CP 87, MACRO-PRUDENTIAL POLICY FOR RESIDENTIAL MORTGAGE LENDING

Sherry FitzGerald Research – Market Response

Contents:

1.0 Introduction:

This document is in response to Consultation Paper CP87 - Macro-prudential policy for residential mortgage lending. Such consultation and readiness to anticipate challenges is a welcome initiative that was sadly lacking in the past. We would echo the comments of the historian, Professor Joe Lee, in his analysis of the recent banking and property crash that 'all the information was there but it wasn't pulled together'.

It is important to say that as a consequence of the banking and property crash there is a new, information seeking culture in the recovering construction and development industry, with a level of curiosity and hunger for data that didn't exist in the past and is now part and parcel of the new industry.

However, markets are markets and private enterprise is understandably focussed on profit and is therefore vigilant; informed regulation is an essential prerequisite to a balanced society. In our view, a chastened industry will support responsible measures aimed at eliminating the risk of future, credit driven, property bubbles.

Undoubtedly, lax and poor regulation in the past was an invitation to cosiness but equally regulation can serve as a barrier if it becomes too restrictive. The approach of this consultation paper is, as we see it, designed to achieve the right balance. Strategically, we completely agree with the principle of proper credit management contained within the consultation paper. Tactically, we would report that our experience is that the impact of the announcement of the consultation paper from the Central Bank has served to further temper the market and price performance since the autumn, with a notable reduction in price inflation in recent weeks.

Regulation, fiscal policy, demographic patterns and economic growth all combine to shape a property market. History has also shown us that intervention in the market can result in both anticipated and unanticipated consequences.

In summary, the evidence that we have examined, coupled with our market experience, would suggest that the aims and objectives, as laid out in CP87, are in the public interest if implemented carefully and astutely over a number of years, probably in the order of four to five years. If the proposals are implemented swiftly and as a whole in 2015, it is our view that they will have unintended negative consequences of slowing construction of dwellings, increasing rents and eroding competitiveness.

The purpose of this document is to provide as much relevant information to the Central Bank as to the state of the market and support with evidence why we think it's essential that the avowed objective of credit management is astutely implemented.

This document is designed to share all relevant information that we have to hand as well as support a view with relevant evidence.

2.0 Current Market Conditions – Towards Stability

After the greatest property crash in post war Europe, the Irish property market began to show signs of stability during 2012. The first evidence of this was during the second quarter of 2012 when prices rose moderately in Dublin, with a notable reduction in the pace of deflation in other locations.

In the subsequent 18 months until June 2014, our house price index indicates that prices rose by 19% in the country as a whole. Dublin, with a new momentum, saw prices rise by 28.7% in 18 months.

The third quarter of this year saw a moderation in the pace of house price inflation in Dublin but an acceleration in the pace of house inflation in the counties outside Dublin. The average Irish house price rose by 3.8% in this quarter, with Dublin house prices rising by a more moderate 3.5%.

When Dublin is excluded from the national figure, the quarterly growth figure was 4.3%. Moreover, residential property outside Dublin rose by 11.7% in the twelve months to end September 2014. The regional centres also experienced upward price movement during the nine month period, most notably in Cork, with price inflation of 14.3% in the nine months and 15.7% in the twelve months to end September.

There is a strong argument that in order for house building to become viable in the key regional centres of Cork, Galway and Limerick, house prices need this type of recovery. Indeed, house building remains quite marginal in these 3 key cities with Limerick in particular lagging in the viability stakes. Equally, there is a fragility in all our cities in terms of affordability. Moreover, in Dublin, housing viability remains a complex issue; while suburban housing is now in many cases viable, apartment building in many locations with complex regulation and expensive construction, remains marginal.

Finally, it is worth noting that the deceleration in the pace of price inflation in Dublin in the third quarter is an interesting trend coinciding as it did with an uplift in the quantity of second hand stock made available for sale in the summer of 2014. Equally, the increase in the pace of price inflation in the rest the country coincided with a reduction in the quantity of property available for sale on the open market in the same period.

3.0 Supply Side Conditions – The Backdrop to Building

Building activity, while on the increase, is still well below the long run average and there are complex issues of viability intertwined with additional building regulations and planning complexities that are combining to limit output.

Before the banking and property crash, the Department of the Environment and Local Authorities, in line with Ireland's sustainability obligations under EU regulations, raised minimum residential densities. The market place digested this change by opting to build more apartments and, during this time, regulations were changed by key local authorities in relation to actual housing development by increasing the size of back gardens, the size of setbacks from roads and streets and the amount of parking provided.

