Where Family Counts

EBS DKM Affordability Index

The EBS DKM Housing Affordability Index is a measure of the proportion of after tax income required to meet first year mortgage repayments for an 'average' First-Time Buyer (FTB) working couple, each on average earnings. It takes into account changes in mortgage rates, changes in the level of mortgage interest relief, and is based on average earnings and new FTB house prices in Dublin and across the State as a whole.

January 2011

The mortgage market has undergone another year of change in 2010 writes **Dara Deering, Director, EBS Membership Business**

The mortgage market has undergone another year of change in 2010. According to the most recent PTSB/ESRI house price index, prices fell by 10.8% in 2010. This means that using the index national house prices have fallen close to 40% since peak. However, the experience on the ground has been different with many commentators now predicting that house prices have already corrected by 50% albeit with some regional variations. If there is a lag effect in the house price index, this would indicate that we could be approaching the bottom of the cycle and that it won't take long before we see positive growth for some properties in some locations.

Housing supply remained at historically low levels in 2010 with 14.6k new units completed. Recent analysis released from the Department of Environment estimates new housing stock at c 33k units nationally, (23,250 units complete and vacant, 9,976 dwellings near complete, and a further 9,854 dwellings at early stages of construction activity). While all of this stock may not be in demand in terms of location or type of property, it will still take some time before this stock of new property is sold meaning that new home completion levels are expected to stay low for the foreseeable future.

Consumer confidence continues to be a key factor influencing new mortgage activity and unsurprisingly given the tumultuous events throughout 2010, the level of new mortgage lending reached a historical low. The most recent ESRI sentiment index published has shown sentiment at 44.4 points. Consumer sentiment showed some increases in early to mid 2010, however, due to very difficult economic conditions, dropped back again at the end of 2010.

On a more positive note rentals have continued to stabilise throughout 2010 and the most recent CSO rental index has shown that year on year negative growth has slowed to -1.5% (versus -15.4% in 2009). This stabilisation could be pointing towards the fact that the supply/demand factors in the rental market are finding equilibrium, and should bring more confidence to the rental market.

New lending has been very subdued throughout 2010 with the overall market continuing to decline. New mortgage lending last year was most likely in the order of c€5bn, a reduction of almost 90% from the peak of €40bn in 2006. However, the first time buyer segment is proving to be the most resilient and based on figures released by the IBF for the first nine months of 2010, lending to this segment represents 43% of the mortgage market. First time buyer lending is likely to remain a significant proportion of the market in 2011.

Overall, there are several key factors that influence the decision to purchase a home; house prices, consumer confidence, affordability and the ability to finding the right property.

Many housing forecasts have already pointed to the fact that the majority of the reductions in house prices have taken place and the choice for new home buyers could not be better both in terms of location and type of property. Therefore in order to see any meaningful increase in the number of people buying their first home, there needs to be both an improvement in consumer confidence and for mortgage affordability to remain strong.

Consumer confidence is likely to increase as soon as Irish consumers believe the country is out of recession, therefore the next few months are important in setting the scene for new mortgage lending this year. Affordability is at an all time low and while personal disposable incomes are reducing and interest rates set to increase, given the significant reduction in house prices, new homes are likely to remain very affordable for some time to come. This is good news for first time buyers who are contemplating buying their first home this year.

Key Highlights January 2011

- House prices fell by 10.8% in 2010.
- Housing supply remained at historically low levels in 2010 with 14.6k new units completed.
- Average FTB working couple nationally in December 2010 using 12.6% of their net income to fund a mortgage.
- Singe buyers spending 25.2% net income to fund a mortgage. This is down from 55.4% at peak (Dec 2006).

Housing affordability continued to improve throughout 2010, writes **Annette Hughes, Director DKM Economic Consultants**

At the end of 2006, and early 2007, house prices in this country peaked, causing affordability to also hit the highest level recorded by the EBS DKM Affordability Index. Over the past four years, we have observed a marked improvement in housing affordability. The index is a measure of the proportion of net (after–tax) income required to meet first year mortgage repayments for an 'average' first-time buyer working couple, each on average earnings. It takes into account house prices, changes in mortgage rates, mortgage interest relief, and disposable income for the average FTB working couple. The data is considered for Dublin residents and those across the country as a whole. The house price figures used are based on permanent tsb/ESRI data.

