Davy Research
Irish economy
February 19 2015

DAVY

Political risks to Ireland's recovery

Conall Mac Coille
conall.maccoille@davy.ie / +353 1 6148770

Economics Team
Conall Mac Coille
research@davy.ie

DAVY VIEW

In this report we consider the political risks to Ireland's recovery.

Political risks to Ireland's recovery

Ireland is scheduled to have a general election by early 2016. Current polls give left-leaning parties such as Sinn Féin and independents close to 50%, benefitting from austerity fatigue, eating into political support for traditional political parties. However, it is far from clear whether Sinn Féin and independent candidates can translate this support into actual electoral success. We have commissioned independent political scientist David Farrell (see separate report, also issued this morning) to assess the current state of Ireland's political landscape. While an extreme left-leaning government seems unlikely – a broader coalition government may be likely after the next election.

In this report we outline the political risks to Ireland's recovery. Ireland's growth strategy has been focused on the export sector and attracting foreign direct investment (FDI). There have been few calls to change Ireland's 12.5% corporation tax rate, even from left-leaning parties. No Irish government is likely to undermine the clear success story of attracting FDI and building a cluster of ICT multinational companies operating in Ireland.

Ireland's fiscal adjustment is now close to complete

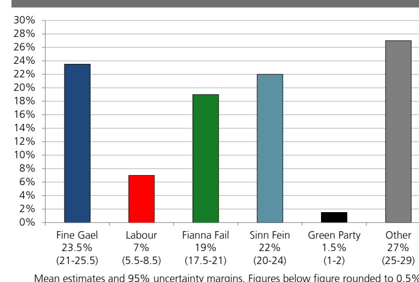
Our forecasts for GDP growth imply that the deficit will narrow to 2% of GDP by 2017 with no further fiscal adjustments. So the next government may not have to implement fresh spending cuts or tax rises. That said, Ireland has traditionally implemented pro-cyclical fiscal policy, with budget giveaways around election time. Political pressures for inappropriate spending increases and tax cuts will surely build – whatever the hue of the next government. However, the bigger picture is that a sharp reversal in budgetary policy would be required to endanger debt sustainability – which we do not think is likely.

The next government is unlikely to interfere with current plans to sell its stakes in the banking sector

The political narrative is focused on how much of the €64bn cost of recapitalising Ireland's banks can eventually be recouped. Stakes in Allied Irish Banks and Bank of Ireland are currently valued at close to 9% of nominal GDP. Realising this value will push the government debt/GDP ratio below 100% and will be recognised as a success story. More concerning may be efforts to extend or increase the banking levy. Pressures on NAMA to deliver a 'social return' could grow, perhaps inhibiting profitability.

Political pressures to prevent repossessions of delinquent mortgage loans could delay loan work-outs (albeit against conservative provisioning) or lead to a further breakdown in payment discipline. Focusing on property markets, residential house price inflation looks set to slow in any case given expiring capital gains tax exemptions, stretched valuations and new rules to curb leveraged mortgage lending. But we do not believe slowing house price inflation will threaten Ireland's export-led recovery. The commercial property market could be more exposed to political developments, which could impact on liquidity and valuations.

Current state of Irish parties in the opinion polls (Jan 25th 2015)



Source: Irish polling indicator

Davy projections for Ireland's gov. deficit and debt (% of nominal GDP)

	2014F	2015F	2016F	2017F
Gov. deficit	-4	-2.9	-2.2	-1.3
Gov. debt	110.9	108.9	104.8	101.7

Source: Central Statistics Office; Davy

See the end of this report for important disclosures and analyst certification. All authors are Research Analysts unless otherwise stated.

Summary: political risks to Ireland's recovery

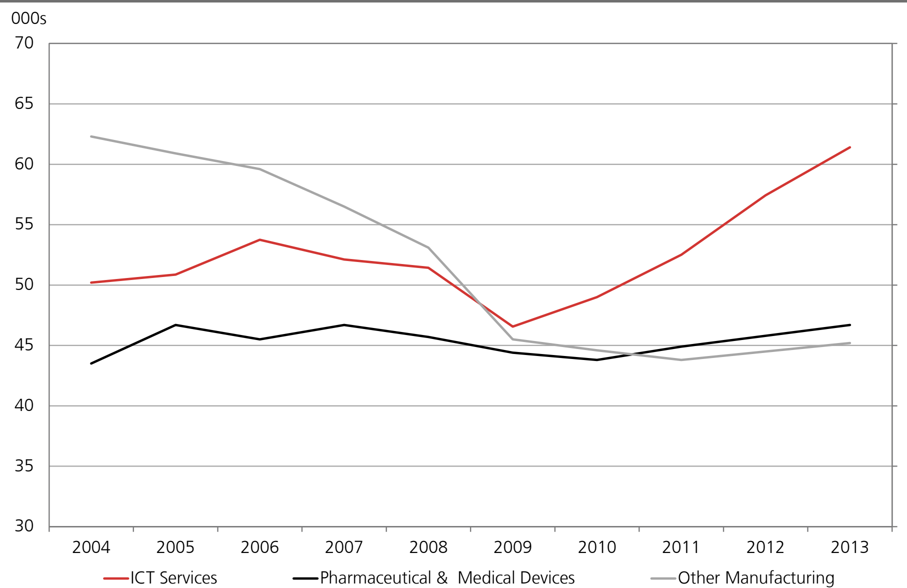
Our current Irish GDP growth forecast is 4.8% in 2014, 3.7% in 2015 and 3.4% in 2016. This means that Ireland will be the fastest-growing economy in Europe. Why? First, the Irish economy is naturally experiencing a catch-up process, having seen one of the deepest and protracted recessions through the financial crisis. The EU/IMF programme of support has helped to stabilise Ireland's public finances and banking sector – providing a platform for growth. However, perhaps missing from similar programmes in Greece and Portugal was an effective growth strategy. Ireland has focussed on the export sector, successfully attracting FDI – evident in the strong expansion of the ICT services sector. Meanwhile, activity in domestic facing sectors such as construction, retail, services and tourism has stabilised and in some cases started to rebound gradually (see "New Irish economic forecasts: Ireland's economy enters the catch-up phase", issued February 2nd 2015).