It has become clear that the markets in our key cities require a mixture of apartments and houses, and these can be contained in a high density environment if the aforementioned regulations were less strict and more flexible. The criteria set for actual housing in Irish cities differ from and are more restrictive than other countries e.g. U.K., Holland, Sweden, Finland, Denmark and Germany. Also, with Dublin becoming the IT capital of Europe, more flexibility is required around smaller apartments and the design approach to student housing. If there is one lesson learned from the global world, it is that countries and cities need to anticipate rapid change and plan for it in advance rather than being surprised and adversely impacted by it.

Moreover, a combination of skills shortages, increased construction costs associated with new building regulations and continuing high levies, means that the cost of construction is too high. Furthermore, the underinvestment in infrastructure and essential services in recent years will hamper the markets ability to deliver new product in many locations. This whole area is in need of urgent review and as a country we need to develop 'best in practice' processes as well as common sense regulation.

Furthermore, the decision making process in planning is complicated and full of delays. There is no such thing as a perfect planning system but we could certainly have a better one. The Department of the Environment's commitment to reform the planning system is a welcome, but overdue, initiative. Neither a top down planning system nor a bottom up system is perfect, but undoubtedly where we need to get to, sooner rather than later, is a speedier system ensuring that demographic demand is met as required. The public sector planners, while not for a minute compromising their commitment to the long term needs of society, need structurally to incorporate more market analysis into their deliberations.

The delayed implementation of revised planning legislation, now delayed to at least the second quarter of 2015, is further limiting supply. Anticipated changes in legislation that could involve the reduction of development contributions and social housing provisions, offer little incentive to commence construction.

In terms of the data available, the CSO figures for quarter two show the volume of planning permissions granted in the second quarter of 2014 reached 1,606; this is broadly unchanged from the figure recorded in the first quarter.

The latest information from the Department of the Environment reveals that a total of 8,796 dwellings were completed in the first ten months of 2014. This represents a 35% increase on the comparable level in 2013, with September recording the largest monthly volume of completions since 2010.

Dublin accounted for 31% of the total, recording 2,724 units. This is notably higher than the comparable figure of just 997 units for Dublin for the same period in 2013. The Cork region accounted for 10% of the total, while the Galway, Kildare and Meath regions accounted for 5%, 5% and 4%, respectively. Notably, the key centres of Dublin, Cork, Galway and Limerick accounted for more than half of the completions in the year to date.

The latest available data on commencements in February, which reveals a notable uplift in the level of commencement notices, is now dated. In order to understand what is actually happening on the ground, we convened a conference call with the leaders of our regional businesses in Dublin, Cork, Galway and Limerick on Tuesday, 2nd December. While there is a discernible increase in activity in the Dublin area, our Cork, Galway and Limerick offices all reported relatively modest activity in terms of new construction in each of the cities. It appears that NAMA is the prime funder of any developments that are commencing in these regional cities but the only other money going into these cities appears to be for development land purchase, in anticipation of future demand.

In terms of the overall picture of housing supply in the country as a whole, we undertake a bi-annual analysis of all dwellings available for sale in all twenty-six counties. The results from the July analysis reveal a contraction in supply levels.

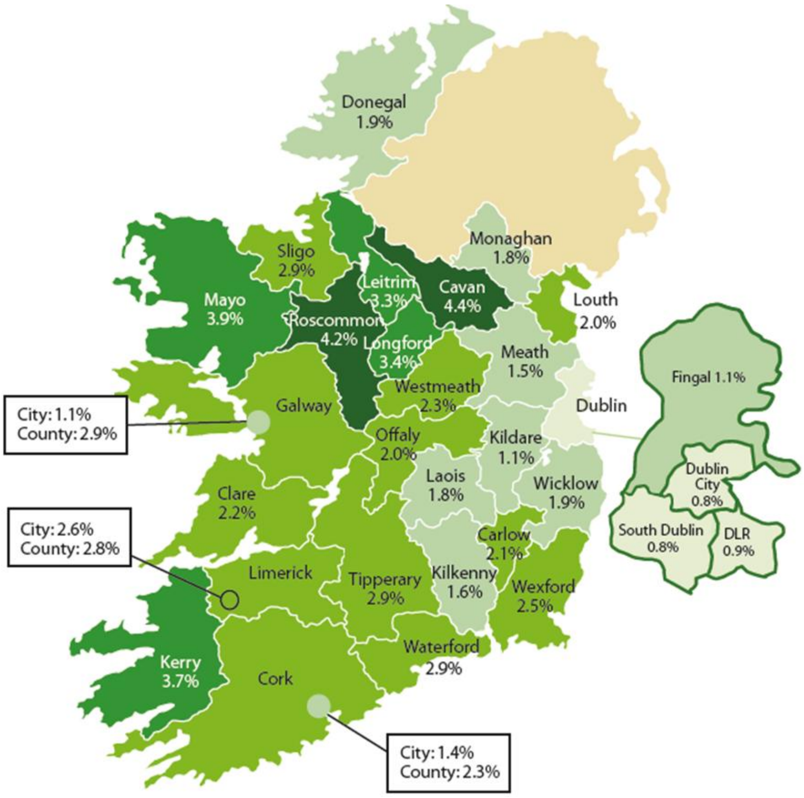
As of July 2014, there were 37,465 dwellings available for sale nationwide. This figure equates to just 2.0% of the private housing stock and represents a reduction of 19% on July 2013 levels when there were 46,203 dwellings for sale in the open Irish market.

