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**RETAIL BANKING SECTOR  
INQUIRY  
PRELIMINARY REPORT II  
CONSULTATION FEEDBACK FORM**

**IRISH BANKERS FEDERATION**

**9 OCTOBER 2006**



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## 1. Introduction

### **RETAIL BANKING SECTOR INQUIRY PRELIMINARY REPORT II CONSULTATION FEEDBACK FORM**

Name of organisation: Irish Bankers Federation

Type of organisation: Representative Body for Banking and Financial Services

Address: Nassau House, Nassau Street, Dublin 2

Country: Ireland

Have you received a request for information as part of the sector inquiry:

☒ Yes

☐ No

IBF welcomes the opportunity to respond to the Commission's "Interim Report II Current Accounts and Related Services" and in doing so will focus on three of the questions raised in section 10.3 of the Report and as set out in the Consultation Feedback Form.



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## 2. Executive Summary

- Markets characterized by high levels of information and transparency facilitate customer choice, and mobility. Voluntary initiatives, such as account switching codes stimulate competition through raising awareness and reducing the administrative burden associated with changing provider, thus ensuring that mobility is a feature of the market.
- The public response to the interim report in Ireland focused largely on certain aspects of the report, particularly the profitability of the sector. We therefore feel that this area requires some further comment, which we hope the Commission will find constructive.
- Our response demonstrates that the principal drivers of varying rates of profitability in the banking sector are the economic health of the market in which a bank operates and the efficiencies achieved within the bank in terms of managing its costbase.
- We also note that highly competitive customer offerings exist within profitable banking sectors.
- Market penetration by non indigenous entities is a normal feature of the Irish market. However, regulatory requirements can impede new market entrants, the examples of price control and stamp duty on cards in Ireland are considered.
- We caution against overreliance on one set of data/interpretations, particularly where methodological issues may arise and where the outputs may not be consistent with others in the field.
- In the interests of brevity, a range of supplementary information is provided by way of appendices to our main response.



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### 3. Detailed Response

#### B. Banks' financial performance and pricing

##### 3. What are the main reasons for the varying rates of profitability and income in retail banking across the Member States?

We will treat of the issues related to profitability and income under four headings:

- Economic Conditions
- Efficiency
- Customer Value Proposition
- Measures of Profitability

##### **Economic Conditions**

The most important driver of varying rates of profitability and income in retail banking across the Member States is the differing economic conditions prevailing in Member States<sup>1</sup>.

Speaking in October 2005, Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank (ECB) noted that “good performance of the economy is generally also reflected in banking (and other industries’) profitability. Hence, countries exhibiting strong growth are more likely to show good profitability in the banking industry.”<sup>2</sup> The banking sector is not alone in this regard; strong levels of profitability are evident across the full economic spectrum in a buoyant economy<sup>3</sup>.

Ireland is cited as one of six Member States with higher levels of profitability in the retail banking sector. The Irish economy has enjoyed more than a decade of dramatic economic growth and wealth creation; the average annual rate of increase of Irish gross domestic

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<sup>1</sup> See Appendix I.

<sup>2</sup> Speech by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB, *Regulation, Competition and Integration in EU banking: What Drives Performance? - Revisiting Freiburg* -, Albert-Ludwigs University of Freiburg, Faculty of Economics and Behavioural Sciences, Opening of the Integrated Master Programmes of the academic year 2005/2006, Freiburg, 21 October 2005.

<sup>3</sup> See Appendix II.



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product (GDP) was 7.7% from 1995 – 2005, the highest in the European Union (EU) and in the Organisation for Economic Cooperation and Development (OECD).

The strong growth in the Irish economy has resulted in:

- a significant increase in the demand for banking services
- a substantial increase in the volume of banking business<sup>4</sup>.
- strong commercial and residential property markets having a significant impact on bank performance<sup>5</sup>
- sustained low rates of unemployment contributing directly to lowering credit risk and minimising bad debts.

These features are confirmed in the European Central Bank (ECB) review of the EU banking sector's financial performance in 2004:

“The main drivers of increased profitability were lower provisioning, a sustained increase in lending, especially to households for housing purposes, and an incipient recovery in lending to non-financial corporates, including small and medium-sized enterprises.”<sup>6</sup>

### **Efficiency**

In addition to the strong economic backdrop, competitive forces ensure that the emphasis on efficiency is to the fore. Irish banking is highly efficient by international standards and has amongst the lowest cost/income ratios in the EU. There is a strong correlation between cost/income ratios and profitability levels, as demonstrated in the chart on page 76 of the Interim Report. Those banking sectors recording the highest profitability ratios usually have the lowest cost/income ratios.