The 2011 Budget brought in a range of income tax/PRSI increases, including a 10% reduction in the value of income tax bands and credits, the removal of the employee PRSI ceiling and the introduction of the new Universal Social Charge to replace the income and health levies, plus other tax raising measures. These changes will increase the burden for all income earners, many of whom will not know the net impact of these changes until they receive their first pay-slips. These changes will result in a reduction in disposable income and as such will have an adverse impact on housing affordability.

The accompanying chart (and table) is a graphic representation of the EBS DKM Affordability Index. It shows trends in the percentages of net income required to fund a mortgage for a working FTB couple and a single person at the end of December each year over the period 2006 to 2010 with projections to March 2011.

As can be seen from the index, the proportion of net income required to fund a mortgage for the average FTB working couple in the State was 12.6% in December down from 13% at the end of September. Throughout 2010 this proportion has narrowly fluctuated around 13%. House prices continued declining during 2010 but mortgage interest rates increased from 3.36% at the start of the year to 3.87% by the year-end. However, purchasers were able to use more of their available mortgage interest relief (MIR) to partly offset the increase in their repayments. As a result, overall housing affordability, measured as the proportion of net income required to fund a mortgage, continued to improve over the past twelve months.

For the corresponding Dublin FTB working couple, the percentage of net income required to fund a mortgage was 14.8% by the end of 2010, down from 16.3% in December 2009. As house prices in Dublin fell faster than across the country as a whole - by 15.1% in 2010 compared with 10.8% across the State as a whole - the improvement in affordability has been more pronounced for Dublin buyers. Again, as mortgage rates increased, buyers were able to avail of a greater amount of MIR, to partly offset the increase in their repayments.

An interesting trend to emerge since the peak has been the convergence of the housing affordability measures for both national and Dublin buyers since the peak.

Single buyers are now spending around 26% of their net incomes

The Table also shows that single persons purchasing in today's market are spending around 26% of their net incomes to fund a mortgage, down from around 55% at the peak (Dec 2006).

House price to income ratios are also in a more affordable territory

The improved affordability is also reflected in the average house price to income ratio, which is down to 4.1 times gross income for a single person and 2.1 times joint income for an average FTB working couple.

Income tax changes in the Budget will temporarily reverse the improving trend in affordability

Although house prices are assumed to continue falling in the first three months of 2011 and mortgage rates are expected to remain unchanged from December 2010 levels, the improving trend in housing affordability, underway since January 2007, suffers a temporary setback in January 2011. This is a result of changes to individuals' disposable incomes, caused by income tax/PRSI increases in the Budget, the new Universal Social Charge, and an assumed average decline of 1% in gross incomes. The combined impact of these changes will result in an increase in the proportion of net income required to fund a mortgage to 12.9% this month (from 12.6% in December) for national FTB working couples. Similarly Dublin FTB working couples will pay 15.1% of their net income in January, up from 14.8% in December 2010.

The above figures exclude the specific initiatives announced in the Budget for the property market relating to changes in stamp duty and these are considered below. However the expectation is that as house prices continue to decline the impact of the budgetary changes will be absorbed and housing affordability should be back on track around March/April.

Another key factor which impacts on affordability is mortgage interest rates. The ECB has signalled that rates are likely to move towards the latter part of this year, likely to be mid Q3. As this is beyond the scope of projections for the index, we have not built them into the model. However, there is a real prospect of an imminent increase in mortgage rates by financial institutions without an ECB rate increase. Therefore, we consider the impact of a 1% increase in mortgage rates below as one of a range of scenarios considered for a first-time buyer couple seeking to buy a property in today's market.