No government is likely to interfere with Ireland's successful growth strategy of attracting FDI

It is hard to see any government tinkering with Ireland's successful growth strategy of attracting foreign direct investment

Assessing the political risks to growth necessarily means focusing on threats to Ireland's attractiveness as a location for FDI. No Irish government is likely to tinker with a clear success story. There have been very few calls to abandon the 12.5% corporation tax rate, even from left-leaning parties, and the government remains resolute that it will be a cornerstone of Ireland's industrial development policy.

Figure 1: Employment in foreign-owned enterprises



Source: Forfás

Rather than focusing on political risks, investors have concentrated on the potential impact of eliminating the 'double-Irish' tax structure

In 2014, attention focused on the decision to eliminate the 'double-Irish' tax structure, with the Minister for Finance indicating that the government will legislate for a new 'Knowledge Development Box' along the lines of existing patent box structures in the UK, Netherlands and Luxembourg, albeit intended to be compliant with the outcome of the OECD's Base Erosion and Profit Shifting (BEPS) project, due to report in the summer. However, while the end-game remains uncertain, our assumption is that Ireland will continue to compete effectively for FDI. Indeed, bottlenecks in terms of available office space and residential property seem a more pressing concern with respect to FDI. Labour shortages of high skills such as IT and the 52% marginal tax rate are also potential factors holding back FDI. For now, however, the pipeline of FDI remains strong.

Fiscal policy: an unlikely U-turn in policy would be required to endanger debt sustainability

Thankfully, Ireland's fiscal adjustment is now close to complete. We expect the deficit will equal 4.0% of GDP in 2014, closing to 2.9% of GDP in 2015 and 2.2% in 2016. These forecasts are based on neutral budgets. That is, Ireland's robust economic growth should be sufficient to narrow the deficit. The new government will not be under pressure to deliver fresh spending cuts or tax rises, over and above existing plans. It is also worth noting that the general election will probably take place after the Budget for 2016 in October. So it could be 2017 before the new government's policies start to influence the trajectory of the public finances. This is a very different situation to the UK, where the Institute for Fiscal Studies (IFS) has estimated that only 50% of required spending cuts to balance the budget by 2018 have been implemented.

However, Ireland has a history of pro-cyclical fiscal policy – with irresponsible budgets not only the preserve of the left. The political reality is that budget giveaways are expected when economic growth is robust and that spending cuts and tax increases are accepted during a recession. Unfortunately, this behaviour was particularly acute around elections in 2002, 2007 and 2011. Political pressures are now clearly growing on the current government for a pre-election giveaway budget. The Irish Fiscal Advisory Council (IFAC) and Fiscal Compact rules have yet to provide tangible evidence they can restrain policy. One year out of the EU/IMF programme, the Irish government implemented a small €1bn budget giveaway against the advice of the IFAC, Central Bank, European Commission and IMF to implement plans for a €2bn fiscal adjustment, albeit with the end-2014 deficit set to equal 4% of GDP – well inside the 4.8% target.

Ireland's fiscal adjustment is now largely complete, so a sharp reversal in budgetary policy would be required to endanger debt sustainability – a scenario we do not think is likely

However, an enormous upheaval in budgetary policy would be required to endanger Ireland's debt sustainability. We do not believe there are likely political scenarios that could lead to such policies – even those including left-leaning parties that would inevitably have to enter a coalition government. Here Sinn Féin's record in Northern Ireland is instructive – implementing a programme of public expenditure and social welfare cuts, with public sector employment set to fall by 9.5% over the next four years in return for powers to set an independent corporation tax rate from the rest of the UK.

Ireland's debt sustainability has been improved by a range of measures; for example, reducing the interest cost of official borrowing from European funds. Similarly, the NTMA recently raised €4bn of 30-year funding at a 2% interest cost from bond markets, which will be used to help refinance relatively expensive IMF loans with a 5% interest cost. The average maturity of Irish government debt is now close to 12 years, among the longest in the OECD.

The political narrative is focused on how much of the €64bn cost of recapitalising banks can be recouped – so a new government is unlikely to interfere with the current process to realise value from financial sector stakes

Banking sector: focus will remain on recouping €64bn cost of recapitalising banks

We are currently forecasting gross government debt to fall to 102% of nominal GDP by 2017. However, this does not include any windfall gain from sales of government stakes in the banking sector. Current valuations on government stakes in Allied Irish Banks and Bank of Ireland are close to €16bn, nearly 9% of nominal GDP. Realising this value will be seen as a success for the next government, helping push the debt/GDP ratio firmly below 100%. Hence, our central view is that a coalition government will not seek to derail the current process to divest stakes in the banking sector. The political narrative is focused on how much of the €64bn cost of recapitalising Ireland's banks can be recouped. That said, political uncertainty leading up to the election could delay Allied Irish Banks' equity market return. Perhaps of more concern is that the existing bank levy, set to end in 2016, might be extended or increased from €150m per annum. However, such moves will be constrained by the divestment process itself.

Investors in Irish banks have focused on the potential for write backs on non-performing loans, particularly on mortgage loans that are conservatively provided for. Provisioning models assume a 52-55% peak-to-trough fall in house prices compared with the current 38% decline. The implementation of the Central Bank's mortgage arrears resolution targets (MART) in 2014 has seen the first material effort to deal with delinquent mortgage loans. As of Q3 2014, banks had proposed solutions for over 80% of non-performing mortgage loans, equally split between loan modifications and repossession (or voluntary sales).

