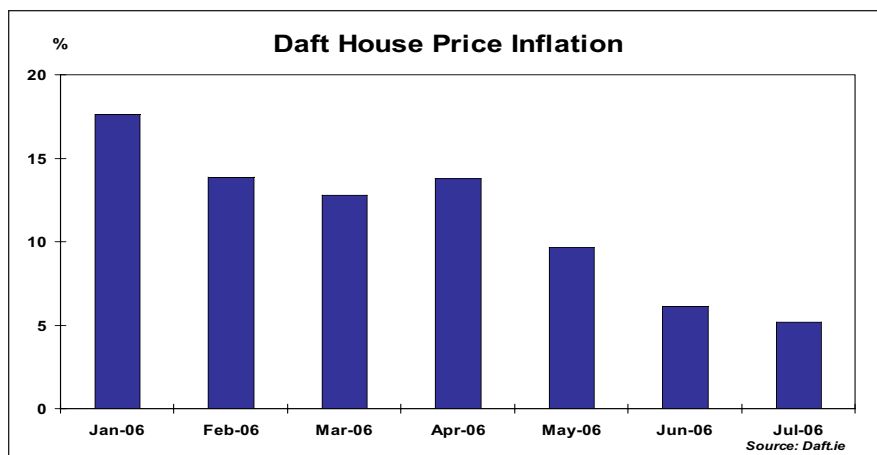


Further indications that prices may have peaked came from the latest DoEHLG data. These show little change in the annual inflation rates in Q2 2006 compared to Q1 this year. For new properties the rate edged slightly higher with a very modest fall in the rate for existing properties.

... and indications of increased realism from sellers

Meanwhile, Daft.ie produces an index of the asking prices for properties advertised on its website. Interestingly, these have shown a sharp downtrend in the recorded inflation rate since the start of the year. In January 2006, asking prices were 17.6% higher than year earlier levels. According to preliminary data, by July the inflation rate had fallen to 5.2%.

Given the short time history of this series, it is important not to read too much into the data. However, it is also important to bear in mind that this index reflects asking prices and not agreed sale prices (as recorded by other



indices). The significant decrease in the rate of growth of Daft.ie asking prices could well reflect increased realism by those advertising properties for sale and a reluctance by vendors to risk pushing prices ahead too fast. If so, it would be an indication that sentiment was already cooling over the first half of the year.

*Housing market not homogeneous*

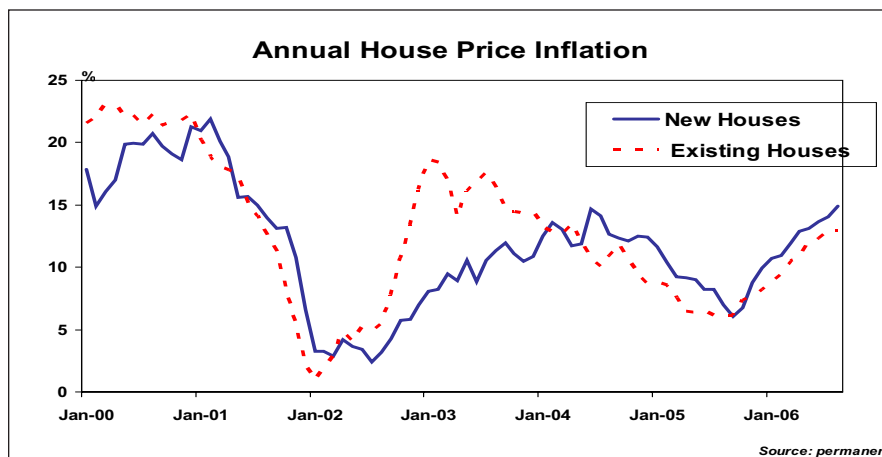
In looking ahead at house prices prospects, it is important to remember that the housing market is not homogeneous. Rather the market is made up of a myriad of distinct sub-sectors (new and existing properties; rural and urban properties; Dublin and elsewhere; first and second time buyers etc) each with its own set of supply/demand characteristics. Thus, the performance of these sub-sectors can vary significantly, though all sectors are inter-related by sentiment towards the market as a whole. Indeed, the moderation in the pace of price rises over the summer months recorded by the permanent tsb data has been seen across all sectors of the market.