Trends in housing affordability for FTB working couple and single person to December 2010 with forecasts to March 2011

	Dec 06	Dec 07	Dec 08	Dec 09	Dec 10	Jan 11 Estimate	March 11 Projected
Average mortgage rate	4.81%	5.35%	4.80%	3.32%	3.87%	3.87%	3.87%
National first time buyer working couple							
Monthly repayments (€)	1,323	1,228	1,008	680	639	635	625
As % of net income	**26.4%**	**23.0%**	**18.6%**	**13.1%**	**12.6%**	**12.9%**	**12.7%**
Ave house price (000s)	279.0	260.8	224.2	177.1	159.5	158.3	155.8
Dublin first time buyer working couple							
Monthly repayments (€)	1,741	1,573	1,326	899	800	786	760
As % of net income	**32.5%**	**27.7%**	**23.0%**	**16.3%**	**14.8%**	**15.1%**	**14.6%**
Ave house price (000s)	359.0	333.9	294.9	234.2	195.5	196.1	189.6
National single first time buyer							
Monthly repayments (€)	1,390	1,304	1,008	680	639	635	625
As % of net income	**55.4%**	**48.9%**	**36.4%**	**25.7%**	**25.2%**	**25.8%**	**25.4%**
Ave house price (000s)	279.0	260.8	224.2	177.1	159.5	158.3	155.8

ASSUMPTIONS:
Monthly FTB House Prices: Permanent tsb/ESRI data up to Q4 2010. FTB prices available up to July 2009. Data from August 2009 derived by assuming that FTB prices fall in line with national average house prices up to December 2010. The average Dublin FTB house price is assumed to be equal to 84% of the average Dublin house price, based on the permanent tsb/ESRI dataset. Post December 2010, assume average monthly reduction for all categories is equal to average monthly decline in 2010 (0.77% nationally and -1.67% in Dublin).
Loan to Value Ratio: 90% Mortgage Term 25 years.
Average Mortgage Rates: Down from peak of 5.87% in August '08 to trough of 3.16% in June'09. Increased thereafter to 3.87% by December 2010 and maintained at this level Jan-Mar 2011.
Maximum Mortgage Interest Relief: €20,000 max available at 25% since Jan 2009 = €417 per month max. MIR to remain for homeowners in negative equity until 2017 (Budget 2010).
Average gross income for FTB working couple of €79,585 in 2009, unchanged from 2008. In 2010 gross income reduced in line with CSO figures, implying a reduction of 3% to €77,197. The FTB couple started out earning €70,000 in June 2005, implying gross income up by 10.3% in 5½ years. For 2011, gross income assumed to decline by 1% as per ESRI QEC Winter 2010.
Income and health levies replaced by the new Universal Social Charge from January 2011.
Incomes of single person set at €35,000 in June 2005 and by 2010 was €38,600 (+10.3% over 5½ years). Average incomes are assumed to be 1% lower in 2011 compared with 2010.
Income of Dublin buyers are assumed to be 10% higher than for buyers across the State as a whole.

Housing is more affordable today than at any time in the past twenty five years, writes Annette Hughes

Based on quarterly figures derived by DKM in the past for the period 1988 to 2004 (and notwithstanding minor differences in the methodologies set out in the notes below), the average working couple is paying slightly less today than at the lowest points in previous housing affordability cycles i.e. in Q2 1988 and Q1 1995. The table below illustrates that despite average house prices today being 2.1 to 3.2 times their average levels in Q1 1995 and Q2 1988 respectively, the proportion of net income required to fund a mortgage reached its lowest point in December 2010: 12.6% today versus 13.4% in Q2 1988 and 13.8% in Q1 1995.

Comparisons of Housing Affordability

	Q2 1988	Q1 1995	December 2010
Average national house price (€)	51,028	77,731	159,490
Loan to value ratio	90%	90%	90%
Mortgage term (years)	20	20	25
Mortgage rate	8.92%	7.30%	3.87%
Gross income married couple (€)	32,175	40,461	77,197
Average tax rate	33.6%	28.5%	21.0%
Net disposable income (€)	21,364	28,946	60,963
Maximum mortgage interest relief (€)	4,571	6,349	20,000
Annual net repayments (€)	2,865	3,983	7,674
As % of disposable income	***13.4%***	***13.8%***	***12.6%***
House price/gross income ratio:			
Married couple	1.59	1.92	2.07
Single person	3.17	3.84	4.13

NOTES:
The house price figures in 1988 and 1995 are national average prices; the December 2010 is national average FTB price.
The mortgage term assumed in the historic quarterly index was 20 years; the currently monthly index assumes a term of 25 years.
The average tax rate in the quarterly model adjusts for income tax only; the December 2010 figure adjusts for PRSI and the income and health levies. Allowing for these differences the disposable income levels in Q2 1988 and Q1 1995 would be lower, but the average house price paid by FTBs might also be lower, implying little or no change in the affordability percentages quoted above for the earlier periods.