Political pressures to prevent repossession could lead to a further breakdown in mortgage payment discipline and delay the resolution of existing non-performing loans

The risk here is that political pressures to delay repossessions could delay resolution of non-performing loans – and the potential for write-backs. Alternatively, there could also be political pressures to resolve delinquent mortgage loans more quickly – through engagement with the PIA process. Effective action to deal with Ireland's mortgage arrears crisis was hindered by the 2011 Dunne ruling, which prevented repossession, and earlier vintages of the Code of Conduct on Mortgage Arrears (CCMA), which prevented banks from contacting delinquent borrowers. If the threat of repossession is eroded even further, an additional breakdown in payment discipline could materialise.

Property markets: foreign investors could be sensitive to political developments

With Irish house prices now at similar valuation multiples to the UK, a slowdown seems inevitable and will not hold back Ireland's export-led recovery

Political developments could pose risks to Ireland's property markets. However, the key factor pushing Ireland's house price inflation rate into double-digit territory has been the lack of supply in urban areas, with the market remaining exceptionally illiquid. The housing market will now have to adjust to the end of capital gains tax exemptions, which appear to have led to a surge in cash purchases in 2014. Moreover, at 5x average incomes, Irish house prices no longer look cheap – with new Central Bank mortgage lending rules designed to prevent a new bubble emerging. So a slowdown in Irish house price inflation is probably inevitable and certainly desirable. This should not pose risks to Ireland's export-led recovery. Irish household savings rates remain exceptionally high at 12% as households continue to pay down debt, currently 177% of disposable incomes. Second, the construction sector has played little role in Ireland's recovery, with activity still at exceptionally depressed levels.

Ireland's commercial property markets, driven by foreign investment, may be more vulnerable to political risks

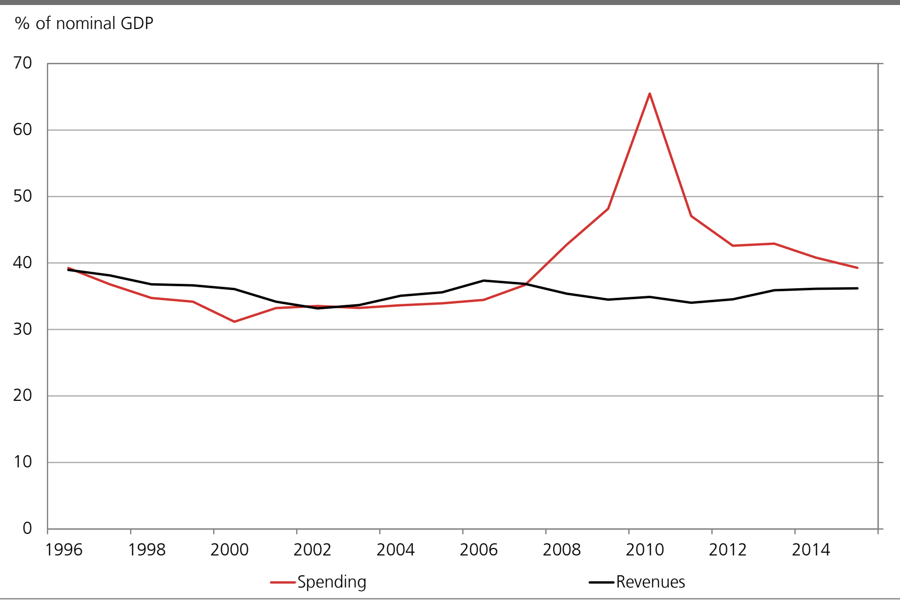
In contrast to the illiquid housing market, 2014 saw almost €4.5bn of commercial property market transactions in addition to €21bn of loan sales. Liquidity has been helped by NAMA sales, exiting foreign banks and the re-trading of properties bought earlier in the cycle. As this de-leveraging process has taken place, a new cohort of investors has emerged including domestic and overseas family offices, international private equity funds, distressed debt specialists, overseas property plcs and the Irish REITs. More recently, more patient capital has been active in the Irish market, with local long only funds such as IPUT and Irish Life Real Estate Investment Managers joined by London-headquartered, long only investors such as Standard Life and Knight Frank Investment Managers. As these investors have entered the market, yields across Ireland's commercial real estate market have compressed. This rotation towards institutional patient investment in Ireland's commercial property market could be sensitive to political developments.

Unlikely reversal in budgetary policy would be required to undermine debt sustainability

The new government will take power when the fiscal adjustment has been completed, probably after budget measures for 2016 have been set

Since Ireland entered the EU/IMF programme, enormous progress has been made in stabilising the public finances. A series of austerity budgets helped to reduce the underlying deficit (excluding banking recapitalisation costs) from 12.0% of GDP to 4% of GDP in 2015. However, Ireland's deficit will still be one of the largest in Europe in 2014, albeit with strong economic growth set to push the deficit below 3% of GDP in 2015. The Budget for 2016 will take place in October, and it now looks likely that the election will take place after this. Assuming the next government sticks to the fiscal calendar, it may be 2017 before its first budget will affect the public finances.

Figure 2: Government spending and revenues as % GDP



Source: OECD

Debt sustainability has been improved by locking in low-cost, long-term funding

Of course, Ireland's debt levels remain relatively high at close to 110% of GDP at end-2014. However, enormous progress has been made in making this debt sustainable by reducing the interest rate on official loans. The EU/IMF's original forecasts at the start of the programme envisaged Ireland's debt interest bill rising to 6.3% of nominal GDP. The latest Department of Finance projections are that the interest bill will equal just 3.8% of GDP in 2015. Since then, the NTMA has raised €4bn of funding from a 30-year bond at a 2.1% interest rate, intended to help fully refinance expensive IMF loans with a 5% interest cost. With Irish 10-year bond yields now close to 1%, debt servicing costs are not a concern. In addition, the ECB promissory note deal has helped to extend the term of Ireland's debt, now close to 12 years – one of the longest average maturities of sovereign debt among OECD countries.