Interestingly, the analysis showed that there were 4,174 dwellings available for sale in the four local authorities of Dublin in July 2014 and, while still low, represents a 38% increase from January 2014, which was a seasonal low and probably contributed to the asset inflation experienced in the first few months of 2014. A comparison with the corresponding period in 2013 reveals a 7% reduction in supply when 4,502 dwellings were advertised for sale in Dublin.

Supply, on the other hand, is tightening in key urban areas outside Dublin. Significant annual decreases were evident in Cork and Galway of 22% and 21% respectively. Meanwhile, Limerick saw a 15% fall in stock available for sale.

Similarly, relatively modest market availability rates are evident in the counties surrounding Dublin, particularly Meath, Kildare and Wicklow.

% of Second Hand Private Housing Stock Advertised for Sale, July 2014



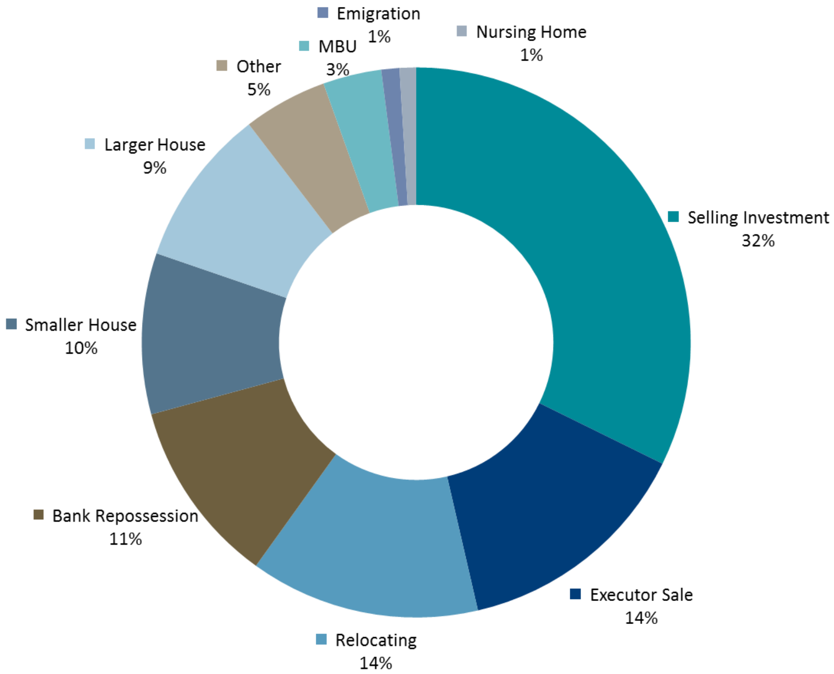
County	% of Second Hand Private Stock Advertised for Sale July 2014
Dublin City	0.8%
South Dublin	0.8%
Dun Laoghaire-Rathdown	0.9%
Fingal	1.1%
Galway City	1.1%
Kildare	1.1%
Cork City	1.4%
Meath	1.5%
Kilkenny	1.6%
Laois	1.8%
Monaghan	1.8%
Wicklow	1.9%
Donegal	1.9%
Louth	2.0%
Offaly	2.0%
Carlow	2.1%
Clare	2.2%
Westmeath	2.3%
Cork County	2.3%
Wexford	2.5%
Limerick City	2.6%
Limerick County	2.8%
Sligo	2.9%
Waterford	2.9%
Tipperary	2.9%
Galway County	2.9%
Leitrim	3.3%
Longford	3.4%
Kerry	3.7%
Mayo	3.9%
Roscommon	4.2%
Cavan	4.4%
State	**2.0%**

Source: Sherry FitzGerald Research

In examining the quantity of properties available for sale it is also worth looking at the reasons for selling and who, in turn, is buying.