However other issues are affecting today's market, most notably the difficulties accessing mortgage funding as well as a general lack of confidence in the housing market, reflecting wider economic conditions, job losses and the increasing income tax burden, which has brought many lower paid single workers into the tax net from January 2011 for the first time since 2005.

Sector specific initiatives in the Budget and their implications for the property market

A number of measures will combine to reduce households' disposable incomes.

The changes in respect of income tax/PRSI and the new Universal Social Charge have already been mentioned and taken into account in the affordability calculations for 2011. There were other immediate changes announced in the Budget which are also likely to reduce disposable incomes, notably the reduction in tax relief on pension contributions, increases in third level registration fees and increased excise duties on fuel.

Changes in stamp duty

The reduction in stamp duty to 1% for all residential transactions with a value up to €1 million and 2% for all transactions over €1 million was broadly welcomed. Previously purchasers other than first-time buyers were paying up to 9% on transactions worth over €125,000. Thus existing owner occupiers will save €3,250 on a house worth €200,000. However, a FTB that was previously exempt will now pay €2,000 on the purchase of this house, so this is also having an impact on FTB affordability. It is unlikely that this measure alone will be sufficient to stimulate a recovery in residential transactions over the coming twelve months for a number of reasons. These include the reductions in disposable incomes from January, the continued difficulties accessing mortgage funds, the increase in savings and the need to repay debt, as well as the expectation of further house price falls in 2011.

Plans to broaden the tax base may further dent disposable incomes

Other changes mooted in the Budget for the medium-term, such as the interim property tax measure due to commence in 2012 (€100 per household per annum), with a full value-based measure in 2013, the VAT increase from 2013 and the introduction of water charges in 2014, can be expected to depress disposable incomes further, thus delaying the return to equilibrium in the property market. However, with the imminent election and the prospect of a new administration, the timing of these medium-term measures may alter and indeed some may never materialise.

What do the Budget changes mean for you?

In terms of the budget we consider a first-time buyer working couple each earning €35,000. They are considering purchasing a property for €200,000 with a 90% loan to value ratio. A number of scenarios are set out below which consider the impact of the Budget changes, reductions in gross income and an increase in mortgage rates.

Scenario	1 Dec-10	2 Jan-11	3 2011	4 2011	5 2011	6 2011
House price	€200,000	€200,000	€200,000	€200,000	€200,000	€200,000
Loan to value ratio	90%	90%	90%	90%	90%	90%
Mortgage term (years)	25	25	25	25	25	25
Mortgage rate	3.87%	3.87%	3.87%	3.87%	4.87%	4.87%
Gross income married couple	€70,000	€70,000	€69,300	€66,500	€69,300	€66,500
Avergage tax rate	18.8%	20.2%	19.87%	18.52%	19.87%	18.52%
Net disposable income	€56,848	€55,867	€55,531	€54,187	€55,531	€54,187
Actual MIR	€1,742	€1,742	€1,742	€1,742	€2,192	€2,192
Annual net repayments	€9,623	€9,623	€9,623	€9,623	€10,414	€10,414
Net monthly repayments	€802	€802	€802	€802	€868	€868
As a % of disposable income	***16.9%***	***17.2%***	***17.3%***	***17.8%***	***18.8%***	***19.2%***

Budget Changes

2. Budget changes in income tax, PRSI and USC.
3. Budget changes and 1% reduction in gross income.
4. Budget changes and 5% reduction in gross income.
5. Budget change, 1% reduction in gross income and a 100 basis point increase in mortgage rate.
6. Budget change, 5% reduction in gross income and a 100 basis point increase in mortgage rate.

Impact:	1	2	3	4	5	6
Disposable income (per month)		-€82	-€111	-€222	-€111	-€222
Net repayments (per month)		€0	€0	€0	€66	€66

The impact of the budget tax/PRSI changes reduces their disposable income by €82 per month. Assuming a further reduction of 1% in their gross income would reduce their disposable income by €111 per month.