Table 1: Davy projections for Ireland's government deficit and debt (% of nominal GDP)

	2010	2011	2012	2013	2014F	2015F	2016F	2017F
Government deficit	-11	-9.3	-9.0	-5.9	-4.0	-2.9	-2.2	-1.3
Government debt	87.4	111.1	121.7	123.3	110.9	108.9	104.8	101.7

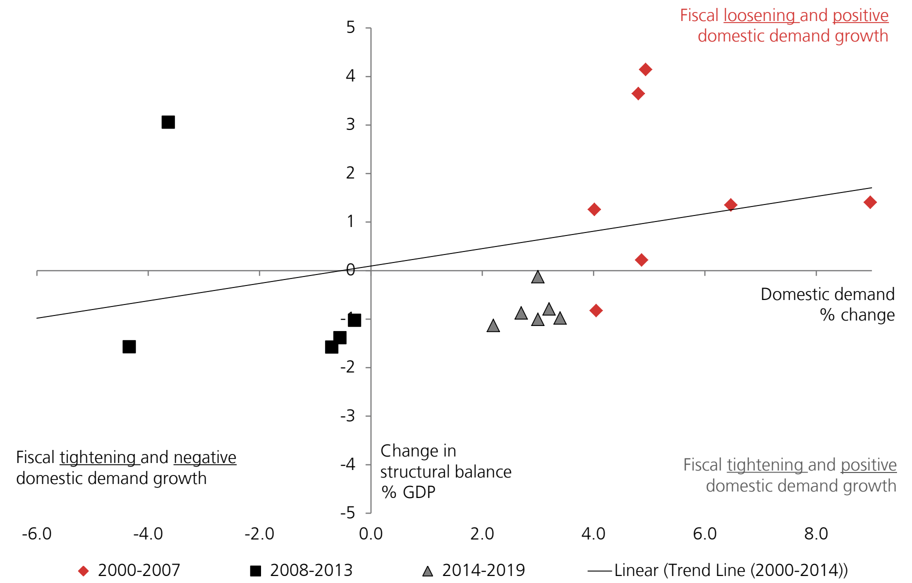
Source: Central Statistics Office; Davy

"When I have it, I spend it" – former Minister of Finance Charlie McCreevy

However, Ireland has a history of pro-cyclical fiscal policy – with irresponsible budgets not only the preserve of the left. The political reality is that budget giveaways are expected when economic growth is robust and spending cuts and tax increases are accepted during recession. During the Celtic Tiger era of the 2000s, large increases in public expenditure and tax cuts were financed by unsustainable revenues related to the housing bubble. Figure 3 illustrates that in every year but one in the period 2000-2007 the structural budget deficit was allowed to get progressively worse, accompanied by robust growth in domestic spending and GDP (red dots). Since 2009, the government has implemented fiscal adjustments as domestic demand has contracted (black dots).

According to the IMF's current projections, the structural balance will gradually improve through 2015-2018 as the economy continues to recover (grey dots). However, it remains to be seen whether Irish politicians can resist the temptation to engage in pro-cyclical fiscal policy (i.e. moving the grey dots into the top-right quadrant). Unfortunately, this behaviour tends to be particularly acute around election time. The two largest increases in Ireland's structural budget deficit directly preceded elections in 2002 and 2007. The 2002 budget included €1.9bn of spending increases (1.6% of GDP) in addition to €634m of personal income tax reductions (0.5% of GDP) and €1.1bn of social welfare increases (0.9% of GDP). The 2007 Budget was even more lavish, providing €1.3bn of income tax cuts, €1.8bn of current expenditure increases and a 13% rise in capital expenditure.

Figure 3: Ireland's pro-cyclical fiscal policy



Source: International Monetary Fund

The Budget for 2015 did not heed the advice from the Irish Fiscal Advisory Council and other institutions

Limiting the influence of the political cycle on the public finances has been a key goal of the EU/IMF programme. In 2012, the Irish Fiscal Advisory Council (IFAC) was put on a statutory footing to provide independent monitoring and advice on Ireland's fiscal policy. However, just one year out of the EU/IMF programme, the Irish government implemented a small €1bn budget giveaway – against the advice of IFAC, the Central Bank of Ireland, the European Commission and the IMF to press on with fiscal consolidation. That Ireland's deficit looks set to equal 4.0% of GDP, inside the original 4.8% Budget 2014 target, helped to undermine calls for further fiscal consolidation.

It remains to be seen whether the Fiscal Compact treaty can act as an effective guard against irresponsible fiscal policy

The next Irish government's options will be restrained to the extent that it abides by the rules of the Fiscal Compact treaty. The treaty was enshrined in Ireland's constitution in May 2012 following a referendum with 60.3% voting in favour, albeit with the campaign focused on ratification as a precondition for ESM funding access, rather than necessarily the merits of budgetary discipline itself. Sinn Féin and the Socialist Party campaigned against the treaty, with Fianna Fáil, Fine Gael and Labour in support. The treaty contains two key rules.

- The structural (cyclically adjusted) deficit must equal 0.5% of GDP
- If debt exceeds 60% of GDP, additional fiscal measures must be implemented to bring down debt by 1/20th of the gap.

The rules allow flexibility for exceptional circumstances. The European Court of Justice has the ultimate sanction of imposing fines up to 0.1% of GDP for non-compliance with the treaty. However, given recent French and Italian disagreements with the European Commission, it remains to be seen whether the Fiscal Compact can check inappropriate fiscal policies. Certainly, the Fiscal Compact rules have had little influence on recent domestic debate on budgetary policy.