The sharp rise in house prices over the past 12 months coupled with higher interest rates are combining to significantly impact on affordability. Thus, it is hardly surprising that we are seeing some moderation in the monthly rate of house price increases. However, the annual inflation rates across most segments of the market remain at or close to recent peaks.

*New house price inflation has remained remarkably firm*

Indeed new house price inflation has remained remarkably firm given the record levels level of supply and it hit a new high for this cycle at 14.9% in August. This indicates the strength of demand pressures which, along with increased site costs and higher development levies, has been putting continued upward pressure on new house prices.

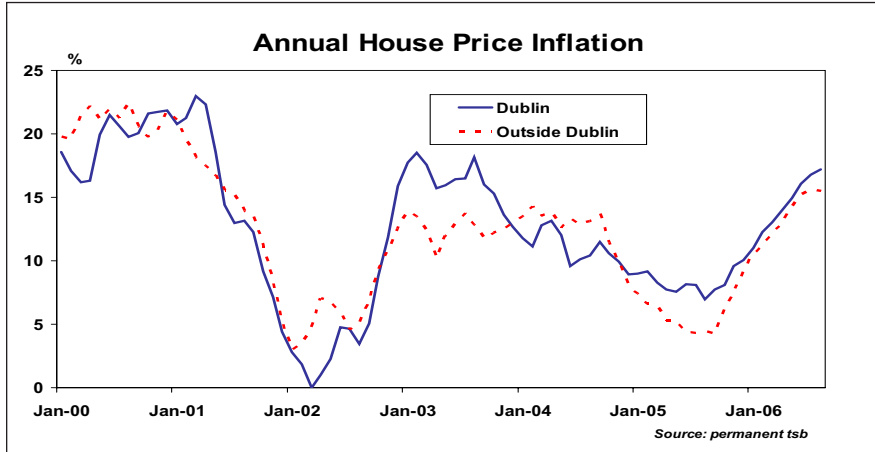
Similarly, for existing houses, the permanent tsb's annual inflation rate of 12.9% in August was very close to the July peak of 13.0%. Within this sector, though, there would appear to be considerable differences across regions, particularly between Dublin and the rest of the country.



*Higher inflation rate in Dublin than elsewhere*

Overall, house price inflation in Dublin is higher than elsewhere in the country. The permanent tsb data show house price inflation in Dublin

running at 17.2% in August as supply constraints impact, with prices outside Dublin increasing at a rate of 15.5% per annum.



*Inflation rate for Dublin may be even higher than permanent tsb data suggest*

As we have noted before, some Dublin estate agents report significantly higher rates of inflation for Dublin properties, in the existing homes sector in particular. The view of the estate agents about the strength of the Dublin second hand market in the early months of the year would appear to be borne out by the official data from the DoEHLG. The DoEHLG figures show, on average, Dublin existing house prices rising by 17.5% year-on-year in Q1 this year compared to the 13.9% year-on-year rate recorded by permanent tsb. However, the permanent tsb data appears to be catching up with the DoEHLG's index. By Q2 2006, the gap between the two had narrowed significantly, with the DoEHLG reporting an inflation rate of 17.3% and the permanent tsb 16.8%.

Year to:	Q4 2005	Q1 2006	Q2 2006	Q3 2006
permanent tsb	10.9	13.9	16.8	
Dept of Environment	15.6	17.5	17.3	
Sherry Fitzgerald	23.3	30.5	33.8	29.2
Douglas Newman Good	22.0	25.8	27.8	24.4

Part of the difference in the price measures may lie in the structure of the indices. For example, the DoEHLG are using a simple average of all transactions reported to it, whereas the permanent tsb data tries to take account of factors such as location and type of property (such as number of rooms). See feature box : *What is the rate of Irish House Price Inflation?*

*Sub-sectors even within the Dublin area*

Meanwhile, the considerably stronger rates on inflation reported by estate agents for existing Dublin properties could, in part, be explained by geographical or property type differences between the catchment areas of the various samples. Indeed, Douglas Newman Good report considerable

## What is the Rate of Irish House Price Inflation ?

When prices were rising strongly the exact level of house price inflation mattered very little. However, the housing market is now cooling. This risks the emergence of negative price changes on a month-to-month basis. Such outcomes would attract a considerable amount of media attention.