Scenarios 5 and 6 consider the impact of a 1% increase in the mortgage rate. In both scenarios, their average repayment increases by €66 per month. The impact of the 1% increase on their repayments is cushioned by the fact that the couple receive 25% relief on the additional interest through mortgage interest relief (MIR), implying they only effectively pay 75% of the increase in their mortgage repayments, until they use all of their interest relief (=€5,000 per annum).

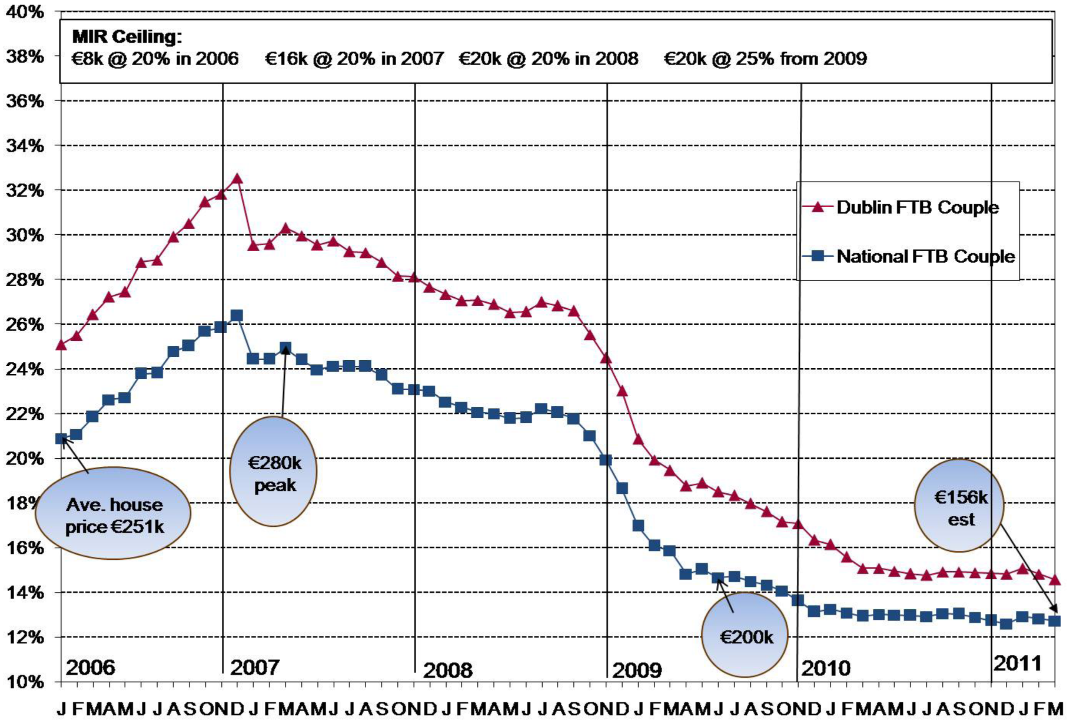
The main point from the above Table is that the proportion of net income required to fund their mortgage is 17.2% in January, up from 16.9% in December 2010. Even with an income reduction of 1%, the proportion increases only marginally to just 17.3%.

In the worst case Scenario above, Scenario 6, the proportion of net income increases to just 19.2%, and is still below the average proportion of net income required to fund a mortgage of 19.5% over the period June 2005 to December 2010.

Thus the proposition is not an unattractive one. With disposable incomes falling and mortgage rates expected to rise, the fact remains that the proportion of income currently required to fund a mortgage is very low and is not going to rise appreciably this year. The range of scenarios demonstrates that on foot of the above changes affordability is not being materially hit for a FTB working couple and is likely to improve as house prices fall further over the coming months.

There will be other impacts on first time buyers disposable income in 2011, most notably the €2,000 in stamp duty, which first-time buyers are now obliged to pay, having being previously exempt. The couple will also need access to the 10% deposit of €20,000 and will need to raise their mortgage, both of which may be difficult in the current environment. There is also the prospect of further tax increases over the period of the National Recovery Plan, which may continue to dent confidence in the property makeover for some time to come.

EBS-DKM housing Affordability Index: The proportion of net income for a FTB working couple required to meet net mortgage repayments on the 'average' FTB house price based on a 90% loan to value ratio and a 25 year mortgage



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