Conservative budget assumptions and buoyant tax revenues have offset a breakdown in spending discipline

It is worth bearing in mind how Ireland has achieved its fiscal targets (see Table 2). In 2013, spending discipline was maintained, albeit with a €138m over-run in the Department of Health offset by lower spending in other departments. However, in 2014, all three of the big spending government departments – Education, Health and Social Protection – were over budget. This overspend was compensated for by a combination of greater-than-expected tax revenues, non-tax revenues and lower debt interest payments. But the underlying picture is that spending pressures are emerging.

Table 2: Fiscal out-turns versus targets, 2013 and 2014 (€m)

	2013 target	2013 out-turn	Beat/ miss	2014 out-turn	2014 target	Beat/ miss
Tax revenues	49,245	49,134	111	53,063	51,645	1,418
Non-tax revenues	2,676	2,360	316	2,446	1,983	463
Capital resources	4,207	2,020	2187	537	334	203
Revenue	**56,128**	**53,514**	**2,614**	**56,045**	**53,962**	**2,084**
Gross voted current spending	**51,097**	**51,146**	**-48**	**50,455**	**49,648**	**807**
Health	13,763	13,624	138	13,357	12,774	584
Social Protection	20,220	20,233	-13	19,712	19,585	127
Education	8,410	8,456	-46	8,296	8,219	78
Gross voted capital	**3,414**	**3,431**	**-17**	**3,550**	**3,339**	**210**
Capital contribution to Irish Water				**461**	**12**	**461**
Debt interest	**7,310**	**7,225**	**85**	**7,466**	**8,154**	**-689**
Expenditure	**67,625**	**69,007**	**-1,381**	**64,091**	**63,127**	**964**

Source: Central Statistics Office

Given the progress thus far, an unlikely reversal in fiscal policy would be required to endanger debt sustainability

However, the key point is that Ireland's fiscal adjustment is now close to complete. The next government will not have to implement fresh spending cuts or tax rises. Political pressures for inappropriate spending increases or tax cuts will surely build – whatever the hue of the next government. But the bigger picture is that a sharp reversal in budgetary policy would be required to endanger debt sustainability – which we do not think is likely.

Sinn Féin has agreed to a programme of cuts in public expenditure, social welfare reform and reductions in public sector employment in Northern Ireland

Given the diverse range of left and right wing independents, it is not possible to describe their policy views. Opinion polls suggest that the only realistic path for Sinn Féin to enter government is in coalition with one of the traditional parties. Here it is worth highlighting Sinn Fein's record in Northern Ireland. In December 2014, Sinn Féin agreed to the Stormont House Agreement – committing to a balanced budget and programme of public sector reform while allowing Northern Ireland to set its own independent corporation tax rate. Sinn Féin's participation was crucial as it forms a majority on the Northern Ireland executive alongside the Democratic Unionist Party (DUP). The 2015 budget envisages a 0.6% cut in current expenditure to £10bn (or -1.4% in real terms) and a 9.5% reduction in public sector jobs over the next four years with significant social welfare reform. In short, Sinn Féin is now implementing a Northern Ireland budget described by the Socialist Party as a 'neo-liberal programme of austerity'.

Banking sector: process to divest banking stakes unlikely to be derailed

The overall story of Ireland's banking sector in 2014 was of further progress. Allied Irish Banks and Bank of Ireland both returned to profit in H1 2014 and passed the autumn stress tests. That said, the tests revealed a capital shortfall in PTSB, which has now submitted a capital plan to the SSM, which has been endorsed. The government has indicated that recapitalisation should be based on private sources by June. Profitability continues to improve due to the reduction in impairment charges to more normalised levels but held back by on-going de-leveraging by Irish households and corporates, leading to negative net loan growth. However, deposit rates continue to fall which will help net interest margins. Meanwhile, there is some tangible evidence that work-out of non-performing loans is accelerating.

We do not believe political pressures will derail the process to divest stakes in the banking sector

A key issue for investors is how the government will divest its remaining stakes in the banking sector. The Irish government's current policy is not to hold investments long term but to exit in a way that generates value for the taxpayer. The Department of Finance has recently established three panels of financial advisors to help assist in the future sale of the remaining stakes. The government currently owns 99.8% of Allied Irish Banks, 14% of Bank of Ireland and 99.2% of PTSB. The state valued its holdings in Allied Irish Banks at €13.3bn as of December 2014 compared with €21bn of government capital injections which the state intends to recoup over time. At current market prices, the 14% stake in Bank of Ireland is worth close to €1.35bn. The Minister for Finance has indicated that a first disposal with respect to Allied Irish Banks may take place before the next election. The government has indicated that it is in no hurry to exit its position in Bank of Ireland.

Selling banking sector stakes will be a key factor helping to push government debt/GDP below 100%, which will also constrain efforts to tax financial sector profits

Our central view is that the next government will not seek to derail the current process to divest stakes in the banking sector. First, asset sales will help push Irish government debt to GDP below 100%. Our current forecast for Irish government debt to fall to 101.7% of GDP by 2017 does not include any asset sales. The valuations above for Allied Irish Banks and Bank of Ireland comprise 9% of nominal GDP. Realising this value will inevitably be seen as a success for the next government. Second, in a recent interview on January 18th, Sinn Féin leader Gerry Adams indicated that he was against the sale of Allied Irish Banks. However, he also indicated that a potential Allied Irish Banks sale was not a red line issue and would be subject for negotiation should Sinn Féin enter a coalition government.

Perhaps more concerning is the possibility of banks' profits being eroded by windfall taxation measures. Budget 2014 imposed a new €150m banking levy, with contributions broadly based on Irish banks' deposit interest tax payments. The levy was set to run for three years from 2014 to 2016. Clearly, a new government could either increase the banking levy or extend it beyond 2016. However, such a decision would be intimately tied to the divestment strategy for the banking sector – perhaps serving as a constraint for significant increases in the levy.