In this context, it is wise to remember that the housing market is not homogeneous, but is made up of a series of distinct sub-sectors all with their own supply/demand characteristics. Thus, there can be considerable variations in price performances across these various sub-sectors.

This also raises the question as to what exactly is the level of Irish house price inflation and how exactly should it be measured. There are several indices available, focusing on different times in the purchase process, with different sample sizes, different catchment areas and different calculation measures, thus all providing different readings on the level of inflation.

IRISH HOUSE PRICE INDICES			
House Purchase Process	House Price Index	Methodology	Coverage
Begin Search - Asking Prices for properties advertised for sale on Website	Daft.ie	Hedonic Index *	National
Expected Selling Price	Sherry Fitzgerald Douglas Newman Good	Valuation on Constant Sample of Properties	Dublin - Existing Properties
Mortgage Approval	Permanent tsb	Hedonic Index *	National : Sub Indices Available Including New, Existing, Dublin and Outside Dublin
Mortgage Approval	DoEHLG	Simple Average	Separate New and Existing Property Indices : National plus Regional Sub Indices
* These indices are calculated using regressions which attempt to calculate changes in prices independent of a number of variables, such as size, location and dwelling type.			

The **Daft.ie** index captures data on asking prices on the property website. As such, it is earlier in the purchase process than other indices and it is a measure of seller's expectations rather than a measure of achieved sale prices.

Permanent tsb and the **Department of the Environment, Heritage and Local Government** (DoEHLG) both provide indices based on mortgage approvals. The coverage of the DoEHLG index is the most broad based, taking data from all the mortgage providers. However, there are only separate indices for new and existing properties (at both national and regional level) with no all encompassing average index. The indices are simple averages of transaction prices and take no account of changing market structures (i.e. more large houses being traded or less properties in an expensive location such as Dublin). Also, the data are published with a considerable time lag with the most recent figures being for Q2 2006.

The **permanent tsb** data, on the other hand, are the most timely, with the most recent figures available being for August this year. There are, in addition, as well as the headline national average figure, several sub-indices covering the main segments of the market which are calculated on a monthly or quarterly

basis. The permanent tsb (in conjunction with the ESRI) attempts to overcome the problem of the mix of property traded by calculating hedonic indices. A number of variables that can influence house price have been identified (i.e. size, dwelling type, location) and a multivariate linear programme is used to explain house price movements in terms of these variables.

The permanent tsb/ESRI have developed separate relationships with these variables for the different sub-indices. This can throw up anomalies between the sub-indices and the headline index. For example, in August the national average inflation rate was 15.4%. However, the rates for both new and existing properties were both lower than this, at 14.9% and 12.9% respectively. Meanwhile the rates for properties in Dublin and outside Dublin were both above the national average (at 17.2% and 15.5% respectively). Similar anomalies occur between the more detailed breakdowns available on a quarterly basis and the monthly data for the same period.

Meanwhile, some of the Dublin estate agents such as **Sherry Fitzgerald** and **Douglas Newman Good** produce their own indices for existing properties, based on the valuation of a constant sample of properties. These indices do not allow for a change in the property mix and, in addition, are biased by the catchment areas of the offices of the particular estate agent. However, the recent considerable differences with the permanent tsb data highlight the problem in trying to assess the true level of house price inflation. For example, in Q2 2006 the rate of inflation for Dublin existing properties was 16.8% according to permanent tsb. The inflation rates reported by the estate agents were considerably higher than this at 33.8% from Sherry Fitzgerald and 27.8% according to Douglas Newman Good.

