

THE IRISH HOUSING MARKET & PERSONAL SECTOR FINANCES

Firm Foundations

- Outlook for housing revised upwards on sustained demand
- No downturn in housing output until 2008
- House prices to continue rising above 5%
- Comfortable affordability despite likely interest rate rise of 0.5% in 2006
- More mortgage lending means higher personal debt ratios, but asset values also rising
- No major external risks to housing sector. Government intervention best avoided

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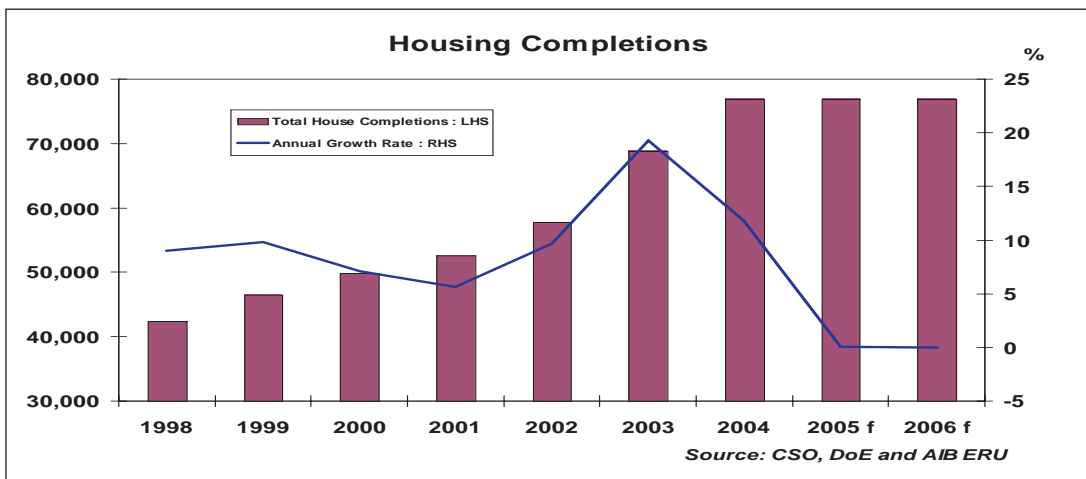
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EXECUTIVE SUMMARY

House Completions to Remain at Elevated Levels

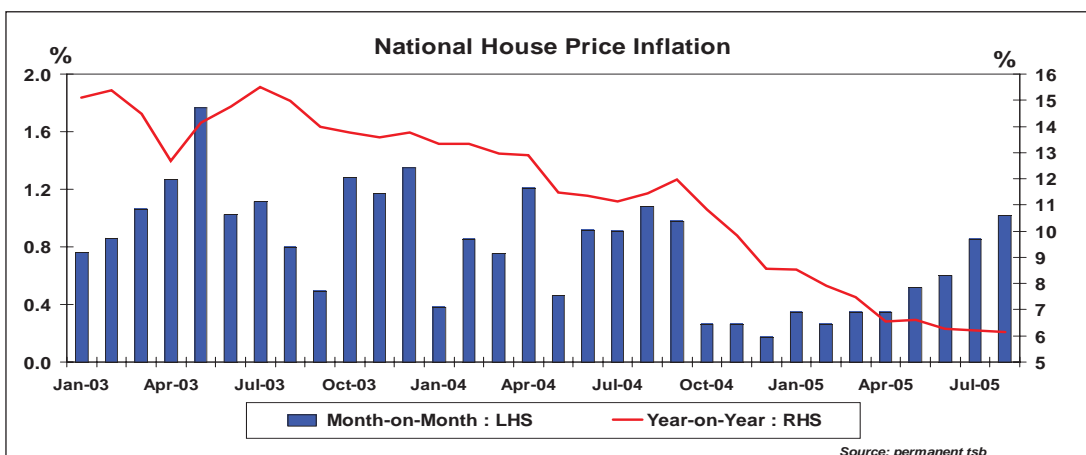
The Irish housing market remains very buoyant, fuelled by exceptionally strong demand, particularly from first time buyers. **House completions are expected to average 77,000 this year, the same as in 2004.** We now believe that completions will remain at this elevated level in 2006 and again in 2007.

It must be emphasised that whatever the longer term supply/demand housing requirements, the short to medium term outlook for demand supports the current level of output. Indeed, supply may be constrained by planning and other limitations. The release of SSIA funds from mid-2006 onwards is also likely to provide a boost to the market over the next two years.



Price Forecasts Revised Upwards

On the prices front, with demand still exceeding supply, the deceleration in the annual growth in house price inflation seems to have halted. Average house prices could now rise by 7% in 2005 and again in 2006, compared with our previous view of a slowdown in the annual rate to 5% at end 2005 and to 2% at end 2006. **Thus, the soft landing to price stability that we envisaged in our last report could be postponed until 2008.**



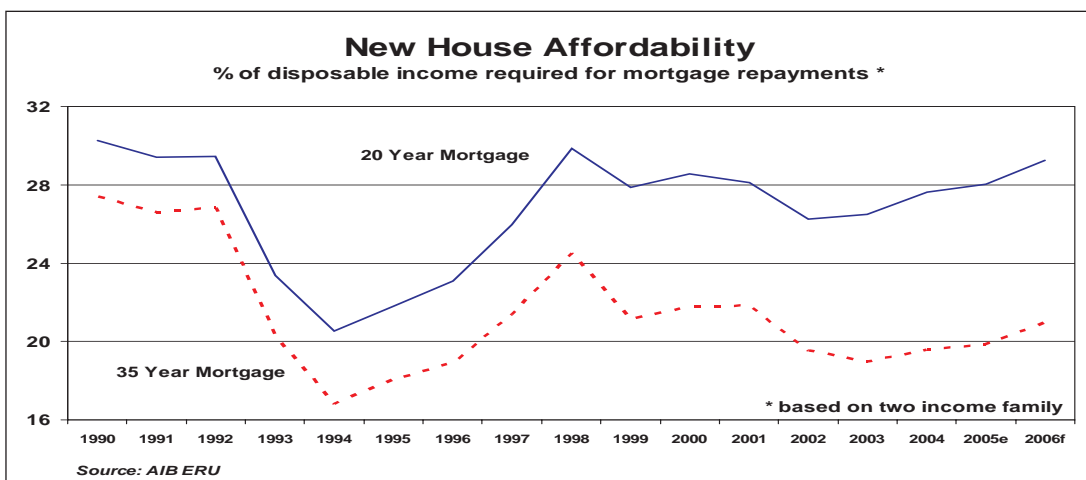
Population Growth and Increased Headship Fuelling Demand

Strong population growth, aided by substantial net inward migration, is fuelling housing demand. However, we also believe that headship rates have increased significantly over the past couple of years and will rise even further, as pent up demand is satisfied.

Housing Demand				
Estimated Distribution of House Completions				
Year to April	2004	2005	2006 (f)	2007 (f)
Indigenous Population Growth	16,800	16,800	16,800	16,800
Net Inward Migration	12,400	21,000	17,900	15,900
Headship	22,000	21,000	25,500	25,200
Second Homes	12,500	9,500	8,000	10,000
Replacement of Obsolete Units	8,100	8,400	8,800	9,100
Completions	71,800	76,700	77,000	77,000

Comfortable Affordability Despite Expected Higher Interest Rates

Affordability is comfortable and is expected to remain so, notwithstanding the likelihood that the ECB will raise official interest rates by 0.5% in 2006. Apart from the impact of a small rise in mortgage rates in 2006, other economic fundamentals will provide a solid underpinning to the level of demand in the Irish housing market.



Supports for First Time Buyers and Investors

Real GDP growth of about 5% in 2006, a further rise in employment of 60,000 and continuing low unemployment will provide a very positive backdrop for first time buyers next year. The expectation of continued sustained increases in house prices will also support the investor segment of the market.