Political pressures to delay resolution of mortgages arrears crisis could emerge

2014 saw the first meaningful efforts to address Ireland's mortgage arrears crisis – raising the possibility of write-backs

The possibility of write-backs on Irish banks' non-performing loans was a key theme for investors in 2014. House prices are now 38% below peak levels, well inside the 52-55% assumptions in banks' provisioning models for non-performing mortgage loans. Through the year Irish banks appear to have met the Central Bank's mortgage arrears resolution targets. In Q3 2014, Irish banks had rolled out 100,000 proposed solutions to

mortgages in arrears. Of these, 51,000 comprised a restructured mortgage. However, in close to 50% of cases (49,000), loss of ownership (repossession) was the solution. Of these, 23,800 have been concluded. We understand this means the bank has applied for a civil bill to move towards court proceedings and repossession.

Table 3: Central Bank Mortgage Arrears Resolution Targets (MART)

Resolution targets	Q3 2014	Q4 2014
Proposals	80,600 (80%)	91,400 (85%)
Concluded	37,600 (40%)	48,400 (45%)
Terms being met	75%	75%
Performance against targets		
Proposals	100,300	
Restructured mortgages	50,800	
Loss of ownership	49,000	
Concluded solutions	60,400	
Restructured mortgages	36,300	
Loss of ownership	23,800	

Source: Central Bank of Ireland

2014 saw encouraging trends in terms of overall mortgage arrears. The 90+ day arrears rate fell to 11.2% in Q3 2014, down from 12.9% one year previously. However, numbers in long-term arrears have continued to climb. The owner-occupier 720+ day arrears rate was 4.9% in Q3 2014, up from 4.4% in Q3 2013. Across both owner-occupier and buy-to-let, 52,919 were in arrears over 720 days in Q3. The concern is that this hard core of longer-term delinquent borrowers, often refusing to engage with banks, are predominantly those currently being threatened with repossession. With banks now set to meet the 85% end-2014 resolution target for non-performing loans, repossessions now look set to rise.

But political pressures could delay loan loss recognition or impede the repossession process so that a further breakdown in payment discipline emerges

However, political pressures may emerge once again to delay this process. This could delay the work-out of non-performing mortgage loans and the potential for write-backs. That said, we still believe Irish banks are conservatively provided for. Perhaps of greater concern is that failure to exhibit effective repossession procedures could encourage a further breakdown in mortgage payment discipline. Ireland's exceptionally high mortgage arrears rates cannot be explained by economic fundamentals. The IMF, among others, has pointed to evidence that a significant breakdown in payment discipline occurred in 2012 and 2013 following the 2011 Dunne judgment, which effectively prevented repossession proceedings, and the Code of Conduct on Mortgage Arrears (CCMA), which severely limited Irish banks' ability to engage with delinquent borrowers.

Alternatively, banks may face stepped-up pressure to embrace the Insolvency service and more effectively use personal insolvency arrangements (PIA) to write down home-owner mortgages. This approach may advance the long-term resolution of mortgage arrears. To date (Q4 2014), only 199 PIA cases have been approved since the organisation's inception, with the banks' effective veto of any proposals frequently cited as an obstacle. The government has also recently held discussions with debt experts and the Insolvency service amid concerns that the insolvency process is not working effectively.

NAMA’s role could be questioned

Another potentially sensitive issue may be NAMA’s role. NAMA's wind-down accelerated dramatically in 2014, with €9.1bn of senior bonds repaid which contrasted with €7.5bn of cumulative redemptions between 2011 and 2013. The agency believes that most of its work will be done and senior bonds fully repaid by end-2017/mid-2018. This accelerated run-down has been criticised at finance committee hearings on the basis that holding the assets for longer would generate a more favourable return for the taxpayer. A change of government could therefore see a slowdown in the pace of NAMA's disposals, which would result in a prolonged drag on banks' net interest margins.

Following the Section 227 review last year, NAMA was also tasked with facilitating the development of residential and commercial construction. Indeed, NAMA has indicated that it could supply half of Dublin's housing needs over the next decade. Arguably, an additional risk is that NAMA takes a more active involvement in development, which is not its core skillset, as well as in social housing provision.

So far, housing supply has shown an extremely muted and disappointing response to latent housing demand. Additional social and development demands on NAMA may weigh on the agency's lifetime return prospects. This could create further risks to the timing and prospect of a full repayment of the NAMA subordinated bonds – impacting both banks and private holders.

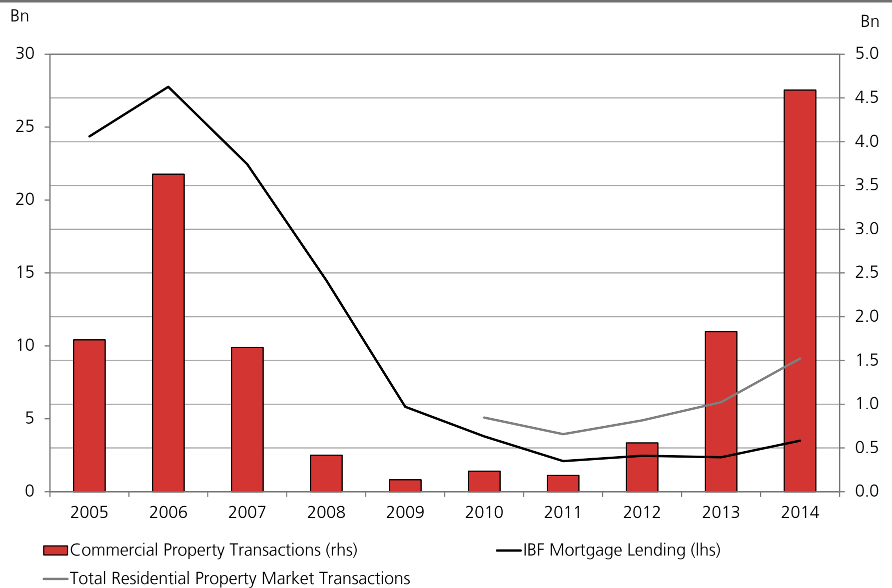
How exposed are Ireland's property markets?