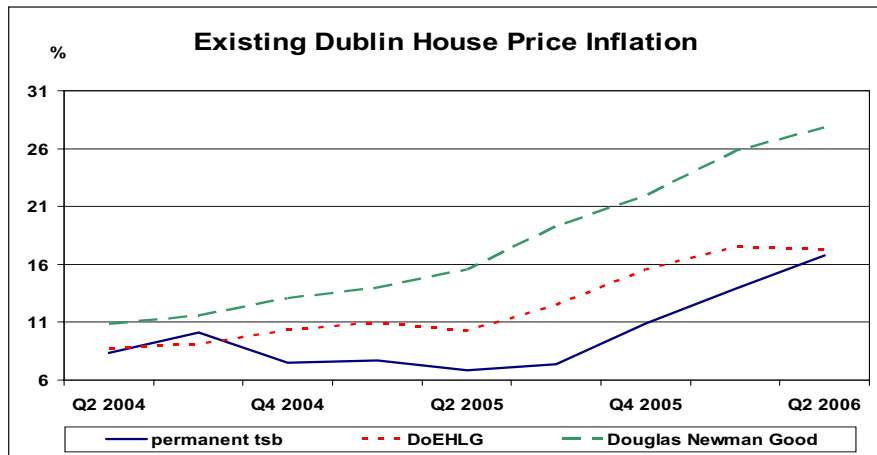
LATEST HOUSE PRICE INFLATION RATES			
Daft.ie	July	National :	5.2
Permanent tsb	August	National :	15.4
		New :	14.9
		Existing :	12.9
Permanent tsb	Q2	Dublin :	17.2
		Outside Dublin :	15.5
		New - Dublin :	9.7
		Existing - Dublin :	16.8
		New - Outside Dublin :	13.4
DoEHLG	Q2	Existing - Outside Dublin :	15.6
		New :	11.9
		New - Dublin :	14.6
		Existing :	14.1
Sherry Fitzgerald	Q3	Existing - Dublin :	17.3
		Existing - Dublin :	29.2
Douglas Newman Good	Q3	Existing - Dublin :	24.4

***The difficulties in assessing the true level of Irish house price inflation will become increasingly important as the house price inflation rate falls. In the absence of any timely official statistics, attention will continue to focus on the permanent tsb data. The first monthly price fall in this index will attract considerable market and media attention.***

Given the anomalies that can be thrown up by these indices ***we would caution against reading too much into a particular index level but rather focus on the messages being sent by the general trend.*** Given the segmented nature of the market, it is also wise to look at the trends for new and existing properties.

The DoEHLG is currently developing a mix-adjusted house price index to take account of different property characteristics. We await this data to see whether it overcomes some of the problems with the existing indices and whether it will be published on a timely enough basis to be of use as a measure of the trends in Irish house price inflation.

differences in price rises across the Dublin region in the third quarter of the year with Southside, Northside and Westside properties increasing in price by 3.82%, 0.84% and 0.15%, respectively, in the quarter.



However, while there is some evidence that the permanent tsb index may be understating house price inflation in some areas, it remains the most timely and relatively comprehensive measure available. Thus, we will continue to monitor its performance as our benchmark for the market.

*Several reasons why further moderation in rate of price rises expected*

We expect that these price indices will show a continuation of the moderating trend in monthly house price rises over the coming months for a number of reasons. Namely:

- Affordability will increasingly become an issue for first time buyers as interest rates continue upwards
- Higher interest rates are also impacting on the return available to investors
- While recent price performance indicates that there is still a supply/demand imbalance, the pace of new house building will help to relieve some of these pressures in the new homes sector
- There is evidence of increased supply in the second hand market which should serve to dampen inflationary pressures in this sector.
- Finally, sentiment towards the market as a whole has deteriorated. The market would appear to be turning from a sellers to a buyers market, leading some purchasers to hold off in the hopes of achieving lower prices.

*Inflation rate still in double figures at end 2006....*

However, even if, as we expect price rises do begin to moderate significantly in the coming months, inflation, as measured by the permanent tsb index is still likely to be in double figures by end 2006 and, indeed, could well still be at or above 12% at end year.

*... but significant moderation expected in 2007 ...*

For 2007, we do expect a significant moderation in the rate of house price inflation. However, it shouldn't be forgotten that the market remains well underpinned by functional demand. Thus, overall, we are looking for a soft landing. That being said it is quite possible that there will be months in which prices will fall.