Risks From Undue Administrative Intervention and Taxation Changes

While we are more confident than previously about the near term outlook for the housing market, and see little or no chance of a crash, the outlook is not without some risks. Notably, **the housing market should not be burdened with undue administrative intervention or taxation changes. Both buyers and suppliers view the risks of property related tax changes as the greatest threat to the sector.**

While Continued Inward Migration Necessary

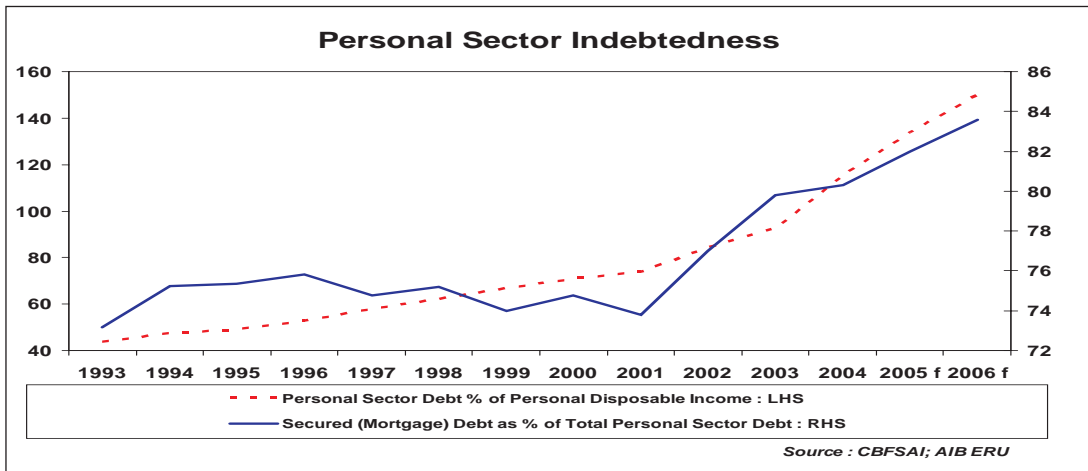
Provided the Irish economy can continue to generate strong employment growth, then there should be further inward migration that will help to sustain housing demand. Indeed, current high levels of housing output can only be justified on the basis of sustained sizeable net inward migration. Furthermore, it is important that those migrant workers currently in the Irish economy, in the construction sector in particular, remain employed in Ireland or migration flows could turn negative, which would have significant adverse consequences for housing demand in the future.

Good Underlying Long Term Demand

However, **we still see the market as having good support at around 60,000 units per annum in the longer term.** In the absence of an unexpected shock to the market, though, we don't see output dropping back to this level for some years. Even then, **the transition to our estimated longer term sustainable level of output may be very gradual.**

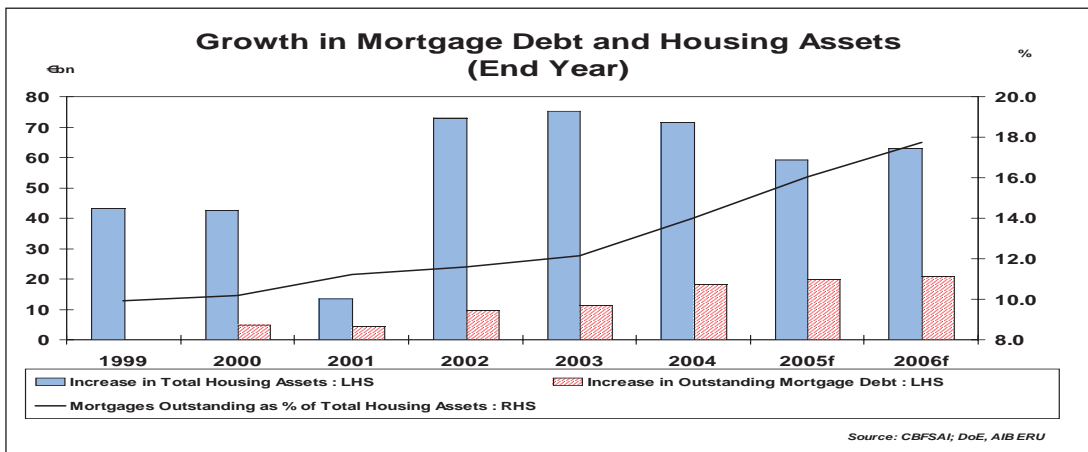
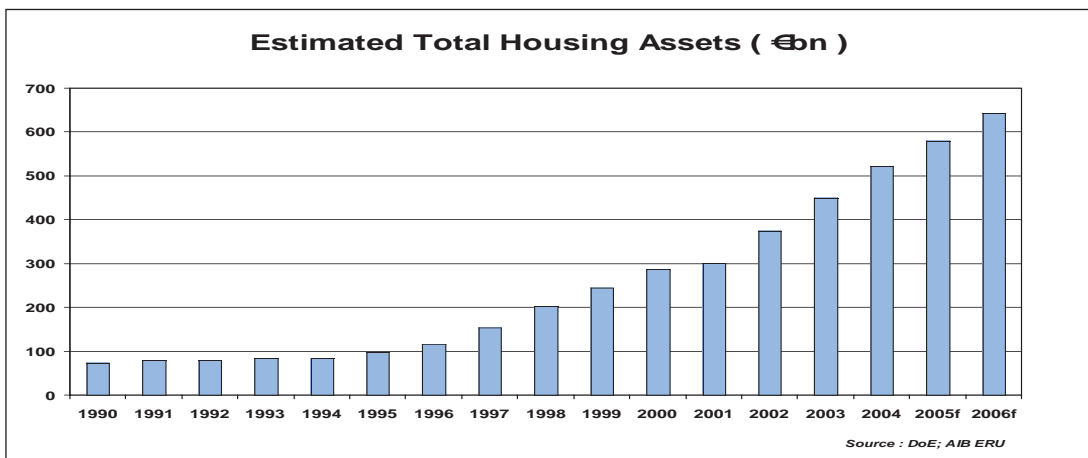
Strong Growth in Mortgage Lending and Personal Debt Levels

Mortgage lending is forecast to grow by 25% in 2005 and by 20% in 2006. This lending constitutes over 80% of all personal sector borrowing. The forecast growth in overall personal lending will result in a further sharp rise in the personal debt to personal disposable income ratio to 150% by 2006, compared with 115% in 2004.



Also Strong Rise in Housing Assets

However, it must be remembered that personal sector assets will also grow strongly, so that **total house mortgage debt will be no more than 18% of total housing assets by 2006**. By end 2006, the value of housing assets will be over 7 times total personal disposable income.



PART I

Prices, Output and Demand

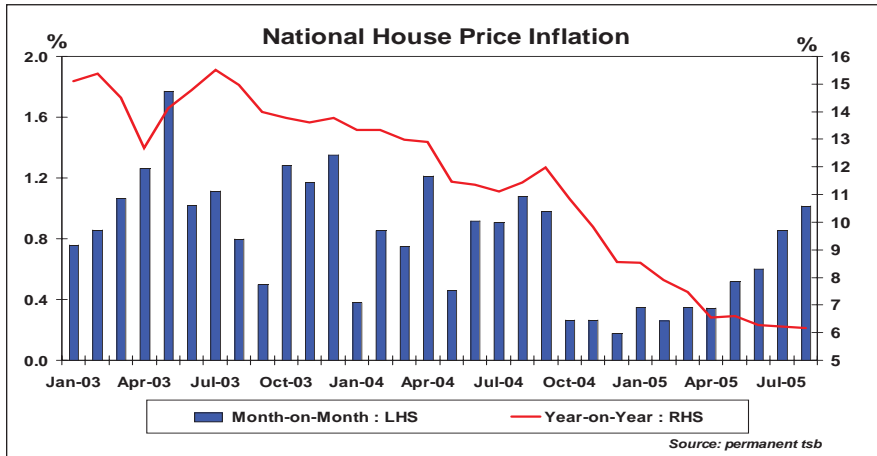
Prices : *Moderating Trend Beginning to Stall*

House price inflation has moderated...

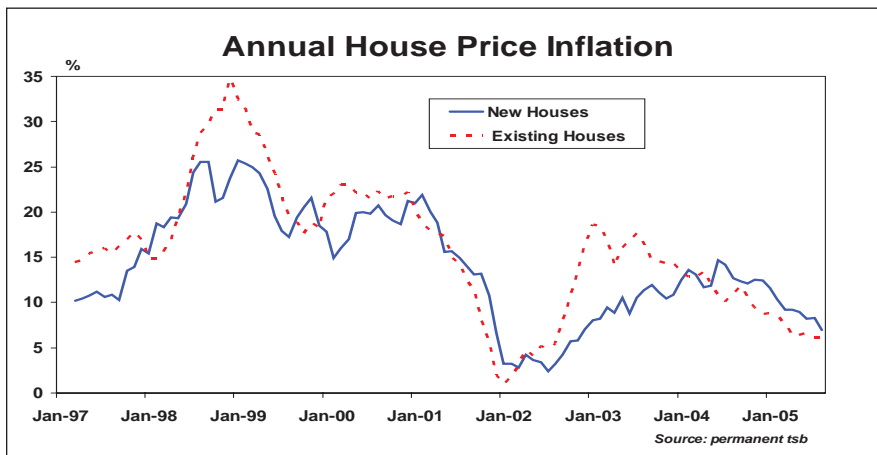
House price inflation moderated in the first eight months of 2005 but there are signs that the rate of decline is stalling. Permanent tsb data show that the inflation rate had fallen to 6.2% in August this year, down from 8.3% in December 2004 and from its peak of 15.5% in July 2003. This downtrend was aided by the fact that over the period from October 2004 to April 2005 the monthly increase in prices was confined to a modest 0.2% to 0.4% range.

... but rate of decline has stalled

Since then, however, there has been some pick-up in the pace of monthly price rises. Indeed, overall prices increased by 0.9% and 1.0% in the months of July and August respectively. This could well be partly due to seasonal factors. However, the annual level of house price inflation has only edged slightly downwards in recent months, from 6.5% in April to August's 6.2%.