2014 saw further upward pressure on both Irish residential and commercial property prices. According to the CSO index, house price inflation was 16.0% in December 2014 – split between 22% in Dublin and 10.1% outside Dublin. In the commercial property market, capital values have run ahead of rising rents, with yields falling toward 5%.

Ireland's residential property market is extremely illiquid and will now have to adjust to the end of capital gains exemptions and new rules to limit mortgage lending

At face value, the residential property market might look exposed given that over 50% of transactions in 2014 were from cash buyers (Figure 4). In addition, investor demand could be sensitive to political developments. However, the bigger picture is that Ireland's residential housing market remains exceptionally illiquid. Overall, there were 42,000 residential housing market transactions in 2014, comprising just 2% of the housing stock. Transactions appeared to be rushed in the final quarter of the year to take advantage of expiring capital gains tax exemptions – especially from cash buyers. So it now seems likely that transaction activity will fall back in any case as cash buyers exit the market.

Figure 4: Ireland's housing and commercial property market transactions



Source: Property Price Register and CBRE

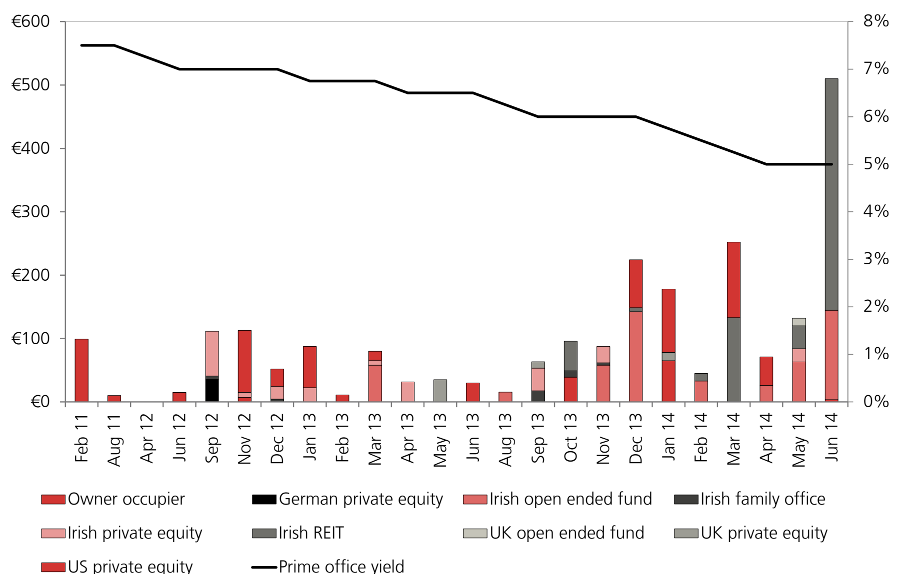
House price inflation may also cool as the new Central Bank rules to limit highly mortgaged lending are implemented in 2015. At 5x average incomes, Irish house prices are now at similar valuation multiples to the UK. So a slowdown in price inflation may be desirable and inevitable. A key point is that the pick-up in house price inflation has been primarily driven by the lack of housing supply rather than any increase in mortgage lending, which contracted by 2.7% in the year to December. Hence, we do not believe a slowdown in Irish house price inflation will threaten the export-led recovery. Irish households are still firmly in de-leveraging mode and have not reacted to rising house prices by reducing their savings. Consumer spending grew by just 0.5% in 2014. Similarly, housing construction remains depressed and has played no role in the recovery so far.

The presence of new global investors in Ireland's commercial property market has helped push prime yields towards 5%

However, the commercial property market does look more exposed to investor sentiment. Figure 5 illustrates that there has been a sharp pick-up in transactions in 2013 and 2014, facilitated by sales of assets from NAMA and exiting foreign banks and by a pick-up in demand from foreign investors. Having repaid €16.6bn, or 55% of its senior debt, by end-December 2014, NAMA has now set a new target to redeem 80% of its senior debt by 2016. NAMA has guided that a further €8bn of loan sales are likely in 2015 and €1bn of direct sales of commercial property assets.

As NAMA has sold assets, facilitated by tax incentives and low interest rates, a new cohort of investors has emerged including domestic and overseas family offices, international private equity funds, distressed debt specialists, overseas property plcs and the Irish REITs. More recently, more patient capital has been active in the Irish market with local long only funds such as IPUT and Irish Life Real Estate Investment Managers joined by London-headquartered, long only investors such as Standard Life and Knight Frank Investment Managers. As these lower cost of capital investors have entered the market, yields across Ireland's commercial real estate market have compressed. Figure 5 illustrates that prime office yields have tracked down towards 5% as investment has flowed in, with sub-5% yields expected in 2015.

Figure 5: Investors in Ireland's commercial property market



Source: Property Price Register; CBRE

The rotation from private equity to institutional investment could be sensitive to political developments

Given the lack of prime office space in Dublin, upward pressure on rents is likely to continue for the foreseeable future. Furthermore, we expect the flow of inward FDI investment to remain strong as Ireland continues to compete effectively for investment. However, as in residential property, commercial property valuations are clearly now more challenging. Furthermore, the investor base in recent years has a limited time horizon and will want to realise returns as yields compress further. Looking forward, there may be a rotation from private equity and distressed debt specialists towards institutional investors with a longer time horizon such as pension funds.

Irish bank lending to non-financial companies contracted by an enormous 7.2% in the year to December 2014. Although Irish banks have completed their deleveraging targets under the EU/IMF programme and are adequately capitalised, households and companies continue to repair their balance sheets by paying down debt. This means that

banks are starved of lending opportunities. Hence, bank funding may be there for the next generation of investors in Irish commercial real estate. However, the concern remains that as yields compress further, a change of government could hurt confidence in commercial real estate investment just as the cohort of investors who benefitted most from Ireland's recovery look to exit the market. So the commercial property market could be more sensitive to political developments, which could impact on liquidity and valuations.