*... with inflation rate of 5-7% in new homes sector*

Looking to the new homes sector, while the high levels of supply should help alleviate the supply/demand imbalance, there have been reports of good enquiries over the summer months and strong initial sales as the autumn selling season gets under way. If sentiment weakens more than expected due to the deteriorating affordability conditions we would expect the initial response from the construction sector to be a delay in the release of further phases of developments rather than cutting prices. Thus, we are forecasting an annual inflation rate of around 5-7% by end 2007. Within this, though, there may be variations, with a shortage of larger family homes in many areas supporting prices in this sector. On the other hand, some sectors of the apartment market may prove more competitive. The overall supply shortage in Dublin, though, should provide support to this region.

*Pressures greater for existing homes ...*

Pressures are likely to be greater in the existing homes sector where individual owners don't have the same capacity to hold onto stock in the face of deteriorating market conditions. Investors holding property in the expectation of capital gains are particularly vulnerable to swings in sentiment.

*... leading to modest price falls in some sectors ...*

The increased amount of stock for sale in the existing homes sector of the market appears to be quickly turning the sector into a buyers' market. This can be expected to increasingly result in longer delays to complete a sale as well as price falls in some sectors of the market. However, we do not expect any significant fall in prices for second homes on a year-on-year basis. The strength of underlying functional demand should be sufficient to attract buyers back into the market should prices decline in any meaningful way. Thus, we are pencilling in an 0-5% inflation rate for the existing homes sector at end 2007.

*... and average inflation rate around 3-6% by end 2007.*

*Inflation to remain low in 2008*

Overall, we would be expecting that house price inflation will remain in low single digits for 2008, possibly contained in a 3 - 5% range.

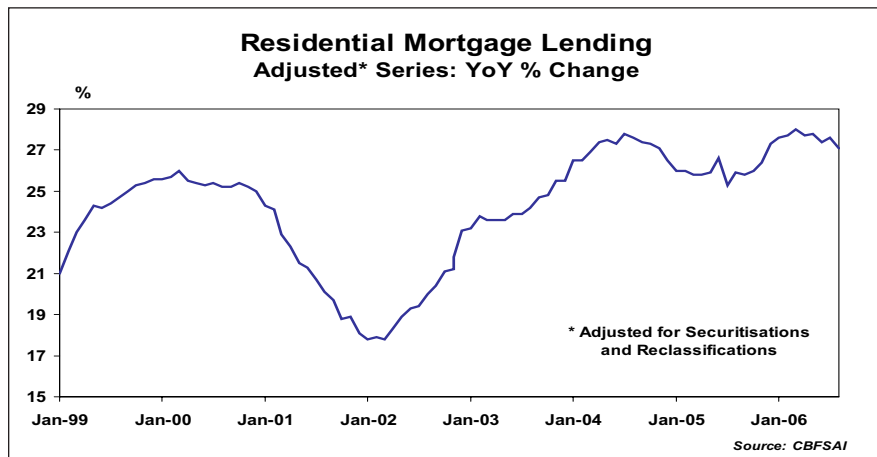
<b>Permanent tsb House Prices Annual % Change (End Year)</b>			
	<b>New</b>	<b>Existing</b>	<b>Average</b>
2002	7.0	16.2	13.3
2003	10.8	14.4	13.8
2004	12.4	8.7	8.6
2005	9.9	8.2	9.3
2006 (f)	13	11	12
2007 (f)	5-7	0-5	3-6
2008 (f)	3-5	3-5	3-5

## Mortgage Lending : Mortgage Credit Growth to Moderate

*Some moderation in the pace of mortgage growth*

The demand for mortgage related borrowing has remained strong, which is hardly surprising, given the continuing strong housing market conditions. However, in tandem with house prices, there has been some slight moderation in the pace of mortgage growth over the summer months.

Indeed, the latest official data from the Central Bank and Financial Services Authority of Ireland (CBFSAI) show that the annual rate of net mortgage lending growth (new mortgages minus redemptions) on an underlying basis (excluding securitisations and reclassifications) had ticked down to 27.1% by August from March's record rate of 28.0%.