The moderating inflation trend of the past two years has been evident for both new and existing properties. Though new house price inflation continues to outpace that for existing houses, its rate of decline year to date has been greater. The permanent tsb data show that new house price inflation stood at 7.0% in August this year, with that for existing houses at 6.1%, down from rates of 12.4% and 8.7%, respectively, at the end of 2004.



Indications of a supply shortfall

The fact that the downtrend in house price inflation has stalled, and indeed is showing signs that it could be reaccelerating, is indicative of a supply shortfall. It would appear that underlying demand is outpacing even the current high levels of output.

On top of the supply shortage of new properties, the stamp duty concessions for first time buyers of second hand properties are providing some support to prices in this sector. Thus, the scope for a further fall in house price inflation seems limited.

House price inflation forecasts revised upwards to 7%

It now appears that overall house price inflation will end 2005 at around 7%. For 2006, it seems more likely that prices will settle above 5% rather than below and we again expect them to end the year around 7%. These are higher than our previous forecasts, which had been that house price inflation would end 2005 at just below 5%, with the inflation rate dropping further to 2.5% by end 2006.

Prices positive for demand

Should annual house price inflation continue to run above 5%, this would in itself be supportive of housing demand, especially from investors. Surveys indicate that potential purchasers expect house prices to continue to rise at a pace around this level. Provided their expectations are being fulfilled, potential purchasers will not be deterred from entering the market.

House Prices Annual % Change (End Year)			
	New	Existing	Average
2002	7.0	16.2	13.3
2003	10.8	14.4	13.8
2004	12.4	8.7	8.6
2005 (f)	7	7	7
2006 (f)	6	8	7

Source: permanent tsb, AIB ERU

Housing Output : *Sustaining High Levels*

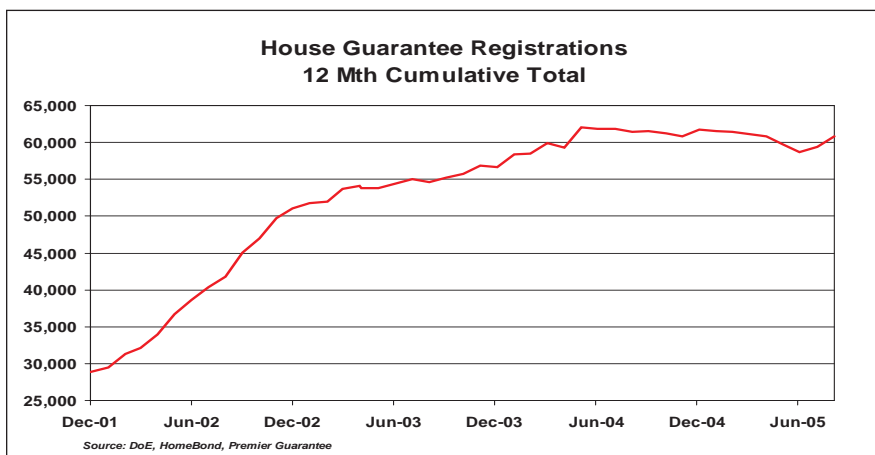
Completions appear to have stabilised at record high level...

Last year was a record one for housing activity with 76,954 new houses completed, an increase of 11.8% on the previous year. The most recent data from the Department of the Environment, Heritage and Local Government (DoE) show that output would appear to have stabilised at close to these record levels. There were 54,394 house completions in the first nine months of 2005, an increase of just 0.4% on the same period a year earlier. Only limited information is available on the breakdown of completions between private and social housing. Of the 35,307 completions in H1 2005, 33,383 were in the private sector with a further 1,924 in the social sector.

.. while house guarantee registrations also broadly stable

House guarantee registrations provide a good proxy for private housing starts, and eventual completions, excluding most once-off housing. Registrations, though, can in some cases significantly pre-date completions for properties sold off the plans with a long lead time before development takes place. Thus, the trend in registrations in 2005 will not be fully reflected in completion totals until 2006 or possibly into 2007.

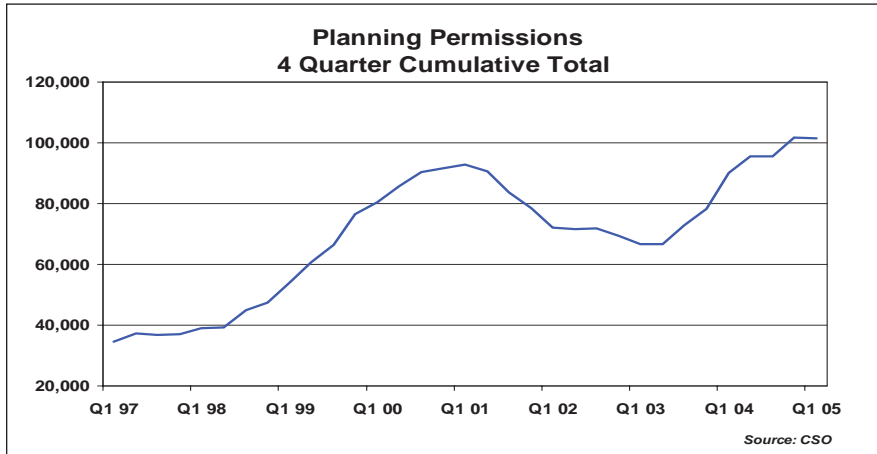
Total registrations were virtually unchanged year-on-year for the first three quarters of 2005. Again, this follows a record performance in 2004, when there were 60,782 registrations issued, an increase of 7% compared to 2003 levels. Having fallen by 3.2% in the first six months of 2005, registrations increased by 8.4% yoy in Q3. Given the volatility in the data, it is too soon at this stage to call the recovery in Q3 a resumption of the uptrend in registrations. Indeed, as the chart below shows, it looks as if house registrations have broadly stabilised, with the trailing 12 month cumulative total of registrations around 60,000. It has been close to this level since mid 2004, following a sharp rise over the previous two and a half years.



Planning permissions also continue to point to buoyant house building activity, with over 100,000 permissions in the year to Q2 2005. Not all of these will translate into completions and some are for developments that will not be started for a considerable period.

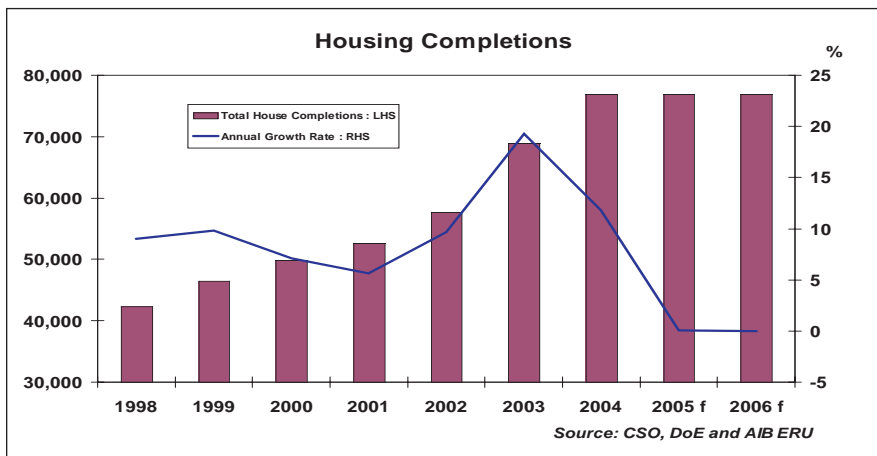
While overall permissions grew by 5% yoy in H1 2005, there was a marked decrease in the number of permissions for apartments. These were down

almost 15% in the period. Given the scale of apartment developments and the uneven nature of the timing of their planning permission approvals, we await more data before we would conclude that there is a sustained trend emerging in this sector.



Continued high levels of output in 2006

Overall, given the level of output year to date and the recent trend in registrations, we expect completions of around 77,000 in 2005, close to 2004 levels. There are, as yet, few indications of any significant downturn in activity, with demand factors remaining very buoyant. Thus, at this stage, we are looking for completion levels to be little changed in 2006 at again close to 77,000. With most SSIA accounts maturing in early 2007, housing completions could also be close to the 77,000 level again in that year.



Demand : *Remains Robust*

The components that drive housing demand can be broken down into the following categories:

- Population growth
- Migration
- Change in headship
- Second, or otherwise vacant, homes
- Replacement of obsolete units

Below we review these factors and we have adjusted our previous estimates in the light of new data and emerging trends.

Revised demand estimates.....

The table below contains our revised estimates for the distribution of housing output between these demand categories. One of the key factors underlying recent robust housing demand has been strong population growth, aided by substantial net inward migration.

..... notably increased headship

However, perhaps the most significant trend that we believe has emerged is a strong rise in headship rates (the proportion of adults in any age cohort who are heads of households). Thus, these revised estimates contain a significant increase in the demand for housing to satisfy increased headship. On the other hand, we do not think there have been as many second homes purchased as we had previously estimated.