An examination of the profile of vendors who sold their property through Sherry FitzGerald in the opening nine months of the year is outlined in the following pie chart. It reveals that 32% of vendors were selling investment properties while a further 11% were bank repossessions most of which were buy-to-let in one guise or another. The proportionally large share of investment properties being sold reflects a dysfunctional market as there is limited supply of family housing emerging from these instructions.

Vendor Profile Year to September 2014



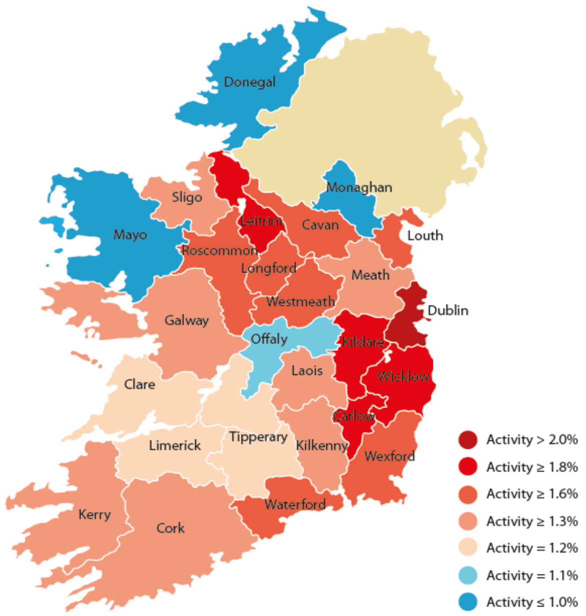
Source: Sherry FitzGerald Research

Moreover, a combination of 32% investor sales and a further 11% bank repossessions, is negatively impacting the quantum of rental properties available on the market and in turn resulting in upward pressure on rental levels. In summary, 43% of the properties we are selling are investment properties while only 17% are being bought by investors.

4.0 Demand Analysis

Approximately 30,000 properties sold in Ireland in 2013, a figure that represents only 1.6% of private housing stock. Activity has increased in the year to date with transactions up 42% in the first nine months of the year when compared to the same period in the previous year. Such volume levels are still very low by either historical or international comparisons.

County by County Analysis of Market Activity



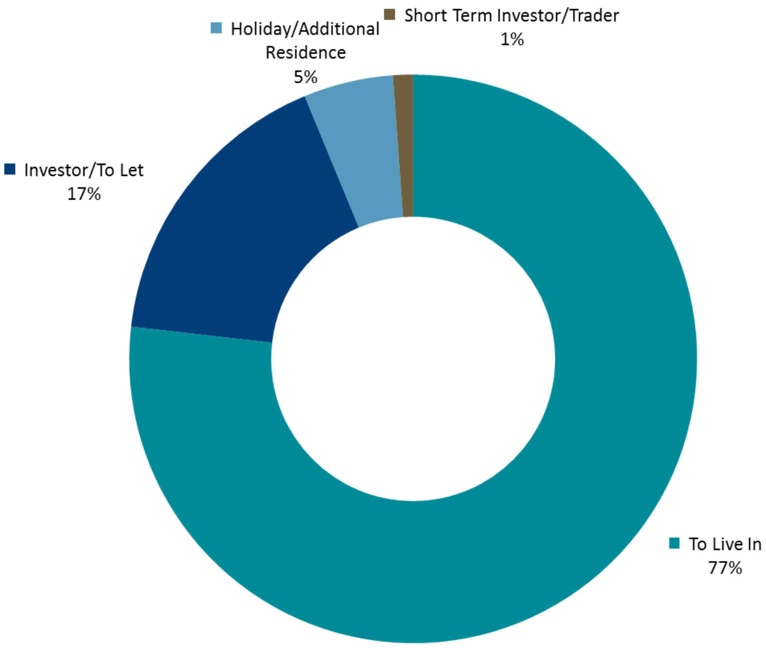
County	% of Housing Stock Versus Sales 2013
Dublin	2.2%
Wicklow	2.0%
Leitrim	2.0%
Kildare	1.8%
Carlow	1.8%
Roscommon	1.7%
Louth	1.6%
Wexford	1.6%
Cavan	1.6%
Waterford	1.6%
Westmeath	1.6%
Longford	1.6%
Cork	1.5%
Meath	1.5%
Galway	1.5%
Sligo	1.4%
Laois	1.4%
Kilkenny	1.3%
Kerry	1.3%
Clare	1.2%
Limerick	1.2%
Tipperary	1.2%
Offaly	1.1%
Monaghan	1.0%
Donegal	1.0%
Mayo	1.0%
State	**1.6%**