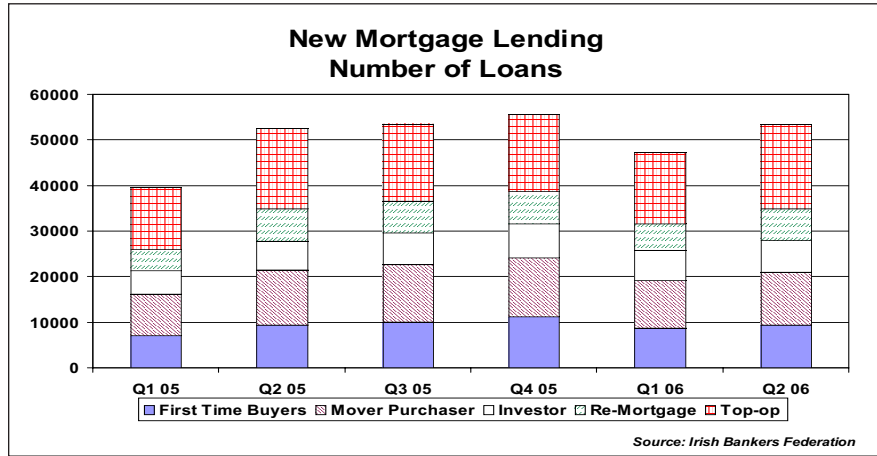
*Trend likely to continue*

The pace of mortgage credit growth should continue to slow as the rate of house price inflation moderates and the level of housing output begins to cool, despite support from activity in the existing homes market and equity withdrawal. We anticipate that underlying mortgage growth will have fallen to 20% by end 2007 and 15% at end 2008.

Meanwhile, the Irish Bankers Federation have recently published quarterly data on gross new mortgage lending. These show that there was just a 1.8% year-on-year increase in the number of mortgage loans drawdown in Q2 2006. This compares to growth of 19.3% in Q1 this year. It is possible that this may reflect a seasonal effect due to differences in the timing of Easter in the two years. Thus, it seems best to consider the two quarters together. For the first half of 2006 as a whole, new mortgage lending was up 9.3%.

*Many top-up mortgages probably for property related expenditure*

In total, in the first half of 2006, there were 100,693 new mortgages drawdown. Of these, 53% (53,796) were for the direct purchase of property, either by first time buyers (18%), those moving to a new residence (22%) or investors (14%). A further 34% of loans were top-up of existing mortgage loans. The large average size of these (€86,489) suggests that a significant number of these were for property related expenditure: either the purchase of a second property; home extensions or deposits for children. Though there are no data on the purpose of equity withdrawal, the amount used for non-property related expenditure, such as on cars and holidays, may be relatively small.



Increasing amount of re-mortgaging

Meanwhile, re-mortgaging accounted for 13% of the new mortgage lending in the first half of this year. This is up from 9% in 2003 and 10% in 2004. The increasing number of re-mortgage loans (up 28% year-on-year in H1 2006) is probably a reflection of two factors. One, is the pressures on existing mortgage holders from deteriorating affordability. This is probably encouraging an increasing mortgage holders to look for cheaper, more attractive options. The other is the greater ease and lower cost of switching mortgage products.

Based on the trend in the first half of the year it looks as if there could be some 220,000 new loans paid in total in 2006. Excluding re-mortgages and top-ups the number could be around 120,000. Further growth in mortgage lending could see in total some 235,000 new mortgages written in 2007.

	Number	% share	% YoY	Value €m	% share	% YoY	Average loan €
Property Purchase	53,976	53	9.7	12,851	69	26.4	238,082
<i>of which</i>							
First Time Buyers	18,196	18	10.1	4,004	22	24.7	220,048
Mover Purchasers	22,050	22	4.3	5,211	28	20.1	236,327
Investors	13,730	14	19.0	3,363	20	38.7	264,822
Re-mortgages	12,701	13	7.3	2,775	15	27.8	218,487
To-ups	34,016	34	9.5	2,942	16	43.4	86,489
Total	100,693	100	9.3	18,568	100	29.0	184,402

Source: Irish Bankers Federation



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