Housing Demand						
Estimated Distribution of House Completions						
Year to April	Avg 1996-2002	2003	2004	2005	2006 (f)	2007 (f)
Indigenous Population Growth	12,550	17,000	16,800	16,800	16,800	16,800
Net Inward Migration	13,650	11,700	12,400	21,000	17,900	15,900
Headship	1,250	10,900	22,000	21,000	25,500	25,200
Second Homes	10,800	12,000	12,500	9,500	8,000	10,000
Replacement of Obsolete Units	6,500	7,800	8,100	8,400	8,800	9,100
Completions	44,750	59,400	71,800	76,700	77,000	77,000

*Source : AIB ERU
1996 - 2002 period based on study of Census data. Data for 2003 - 2007 are AIB ERU best estimates*

Demand also reflects first time buyer and investor interest

Population growth, migration flows and headship changes are the fundamental factors underlying household formation. Together with the supply of second, otherwise vacant and replacement units they constitute overall housing demand. However, housing market demand may also be viewed from the perspective of those buying property, be they first time buyers or investors (with or without the intention of letting the property).

For first time buyers, in particular, affordability is crucial. This would not appear to be a major problem near term, though there may be some erosion of residual income (disposable income after mortgage payments are deducted) as prices rise elsewhere in the economy. For investors, rental return and capital appreciation are the key. Rising prices and the fact that rental levels are beginning to recover should provide support to this sector.

With additional boost from SSIA funds

The release of SSIA funds from mid-2006 onwards should serve to underpin demand over the next few years. Thus, we expect recent high levels of output to continue. To the extent that output fails to match apparent ongoing strong demand, house price inflation is unlikely to fall back significantly.

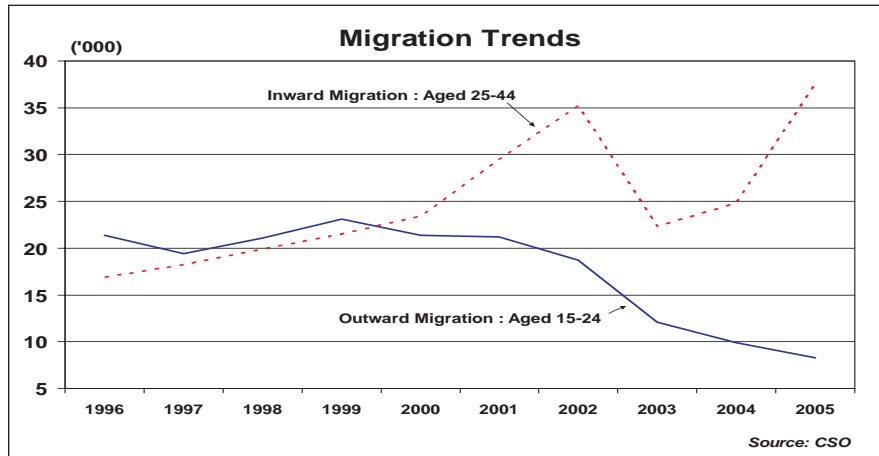
Population Growth and Migration Flows

Revised migration estimates

Housing demand has, in particular, been supported by exceptionally high levels of population growth. The CSO has published population and migration estimates for the year to April 2005. These data show that the total population expanded by 87,000 in the year. In large part this was due to strong net inward migration of 53,400, which was up sharply from 31,600 in the year to April 2004. This represents both a rise in inward migration (to 70,000 from 50,100 previously) and a modest fall in the level of outward migration (to 16,600 from 18,500 previously).

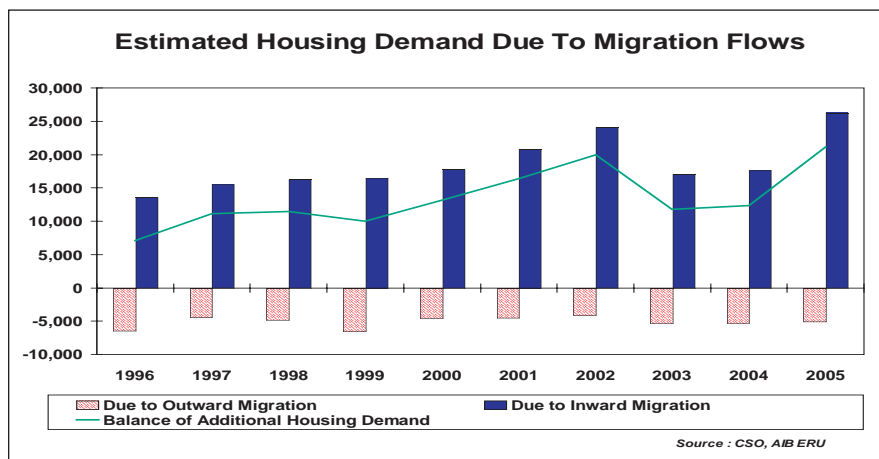
The current period of positive net inward migration only began in 1996. Changes in the migration trends of just two age cohorts account for the bulk of the strong rise in net inward migration since then. Firstly, there has been a strong rise in the level of inward migration in the 25-44 age group. Meanwhile, there has also been a decline in outward migration amongst the 15-24 age group. These two trends are positive for short and medium term housing demand respectively.

The 25-44 age group is the main cohort in terms of household formation. Thus, the high level of immigration in this age group has been very supportive of housing demand. Meanwhile, though there is some anecdotal evidence of an increased desire by 15-24 year olds to establish their own households, few in this age group are indeed householders. This age cohort, though, will in time migrate into 25-44 year olds. Thus, the decline in emigration of 15-24 year olds points to an increase in future housing demand.



....boosting housing demand

One can obtain an approximate estimate of housing demand from overall migration flows by applying existing headship rates (the proportion of adults in any one age group that are heads of household) to the various age cohorts. Such an exercise indicates that the strong level of inward migration, particularly amongst 25-44 year olds, in the year to April 2005 could have resulted in demand for an additional 26,000 housing units. Meanwhile, emigration flows could have reduced housing demand by some 5,000 units. This leaves an estimated balance of net additional housing demand from migration flows in the year to April 2005 of around 21,000 units.



Migration flows reflect strong labour market

These migrations flows are a function of the high level of employment growth in Ireland, which itself reflects the country's strong economic performance. The number employed grew by 93,000 in the year to Q2 2005, an annual growth rate of 5.1%. The data show that construction employment increased by 17.7% or 36,400 persons in the period. While this rise may be somewhat overstated, there is no doubt that the construction sector has become a very important source of employment growth in the economy in recent years.

Provided the Irish economy can continue to generate strong employment growth, then there should be further inward migration that will help to sustain housing demand. Indeed, current high levels of housing output can only be justified on the basis of sustained sizeable net inward migration. Furthermore, it is important that those migrant workers currently in the Irish economy, in the construction sector in particular, remain employed in Ireland or migration flows could turn negative, which would have significant adverse consequences for housing demand.

Net inward migration expected to continue.....

However, while net inward migration is unlikely to be maintained at the exceptional high level of the period to April 2005, which encompassed the opening up of Ireland to workers from the new EU accession states, there is no reason to believe that Ireland will not experience and be able to support continued high net inward migration flows over the next few years.

.....given strength of the economy

The Irish economy continues to perform well and thus should be able to continue generating robust jobs growth. It is currently being supported by relatively stimulatory fiscal policy and a good overall performance by the global economy. In addition, official interest rates in the eurozone are set to remain at low levels. The ECB has maintained the refi rate at 2% since June 2003 and we do not expect to see policy tightened until 2006, with then only relatively modest increases. Given the importance of variable rates to the Irish corporate and household sectors, the continuing low interest rate environment will be of considerable support to the economy, especially the housing market. At this stage, we expect the economy to grow by 4.5% in 2005.

SSIA monies to boost economy from 2006

Turning to 2006 and 2007, growth will receive a considerable boost from the release of SSIA monies into the economy during this period. Some €15bn of SSIA funds will mature between May 2006 and April 2007, equivalent to over 8.5% of GDP. It is unclear whether the government will offer incentives to roll the SSIA monies into pension schemes. Even if it does, a significant portion of these SSIA's is still likely to be spent on holidays, cars, home improvements etc. Furthermore, it is unlikely that people will continue to save to the same extent as before, once their monthly payments into SSIA accounts cease.

Boosted by maturing SSIA funds, growth is likely to accelerate further in these two years and we look for GDP to rise by around 5% in 2006 and 5.5% in 2007. However, it will be a temporary once-off boost to activity that fades in 2008.

(For more details of our outlook on the Irish economy see our Irish Economic Quarterly October 2005.)