Source: Sherry FitzGerald Research/PPR

Furthermore, there are large tracts of the country where the volume of property transactions remains well below 1.5% of the private stock which is effectively less than half of the volume that one would expect from a normally functioning market.

An analysis of all transactions through Sherry FitzGerald in the first nine months of the year reveals the continued demand from owner occupiers who were responsible for 77% of all transactions, while investors now account for 17% of all purchasers in the opening nine months.

Purchaser Profile Year to September 2014



Source: Sherry FitzGerald Research

First time buyers remain a relatively active cohort in the market accounting for 16% of the dwellings traded in the year to date.

5.0 Market Performance – November 2014.

An analysis of market performance in the year to date has shown some interesting trends. All four markets - Dublin, Cork, Galway and Limerick - report a notable shortage of available product and upward pressure on both rents and capital values.

Interestingly, our Dublin, Cork and Galway offices all experienced a marked shift in consumer sentiment in the autumn market. Consumers have become more cautious, more price sensitive with a consequent reduction in agreed sales. Commentary from our regional directors points to a correlation between this reduction in sale agreed properties and the announcement in early October regarding possible regulatory changes for mortgage lending.

The Limerick market does appear to be the exception to the above trend. This market has lagged behind the other regional centres in the recovery with consistently higher levels of stock, lower volumes of transactions and prices slower to recover. However, this market has bucked the trend with an increase in activity in terms of agreed sales in November 2014 when compared to the same month in the previous year.

The above commentary represents a snapshot and we certainly don't think it should be over-amplified. Nonetheless, we feel it is a trend line worth sharing.

Looking to the year ahead, Dublin, Cork, Galway and Limerick all report concerns regarding the limited level of new housing starts that they anticipate in 2015.

In terms of capital values it would appear that capital values for a typical three bedroom house in the suburbs of Limerick is approximately €130-140 per sq. ft. In Galway's suburbs the equivalent figure is approximately €220 per sq ft. In Cork's suburbs, three bed semis are achieving between €220 and €230 per sq ft. Finally, in Dublin the equivalent is approximately €350 - €375 per sq ft.

The profile of the Sherry FitzGerald New Homes purchasers in the year to date comprised 57% first time buyers. A significant reduction in the quantity of first time buyers available to buy new homes in the year ahead will negatively impact the incentive to develop schemes thereby negatively impacting development activity.

As first time buyers delay their purchase decision, they will need to remain in rented accommodation for longer, potentially for years longer. This will put further upward pressure on demand and the level of market rents.

6.0 Conclusion

The Irish residential market has stabilised post the banking and property crash. Nevertheless, transaction levels remain well below normal with only 1.6% of the market transacting in 2013. There is a notable shortage of dwellings both for sale and to rent particularly in the key cities and this is causing rental and capital values to rise.

Due to the limited investment in social housing in Ireland since the 1980s, there is also a critical supply shortage of social houses. Clearly both private and social housing are interconnected and a significant change in the supply of one will impact the performance of the other, as has happened to date.

Furthermore, if one considers that 32% of existing vendors in 2014 are selling buy-to-let properties and that 29% of existing landlords plan to sell as soon as possible according to the recent research by DKM Economic Consultants and the ESRI on behalf of the PRTB, there is undoubtedly further downward pressure on the stock of available property in the rental sector. However, if the new regulatory policy is implemented as is, we may need 450,000 to 500,000 private rented dwellings in the country by 2025; while structures such as REITs and QIFs will help, it is nigh on impossible to envisage such a large cohort of landlords emerging to supply this market, given the chastening experience so many of our citizens have had as landlords in the last decade.

Moreover, our demographic profile indicates an increasing demand for accommodation in our key cities. Undoubtedly, there is a Western phenomenon of a gravitation of young people to live in what are regarded as fashionable cities. Dublin in particular is one such city. Furthermore, immigration policy within Europe and the U.S. has had an impact on residential demand in our key cities, particularly Dublin.