Important Disclosures

Analyst certification

I, Conall Mac Coille, hereby certify that: (1) the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendation or views expressed in this report.

Investment ratings

A summary of existing and previous ratings for each company under coverage, together with an indication of which of these companies Davy has provided investment banking services to, is available at www.davy.ie/ratings.

Investment ratings definitions

Davy ratings are indicators of the expected performance of the stock relative to its sector index (FTSE E300) over the next 12 months. At times, the performance might fall outside the general ranges stated below due to near-term events, market conditions, stock volatility or – in some cases – company-specific issues. Research reports and ratings should not be relied upon as individual investment advice. As always, an investor's decision to buy or sell a security must depend on individual circumstances, including existing holdings, time horizons and risk tolerance.

Our ratings are based on the following parameters:

Outperform: Outperforms the relevant E300 sector by 10% or more over the next 12 months.

Neutral: Performs in-line with the relevant E300 sector (+/-10%) over the next 12 months.

Underperform: Underperforms the relevant E300 sector by 10% or more over the next 12 months.

Under Review: Rating is actively under review.

Suspended: Rating is suspended until further notice.

Restricted: The rating has been removed in accordance with Davy policy and/or applicable law and regulations where Davy is engaged in an investment banking transaction and in certain other circumstances.

Distribution of ratings/investment banking relationships

			Investment banking services/Past 12 months	
Rating	*Count*	*Percent*	*Count*	*Percent*
Outperform	62	52	28	75
Neutral	33	27	3	8
Underperform	11	9	0	0
Under Review	5	4	3	8
Suspended	5	4	0	0
Restricted	3	2	3	8

This is a summary of Davy ratings for all companies under research coverage, including those companies under coverage to which Davy has provided material investment banking services in the previous 12 months. This summary is updated on a quarterly basis. The term 'material investment banking services' includes Davy acting as broker as well as the provision of corporate finance services, such as underwriting and managing or advising on a public offer.

Regulatory and other important information

J&E Davy, trading as Davy, is regulated by the Central Bank of Ireland. Davy is a member of the Irish Stock Exchange, the London Stock Exchange and Euronext. In the UK, Davy is authorised by the Central Bank of Ireland and authorised and subject to limited regulation by the Financial Conduct Authority. Details about the extent of our authorisation and regulation by the Financial Conduct Authority are available from us on request. No part of this document is to be reproduced without our written permission. This publication is solely for information purposes and does not constitute an offer or solicitation to buy or sell securities. This document does not constitute investment advice and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities/strategy discussed in this report may not be suitable or appropriate for all investors. The value of investments can fall as well as rise and there is no guarantee that investors will receive back their capital invested. **Past performance and simulated performance is not a reliable guide to future performance. Projected returns are estimates only and are not a reliable guide to the future performance of this investment.** Forecasted returns depend on assumptions that involve subjective judgment and on analysis that may or may not be correct. Any information related to the tax status of the securities discussed herein is not intended to provide tax advice or to be used as tax advice. Tax treatment depends on individual circumstances and may be subject to change. You should consult your tax adviser about the rules that apply in your individual circumstances.

This document has been prepared and issued by Davy on the basis of publicly available information, internally developed data and other sources believed to be reliable. While all reasonable care has been taken in the preparation of this document, we do not guarantee the accuracy or completeness of the information contained herein. Any opinion expressed (including estimates and forecasts) may be subject to change without notice. We or any of our connected or affiliated companies or their employees may have a position in any of the securities or may have provided, within the last twelve months, significant advice or investment services in relation to any of the securities or related investments referred to in this document.

While reasonable care has been taken in the preparation of the information contained in this document, no warranty or representation, express or implied, is or will be provided by Davy or any of its shareholders, subsidiaries or affiliated entities or any person, firm or body corporate under its control or under common control or by any of their respective directors, officers, employees, agents, advisers and representatives, all of whom expressly disclaim any and all liability for the contents of, or omissions from, this document, the information or opinions on which it is based and/or whether it is a reasonable summary of the securities in this document and for any other written or oral communication transmitted or made available to the recipient or any of its officers, employees, agents or representatives.

Neither Davy nor any of its shareholders, subsidiaries, affiliated entities or any person, form or body corporate under its control or under common control or their respective directors, officers, agents, employees, advisors, representatives or any associated entities (each an "Indemnified Party") will be responsible or liable for any costs, losses or expenses incurred by investors in connection with the information contained in this document. The investor indemnifies and holds harmless Davy and each Indemnified Party for any losses, liabilities or claims, joint or several, howsoever arising, except upon such Indemnified Party's bad faith or gross negligence.

Share ownership policy

Davy allows analysts to own shares in companies they issue recommendations on, subject to strict compliance with our internal rules governing own-account trading by staff members.

We are satisfied that our internal policy on share ownership does not compromise the objectivity of analysts in issuing recommendations.

Conflicts of interest

Our conflicts of interest management policy is available at www.davy.ie/ConflictsOfInterest.

US Securities Exchange Act, 1934

This report is only distributed in the US to major institutional investors as defined by S15a-6 of the Securities Exchange Act, 1934 as amended. By accepting this report, a US recipient warrants that it is a major institutional investor as defined and shall not distribute or provide this report, or any part thereof, to any other person.

Distribution of research to clients of Davy Securities in the US

Davy Securities distributes third-party research produced by its affiliate, J&E Davy.

Davy Securities is regulated by the Central Bank of Ireland. Davy Securities is a member of FINRA and SIPC.

Confidentiality and copyright statement

Davy, Research Department, Davy House, 49 Dawson St., Dublin 2, Ireland. Confidential © Davy 2015.