Headship

Significant change in composition of demand

As we have remarked before, one of the most notable findings to emerge from an examination of Census 2002 was that there was virtually no increase in Irish headship rates between April 1996 and April 2002 - that is to say, little or no overall increase in the percentage of adults that were heading up households. Indeed, on average over the period, we estimate that there were only 1,250 new households per annum created due to increased headship rates. This situation would, though, appear to have changed significantly in recent years and we have revised up considerably our estimates of the number of housing units absorbed by headship changes.

Indeed, we are guesstimating that headship currently accounts for some 20,000 - 25,000 new households per annum. While this is an astoundingly high figure, there are several indicators that would lead us to conclude that headship rates have been improving. These include:

Strong first time buyer interest

- The substantial amount of survey and anecdotal evidence that indicates that first time buyers (FTB) are prominent purchasers in the housing market.
- The significant improvement in affordability in recent years, in particular from the extension of mortgage terms out to 35 years, that has helped first time buyers to enter the housing market.

Further,

- Survey evidence shows expectations that prices will continue to rise at over 5% per annum. Furthermore, these price expectations are being fulfilled. This will encourage those in a position to purchase to buy now rather than to delay.

It must be noted, though, that FTB purchases are only indicative of the degree of household formation due to headship changes. There are also many households formed where the property is owned by an investor. Meanwhile, FTBs are not necessarily owner occupiers.

On a comparative basis, it has to be noted that Irish headship rates are low by comparison with, for example, the UK, with the greatest shortfall in the 25-34 age cohort. We estimate that, in 2002, an additional 250,000 housing units would have been required if Ireland's headship rates were to rise to UK levels. This implies that in April 2002 there was a substantial level of pent-up demand, most notably from young adults.

Irish market playing 'catch-up'

The Irish housing market would appear to be going through a period of 'catch-up' which underlies the substantial increases in headship taking place. Should headship continue to increase at the levels we are currently estimating and forecasting, then Irish headship rates would be approaching UK levels early in the next decade.

We do not believe that Irish social structures as yet match those in the UK. Thus, while changes in the pattern of Irish households can be expected to lead to increased headship rates, we do not see Irish headship rates matching those in the UK for some time. Thus, while we anticipate that headship changes will continue to be very supportive of housing demand over the next few years, we do not believe that it can continue at current estimated levels indefinitely.

Second Homes Market

One of the notable features of recent years has been the strength of the second homes market. Examination of census data indicates that, over the period from April 1996 to April 2002, second homes (or otherwise vacant units) accounted for, on average, an estimated 10,800 completions per annum. While it is impossible to break out the number of second home purchased since the last census, it would appear that since then the second homes market has remained strong. Investors have continued to take advantage of the large number of tax based and other holiday developments built over the past few years, with also an increased incidence of pre-retirement purchases.

Some fall in demand for holiday homes

However, the tax based holiday schemes are coming to an end. Meanwhile, there is increasing competition from overseas for holiday properties, both in terms of an investment or for own use. Thus, the level of second homes purchases will probably slow down in the year to April 2006. There may be some renewed pick-up, though, in the following year as the impact of SSIA flows begins to be felt.

In previous reports, we had assumed that the second homes market accounted for a substantial amount of the increase in housing output of recent years. We have, however, revised downwards our estimates of the number of new second homes that have been acquired in the light of continuing anecdotal evidence about the strength of demand from first time buyers and consequent headship changes.

We are now estimating that the second homes market accounted for some 12,000 housing units in each of the two years to April 2003 and 2004. With the phasing out of tax incentive schemes we see this total falling back to about 10,000 and 8,000 in the years to April 2005 and 2006, respectively. For the year to April 2007, we have pencilled in a figure of 10,000 as the release of SSIA monies boosts demand.

Release of SSIA Monies

SSIA monies will boost housing demand

One of the sectors likely to benefit from the release of SSIA monies should be the housing market. While the individual amounts are relatively small in terms of overall Irish house prices, they may well be sufficient to ease entry

onto the property ladder, in terms of raising a deposit for first time buyers or those considering a second home or a property investment. This is particularly so in the case of joint purchasers. Indeed, surveys of the intentions of SSIA holders indicate that this will be the case.

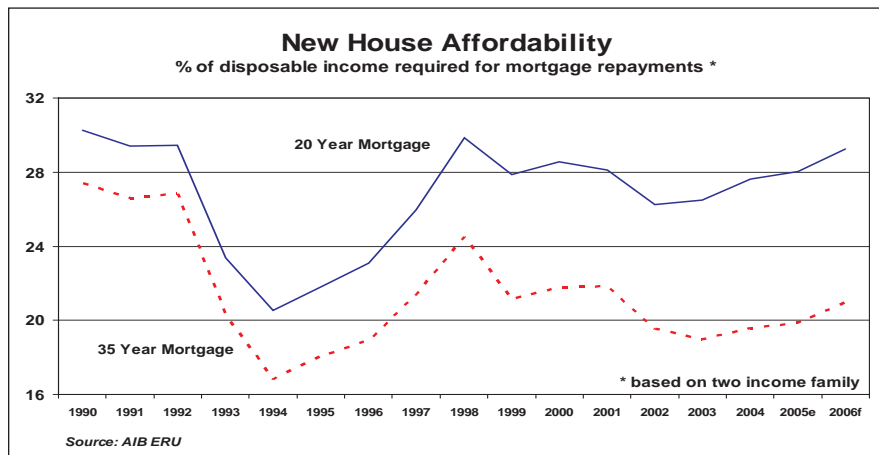
On a working assumption that 5% of SSIA holders purchase a property on a joint basis this would translate into some 27,500 property purchases. If just 2% purchased a property on a joint basis this would imply 11,000 house purchases. Not all of these would be in Ireland, especially given the relatively small amounts released from SSIA funds and the relatively lower costs of overseas properties. Undoubtedly, though, maturing SSIA funds will support housing demand, particularly from 2007 onwards when the majority of these funds are due to mature.

Affordability

Comfortable repayment affordability

There would appear to be little pressure on purchasers from mortgage repayment affordability. There has been only a modest deterioration in overall affordability for a new market entrant in 2004 and 2005 given some moderation in the uptrend in house prices and stable interest rates. A reduced income tax burden this year has also been helpful. As a result, affordability for a comparable term mortgage in 2005 is estimated to be not much above its average for the period since 1998. As we have noted before, though, these trends are far outweighed by the impact of the extension of mortgage terms out to 35 years, which has served to significantly lower the mortgage repayment burden for new market entrants.

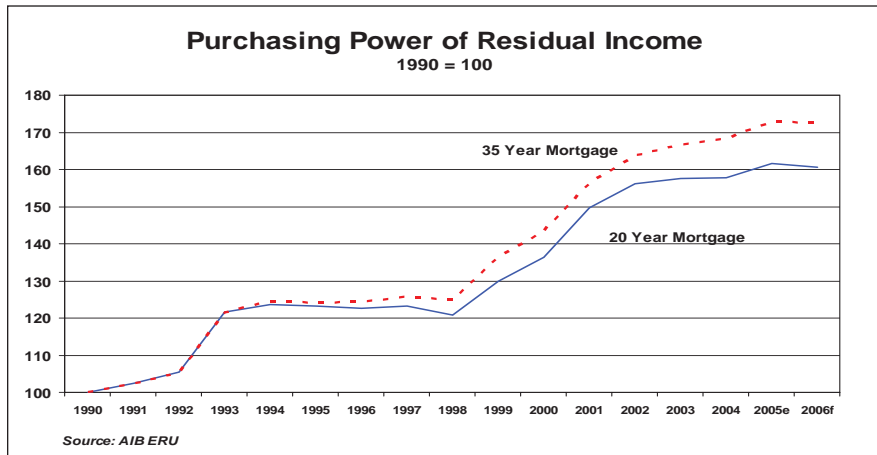
Looking to 2006, it is expected that there will be some further modest deterioration in repayment affordability given that interest rates are expected to rise and it is anticipated that house prices will continue to increase. However, this should not pose any major problems given that survey evidence points to the fact that most recent purchasers are not experiencing major problems with mortgage repayments.



Meanwhile, the pace of growth in disposable income has generally outpaced the rate of consumer price inflation in recent years. Furthermore, there has been a significant increase in the purchasing power of the residual disposable income, after deducting mortgage repayments. For those taking out a 20 year mortgage in 2004, the purchasing power of residual income (disposable income minus mortgage repayments deflated by the change in the consumer price index) was over 1.6 times what it would have been in 1990. The difference is even greater on a 35 year mortgage at over 1.7 times.

Growth in real residual income coming to an end

However, this growth in real residual income could well be coming to an end, given the increase in repayment costs and as rising prices elsewhere in the economy impact. Higher energy prices, in particular, have the potential to eat into the level of residual income. This could have some modest impact on the ability to service mortgage repayments.