Since 2004, Ireland along with the UK and Sweden, are the only countries in the EU that have allowed the free movement of people from within the EU. This coincided with 10 new countries joining the EU in that year. Granted, the nature of our culture, our jurisprudence system and the tax system all combine to make Ireland an attractive company for U.S. companies looking to have business bases in Europe. Approximately 70% of U.S. inward investment, encouraged by the IDA, comes from the West Coast. There is an impact on Ireland of a dysfunctional, inward looking U.S. immigration system, in that U.S. tech companies on the West Coast can't find sufficient employees with the required skill set to join them in their own states. Hence, these companies have been attracted to Ireland with the freer EU-wide availability of labour and new-found competitiveness as a consequence of the crash.

While the Central Bank's role as a regulator is clear and it has to control what it is responsible for, it nonetheless operates in a market place. This market place continues to be dysfunctional and if the agreed, avowed objective is to manage credit availability in the medium to long term, then a number of coordinated responses should ideally occur. These include planning reform, with more flexibility around densities in line with European norms, a reduction in construction costs through possibly reduced contributions/VAT rates and the use of more pre-fabricated, cost-controlled construction processes. The ideal solution involves managing the price of development land through the management of consumer credit but also making construction more viable, efficient and easier to achieve.

The measures as outlined in CP87, if implemented immediately, are likely to have the short term impact of stalling construction, as purchasers will find their ability to enter the market delayed as they will require a longer period to raise a deposit whilst continuing to rent in a market of diminishing supply.

7.0 Recommended Actions:

There is no doubt that de-risking the market from a credit driven property bubble is laudable. However, it would be preferable to limit the unintended negative consequences for first time buyers, the rental sector and the housing construction sector.

In our opinion, this could be achieved by simply bringing in the new measures on a phased basis over time. Clearly there is no evidence of a credit driven bubble at the moment given that 50% of property transactions do not have a mortgage attached. Introducing the new measures over time should protect the citizen and help ensure that the property market serves the economy, rather than the economy serving the property market, as it did in the past. It is imperative that rapidly increasing house prices are not allowed to persist over the medium term.

By gradually introducing the measures over a four to five year period, potential first time buyers would have the opportunity to adjust their saving behaviour and prevent a sharp, harsh drop in activity from this cohort.

To this end, we would suggest that current loan to value ratios be maintained in 2015 with a gradual movement in the following three to five years towards the proposed new LTV and LTI rates, see attached table.

Year	Proposed LTV
2015	90.0%
2016	87.5%
2017	85.0%
2018	82.5%
2019	80.0%

Indeed, a similar pattern could also be followed in terms of LTI's. Both processes could be altered in either direction if there was to be evidence of an increase in the risk of a credit led property bubble on the one hand, or a continuing lack of appetite from landlords to supply rented dwellings on the other hand.

In summary, price inflation, which is largely an urban concern, is fuelled by inadequate supply. It is important that measures are put in place now that make development viable. A reduction in VAT from 13.5% to 9% would be perhaps the single most effective way to encourage the development of new homes, including student accommodation and social housing, in our key cities. Equally, we are losing too many landlords too quickly; part of the reason for this is an inevitable consequence of the crash, but also part of it is due to the current tax treatment of landlords.

Furthermore, in an effort to support new housing construction, development contributions paid to local authorities should be reviewed. Such levies can be punitive, especially in urban areas in which they fund critical infrastructure. While a number of local authorities have lowered their levies on new development to reflect the changing market needs, this has not been a uniform approach. Measures need to be taken to ensure such levies do not act as a barrier to house building in our key cities.

Equally, it is important that the building regulations and controls introduced in the market place in the past ten years are kept under constant review within the context of their limiting impact on supply, and opportunities are sought to allow the market to deliver a full spectrum of dwellings to meet the ever changing market demand.

In conclusion, the Irish housing sector is at a critical juncture. Increased consumer confidence in the economy at large has led to an uplift in demand for dwellings in our key cities. The combination of limited construction activity during the recession and a dysfunctional second-hand market has led to a shortage of available dwellings for sale and as a result the market has, until recently, exhibited high levels of price inflation. However, there is no evidence to suggest that this is impacted by excessive credit availability; in fact almost half of all property transactions were not financed with a mortgage.

The measures proposed in CP87 are preventative in nature and international experience would indicate that they are justified, if properly implemented.

We would recommend that these regulatory changes are phased in over a period of years and kept under constant review.