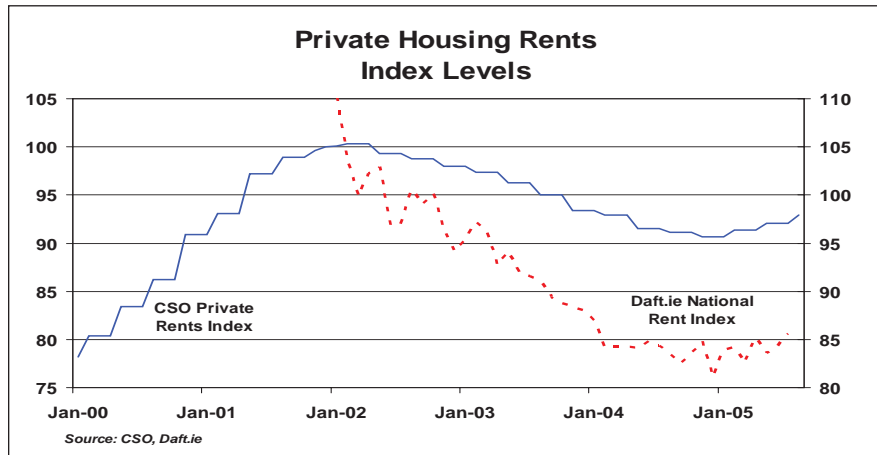
Investment Sector

Further strong investor interest expected...

The investment sector continues to be an important part of the market in terms of buyer profile. We had been concerned that falling rental incomes, coupled with low levels of price appreciation, might see significant withdrawal of investor interest. However, while we continue to monitor the investor sector, we are now becoming more confident that near term there will be continued strong investor interest.

... as rents recover...

Notably, the downturn in private housing rents has ended. The private housing rents component of the consumer price index had been in continuous decline between the second quarter of 2002 and end 2004. To date in 2005, though, according to this index, rental levels have risen by almost 2.5%. However, they are still almost 7.5% off their early 2002 highs. A similar modest pick up is indicated by the national rent index calculated by property website Daft.ie, though this tends to be volatile on a month-on-month basis.



*... and with house prices
still rising*

Meanwhile, although the rate of house price inflation has moderated, prices are still rising at well over 5% per annum. The fact that investor expectations of continued capital appreciation continue to be satisfied, and with no immediate prospect of a change in this favourable scenario, should be sufficient to sustain investor interest in the market. Further, property continues to hold strong attractions as a DIY pension investment.

Thus, it is hardly surprising that investors would still appear to be significant buyers of the market. Indeed, an analysis by Sherry FitzGerald of new homes traded through their offices during the first three quarters of 2005 found that investors accounted for 31% of purchases. This is a marked increase on the 19% level recorded in the same period the last year. However, it should be noted that this increase also reflects the fact that first time buyers have become more active in the second hand market following the stamp duty changes in Budget 2005, and thus have reduced their interest in new properties.

Overall, Sherry FitzGerald estimate that investors purchased 17% of second hand properties traded in the first nine months of 2005, down just slightly from 19% in the same period of 2004. Meanwhile, there has also been a small increase in the number of investors selling properties. Investors accounted for 28% of sales in the opening months of 2005 compared to just 27% of sales during 2004.

PART 2

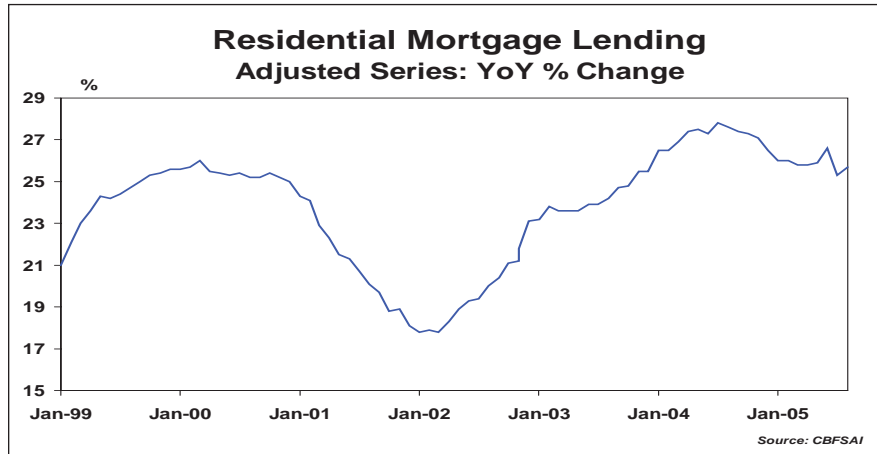
Mortgage Lending, Personal Debt and Assets

Mortgage Lending : *Continuing Buoyant Growth in Mortgage Lending*

Mortgage lending firm but begins to moderate

The moderating trend in house price inflation and stable output are reflected in a slight slowdown in the pace of growth of mortgage credit. However, mortgage lending growth remains elevated. 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) had declined only slightly to 25.7% in August 2005, from its peak of 27.8% in July 2004.

With Irish housing output and house price inflation expected to stay close to current levels, we are pencilling in continuing strong underlying growth rates for mortgage lending of 25% and 20% by end 2005 and 2006, respectively.



The number of new mortgages continues to grow

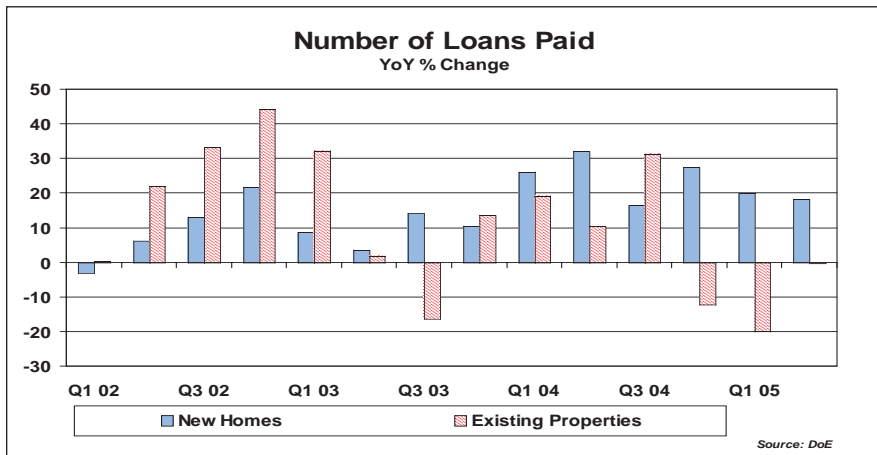
Meanwhile, DoE data on gross new mortgage lending also indicate a significant moderation in the pace of housing market activity. These data show that in H1 2005, 2.7% additional mortgages were paid compared with the same period a year earlier, down from 16.5% for the year 2004 as a whole.

Housing Loans Paid				
	Number	YoY%	Average Value (€)	YoY%
2000	74,258	4.9	102,322	11.2
2001	66,786	-10.1	114,755	12.2
2002	79,292	18.7	136,523	19.0
2003	84,749	6.9	158,892	16.4
2004	98,709	16.5	170,712	7.4
2005 H1	21,029	2.7	187,308	18.3
2005 (f)	103,600	5		
2006 (f)	108,800	5		

Source: DoE, AIB ERU

Interestingly, the overall data mask significantly different trends in loan payments on new and existing properties. The number of loans paid on existing properties has fallen year-on-year in each of the three quarters to Q2 2005 and was down 9.8% in H1 2005. This may reflect reduced turnover, with existing holders reluctant to sell against the background of still rising prices.

Meanwhile, there was a 19% increase in the number of loans paid for new properties. This would be supportive of the other evidence that a large amount of the interest in the new homes market is from first time buyers, who would almost all have to avail of a mortgage. Indeed, there was a sizeable jump in the number of loans paid for new houses as a proportion of private house completions in H1 2005 to 72%, compared to 62% for 2004 as a whole. The increase in loans paid for new houses may also reflect increased demand for new overseas properties.



Thus, although the number of new house completions has levelled off, mortgage lending growth remains at high levels. This reflects a continuing marked uptrend in house prices, a sizeable increase in the number of new houses funded by mortgages (itself reflecting strong demand from first time buyers and for new overseas properties), as well as mortgage lending for home improvements and equity withdrawal.

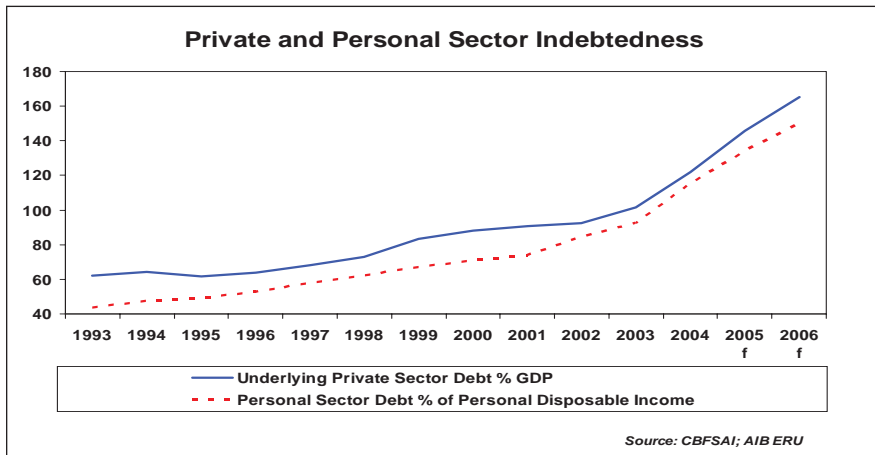
Continued strong mortgage demand

The total number of new mortgages written in 2005 looks set to comfortably exceed the 100,000 level, compared to 98,709 in 2004. While completions in 2006 are expected to remain close to 2005 levels, we would expect a continued increase in demand for overseas property, investment and home improvement loans. This is especially so as the release of SSIA monies will begin to be felt next year, which is likely to generate additional lending for house purchase and home improvement loans. Thus, we are forecasting further modest growth of 5% in the number of mortgages written to an estimated 108,800 in 2006.

Personal Sector Debt : *Ratios Continue Rising at Rapid Rate*

Sharp rise in personal sector debt...

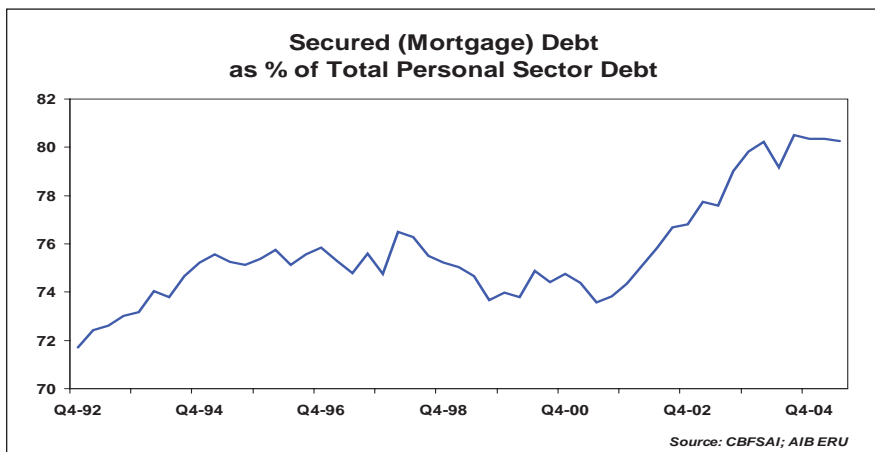
The marked growth in the economy and the boom in the housing market have been accompanied by a sharp rise in the ratio of private sector credit to GDP (PSC/GDP) and in the ratio of personal sector debt to personal disposable income (PD/PDI).



The sharp rise in both ratios, particularly the rise in the PD/PDI ratio to well above 100% in 2004, has often been interpreted to mean that we are "living beyond our means" or that we have become irrational in our behaviour and are ignoring the risks of a sharp rise in interest rates or other factors. We do not envisage a sharp rise in interest rates over the forecast period. There is a very positive outlook for employment and for real income developments, coupled with an increasing diversity of income generating sectors in the economy (notwithstanding the growing share of construction). Thus, it is not unreasonable that, within this favourable environment, consumers are willing to borrow and lenders are willing to lend.

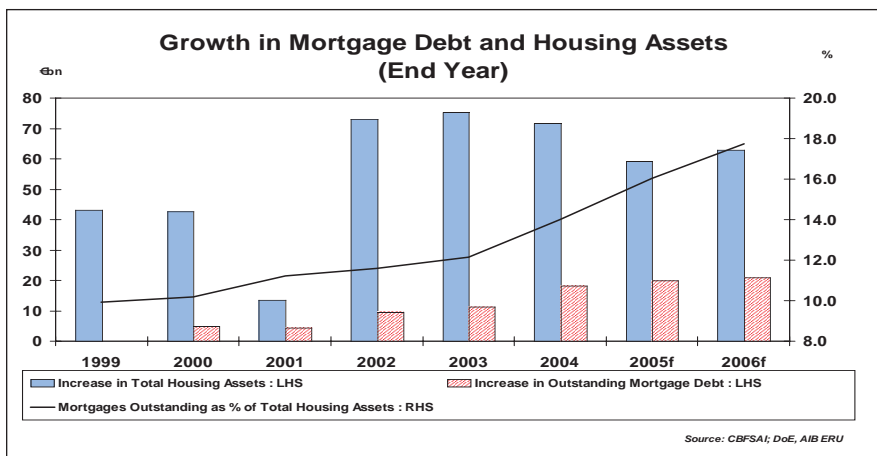
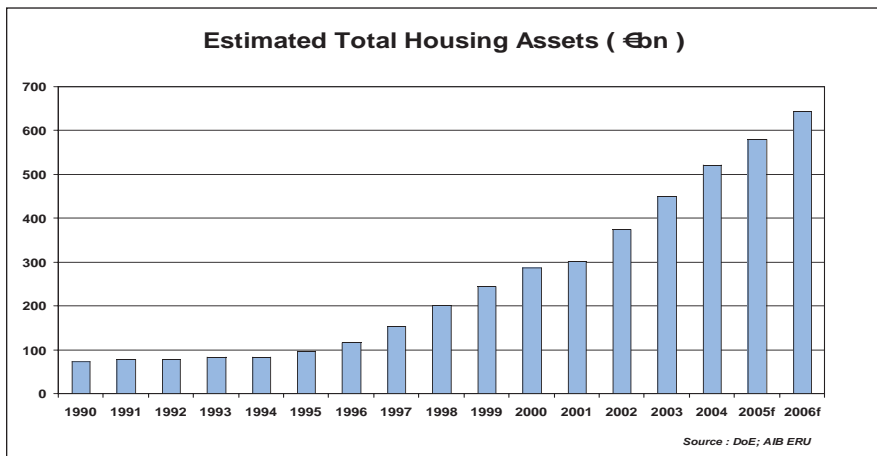
... but largely secured on property

It is absolutely crucial to understand that the rise in the ratio of underlying private sector debt to GDP and in the personal debt to personal disposable income ratio are largely due to the rapid growth in mortgage lending. Furthermore, mortgage lending accounts for over 80% of personal debt. Thus, the bulk of personal debt is secured by property.



We tend to judge the trend in personal sector debt by reference to either GDP or to personal disposable income. The latter two measures are flow data, while personal sector debt is a stock figure. In an environment of sustained employment creation and in a country where the aspiration to home ownership is the norm, the steady growth in the stream of aggregate income will over time encourage a multiple of borrowing relative to income. As a result, the ratio of outstanding debt to income has risen.

Employment grew by almost 650,000 between 1995 and 2005, generating a rise in both non-agricultural wages and salaries and in self-employed income of €43 billion. More importantly, personal disposable income, a key driver of housing demand, rose by €52 billion over the same period. Against a background of a healthy labour market, it was inevitable that personal sector debt, particularly for property, would rise by a multiple of that income base. This trend has been further fuelled by the shift to a very low interest rate environment, which is expected to be sustained.



There was an exceptionally sharp rise in the PD/PDI ratio from 92.6% in 2003 to 115.5% in 2004. This reflected a significant rise in mortgage lending relative to the incremental growth in income in that year. Looking ahead, we

expect that the PSD/GDP and PD/PDI ratios will continue to rise in 2005 and 2006. The latter is forecast to reach 150% by 2006.

Ratio of mortgage debt to housing assets remains low

A more accurate measure of the risk/reward balance in the Irish housing market is to compare the ratio of the stock of mortgage debt to the stock of housing market equity. This shows that the ratio is very favourable for the sector as a whole. At end 2005, the outstanding level of residential mortgage debt will be equivalent to around 16% of the value of the housing stock.

Also, high savings ratio

It should also be noted that while we focus on the personal debt burden, the personal sector has a very high ratio of savings to disposable income. This ratio stood at 12.8% in 2004, up from 9.4% in 2002. The very high ratio by international standards also offers another important support to the personal sector. Furthermore, we expect that the ratio will rise to 13.5% in 2005.

MONETARY AGGREGATES				
Annual % Change (End Year)	2003	2004	2005 (f)	2006 (f)
Private Sector Credit (adj)	16.9	27.9	28.0	22.0
Private Sector Debt/GDP Ratio (%)	101.1	121.1	144.9	163.4
Residential Mortgage Lending	26.0	33.6	27.5	22.5
Residential Mortgage/GDP Ratio (%)	39.3	49.2	58.6	66.4
Personal Sector Lending	21.5	32.7	25.0	20.0
Residential Mortgage Lending as % of Total Personal Lending	79.8	80.3	82.0	83.6
Personal Sector Debt/Disposable Income Ratio (%)	92.6	115.5	134.0	150.0
Personal Savings Ratio (%)	11.9	12.8	13.5	12.1
Mortgage Debt as % of Total Housing Assets	12.2	14.0	16.0	17.7
Total Construction Related Borrowing as % of Total Private Sector Borrowing	56.2	59.8	60.5	61.0

PART 3

Housing Market Risks, Longer Term Outlook

Housing Market Risks : *Unlikely to Materialise*

Market not without some potential risks

While we are more confident about the near term outlook for the housing market, and see little or no chance of a crash, it is necessary to consider some of the potential risks. These include :

- Nervousness as interest rates begin to move upwards
- The current dependence of the Irish economy on the construction sector
- Decline in investor interest
- The risk of a significant slowdown in recent immigration flows
- Administrative intervention and taxation
- Excessive industry optimism

We still see the market as having good support at around 60,000 units per annum in the longer term. However, in the absence of an unexpected shock to the market, we don't see output dropping back to this level for some years. Even then, the transition to our estimated longer term level of output may be very gradual.

Interest Rate Sensitivity

Interest rates to rise for first time since 2000

Official interest rates in the euro area have now been kept on hold at 2.0% since June 2003. The interest rate level, though, is likely to change during the course of 2006 with **the first increase in rates since October 2000**. We are expecting two 0.25% increases in interest rates before end 2006, with the first move possibly not occurring before mid-year. However, this key psychological turning point **could be important for the housing market**.

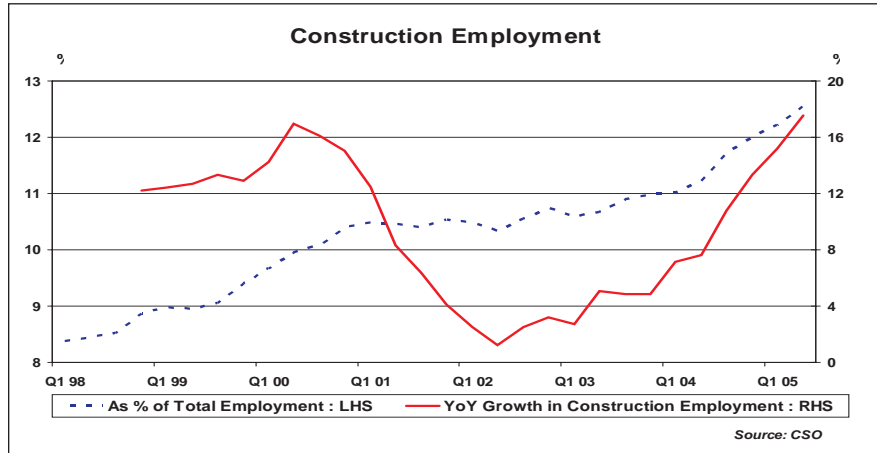
If investors and first time buyers see this as the beginning of an uptrend in interest rates, that could significantly impact on mortgage funding costs, then there could be a noticeable impact on housing demand. If, on the other hand, the move is seen more as just a slight upward adjustment in a period of still very low interest rates (particularly by historical standards), then the impact will be more muted.

Economy's Current Exposure to Construction Sector

Importance of construction sector continues to grow..

Construction activity in general, and housing output in particular, is becoming increasingly important to the Irish economy. In 2004, residential construction investment accounted for 10.7% of total GDP and 1.5 percentage points, or one third, of the 4.5% rise in GDP in that year. Its contribution to the growth of the economy, though, has greatly diminished in 2005. A contribution of just 0.4 percentage points out of a total GDP growth rate of 4.5% is forecast for 2005.

Meanwhile, the construction sector is also becoming increasingly important in terms of employment. There were some 242,000 employed in construction activity in Q2 2005, which represents 12.6% of total employment. This compares to just 8.4% in Q1 1998.



... raising concerns ...

Concerns have been raised over the Irish economy's exposure to the construction sector and housebuilding in particular. However, we see the construction sector of the economy remaining buoyant in the near to medium term with stable employment levels.

House building output should remain at or close to recent levels over the next two to three years. Meanwhile, the release of SSIA funds should be highly supportive of the home improvement sector of the construction industry. In addition, there is likely to be strong growth in demand for non-residential construction output as the economy makes inroads into its infrastructural deficit. The government is committed to further boosting public capital spending in the years ahead. A recent report by A & L Goodbody Consulting estimates that the equivalent of €140bn of public sector investment will be required by 2020 to meet Ireland's infrastructural needs.

... but we see no immediate threat

Thus, we see little immediate threat from the current large exposure of the economy to the construction sector and, indeed, its importance in the Irish economy may increase yet further over the next few years.

Decline in Investor Interest

Continued investor interest expected ...

As we noted in Part I of this report, the investment sector continues to be an important part of the market in terms of buyer profile. Any significant withdrawal of investor interest could have serious consequences for the market and we continue to monitor this segment of the market. However, as indicated in this earlier sector, we believe that a combination of recovering rental incomes, still rising house prices and an expected boost from the release of SSIA monies, should be sufficient to sustain investor interest out to 2008.

... but sector needs continued monitoring

Beyond that, though there could be a fall off in investor interest, especially if house prices do not continue rising. There has been a substantial erosion of yield levels in recent years so investors are looking to capital gains to enhance their return in the market. As ever, the investor sector continues to

require careful monitoring, even though we expect investor interest to be sustained in the next couple of years.

Sustainability of Recent Immigrant Flows

Any significant fall in immigration would be damaging

As we have noted earlier, strong net inward migration flows have been a significant factor underlying the recent robust housing demand. If these net inflows should fall back substantially, or worse still turn negative, then housing demand would fall back significantly.

In the near term we see the employment situation in Ireland as being supportive of further net inward migration, if perhaps not at the high levels of the most recently reported period to April 2005. This period encompassed the opening up of Ireland to migrants from the new EU Accession States.

... but economy should support further inward flows

However, there could be some threat to continued strong inward migration from high and rising Irish cost levels, not just for housing but for other goods as well. This could make Ireland too expensive as a location for some migrant workers. As yet, though, there is no significant evidence that migrants' enthusiasm is being in any way dampened. Further, we see a continuing strong performance by the Irish economy over the next few years, which should be sufficient to support continued strong net inward migration flows.

Administrative Intervention and Taxation

Housing market needs stability

What the house building industry plus house purchasers and owners need is stability in terms of intervention by government and other administrative authorities. Perhaps the greatest threat to the housing market could come from any changes in taxation or other administrative changes. In the past, the destabilising impact of taxation changes, be they positive or negative, or from changes in planning regulations has been marked.

Taxation changes could be particularly damaging

In particular, any proposal for increased taxation affecting the market as a whole or on a particular segment of the market, such as second homes, would have a significant impact on sentiment, activity and prices. Indeed, **the impact of a negative taxation shock from the government could be more catastrophic than any possible external shock.**

Excessive Industry Optimism

Industry needs to remain responsive and avoid risks of complacency

The Irish construction industry, perhaps understandably given that demand appears to be outstripping supply, is optimistic about the outlook for house building over the next few years. In times of stability, there is a considerable risk that complacency could become established. Thus, it is important that the industry does not become excessively optimistic and complacent and that it stands ready to adjust supply downwards if, as we think will be the case, demand does adjust downwards over a longer term horizon.

Longer Term Market Outlook : *Gradual Transition to Lower Activity Levels*

As we have commented in the demand section of this report, there would appear to be robust near term demand forces such that overall demand is outstripping supply. These conditions are likely to prevail for the next two to three years. Notably, the market is, and should continued to be, supported by a combination of :

- Natural population growth
- Strong inward migration
- Increased headship rates
- Continued increase in second home ownership
- Favourable, economic circumstances including strong employment growth, low interest rates and comfortable affordability
- The release of SSIA monies

Market underpinned by long term demand at 60,000 units

However, over the longer term, we still believe that demand will drop back towards our previous forecast of around 60,000. Notably:

- Underlying demand from population growth is expected to drop back slightly as the population ages.
- The current high levels of net inward migration are unlikely to be sustained.
- The apparent recent increases in headship would seem to be unsustainable. If headship were to continue to increase at the pace we have estimated for the 2003 - 2007 period, then Irish headship rates would be on course to match those in the UK by early in the next decade. Given that the changes in Irish social structures significantly lag those in the UK, this would seem to us an unlikely scenario. Rather, we feel that recent headship changes reflect a bringing forward of demand from future years as well as an element of catch up from past unsatisfied demand. Thus, rapidly rising headship rates are unlikely to be sustained beyond the next few years.
- The economic environment may not be as supportive post the boost to growth from SSIA flows which is unlikely to extend beyond 2007 - 2008. Meanwhile, interest rates may also be somewhat higher than at present. However, we still expect interest rates to remain relatively low, given Ireland's membership of the euro area.

However, while our long term demand forecast is below current levels of output, it would be wrong to state, as is often done, that the market is being oversupplied with new houses. Indeed, we believe that demand is still outstripping supply.

Gradual transition to this level and not for a few years

Further, in the absence of an unexpected shock to the market, we don't see output dropping back to our long term demand level of 60,000 unit for some years. Even then, the transition to this estimated longer term level of output may be very gradual.

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