In a January 2006 report, “Bank Industry Risk Analysis: Ireland (Republic of)”, the international rating agency Standard & Poor's said: “Efficiency is already solid - the average cost-to-income ratio for the rated peer group is just less than one-half, which compares well on an international basis, but Standard & Poor's is expecting to see a further improvement over time.”<sup>7</sup>

At the same time, net interest margins have been under consistent downward pressure. A recent working paper published by the OECD notes:

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<sup>4</sup> See Appendix III

<sup>5</sup> See Appendix IV.

<sup>6</sup> *EU banking sector stability*, European Central Bank, October 2005.

<sup>7</sup> “Bank Industry Risk Analysis: Ireland (Republic of)”, Standard & Poor's, 30 January 2006.



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“Overhead costs as well as net interest margins show that cost structures and pricing strategies vary to a great extent...Banks’ overhead costs tend to be relatively high in some lower income countries, reaching nearly 7% of total assets in Mexico and Turkey, whereas it is comparatively low (less than 1.5%) in Luxembourg and Ireland. Similarly, banks’ net interest margins are particularly high in Turkey (11.7% of total interest-bearing assets), while they are less than 1.5% of total interest-bearing assets in Ireland and Luxembourg.”<sup>8</sup>

### **Customer Value Proposition**

Strong profitability does not preclude a competitive market characterised by an excellent customer value proposition.

In this regard the Irish market:

- Has low bank charges; the 2005 Capgemini study<sup>9</sup>, confirmed Ireland as the third cheapest of 20 countries surveyed on day to day banking costs for consumers. The annual cost of €9 in Ireland compared with an average of €108. Only the Netherlands and China had lower costs.
- This is further borne out by the chart on page 89 of the Interim Report which shows that the Irish retail banking market obtains below average income from fees per transaction and account management fees.
- A broad range of banking products and services are available to customers.
- Free banking is widely available, with most institutions now offering a free banking product – a development which has been recognised and welcomed by the Financial Regulator.
- Increases in the cost of banking services have been considerably lower than price changes in most other areas of the economy. When the effect of Government Stamp Duties is stripped out, the cost of financial services increased by just 5.9% between January 2000 and July 2006, as compared to an overall inflation rate of 28.4%.
- APRC’s in Ireland are very competitive with the rest of the euro area<sup>10</sup>.

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<sup>8</sup> “Regulation of Financial Systems and Economic Growth”, Economics Department Working Papers No. 506, Alain de Serres, Shuji Kobayakawa, Torsten Sløk and Laura Vartia, OECD, 2 August 2006.

<sup>9</sup> World Retail Banking Report, Cap Gemini 2005: see [http://www.ibf.ie/resource\\_ctr/stats/charges.html](http://www.ibf.ie/resource_ctr/stats/charges.html).

<sup>10</sup> See Appendix V.





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### **Measures of Profitability**

There are various measures of profitability available to analysts of the banking sector. The measure and the data used can have a significant bearing on the result. We need to be cautious about drawing definitive conclusions from one set of data and a single measurement mechanism. There would need to be a high level of confidence that the outputs correlate with those of other studies in the area if they are to be relied upon.

One factor which needs to be considered in assessing the report is the degree to which interpretations of the data components converge across respondents. This is an unknown, and could reflect differing local interpretations, differences in accounting practice etc. This variation could potentially extend from the definition of “retail banking” through to lower level definitions. Whilst we appreciate the need for a practical approach, and hence the reliance on firm specific definitions, the potential impact of diverging definitions must be recognised.

In addition, we would suggest that further consideration be given to the gross income per customer data. The validity of the comparison may be limited as it does not scale for usage factors e.g. amount borrowed, usage of account. Equally, varying product features are unlikely to be adequately represented in such a high level comparison. The gross income per customer concept may be open to misinterpretation. It does not reflect the average cost for consumers, as the Interim Report concedes in Section 5.3.1 (pg 61) when it states that the “variable gross income captures all revenue that banks make on banking activity, covering interest and non-interest sources. Clearly not all gross income is paid directly from consumers to banks.” These figures reflect, in the Commission’s own words, a “back of the envelope” approach and therefore cannot support definitive conclusions.



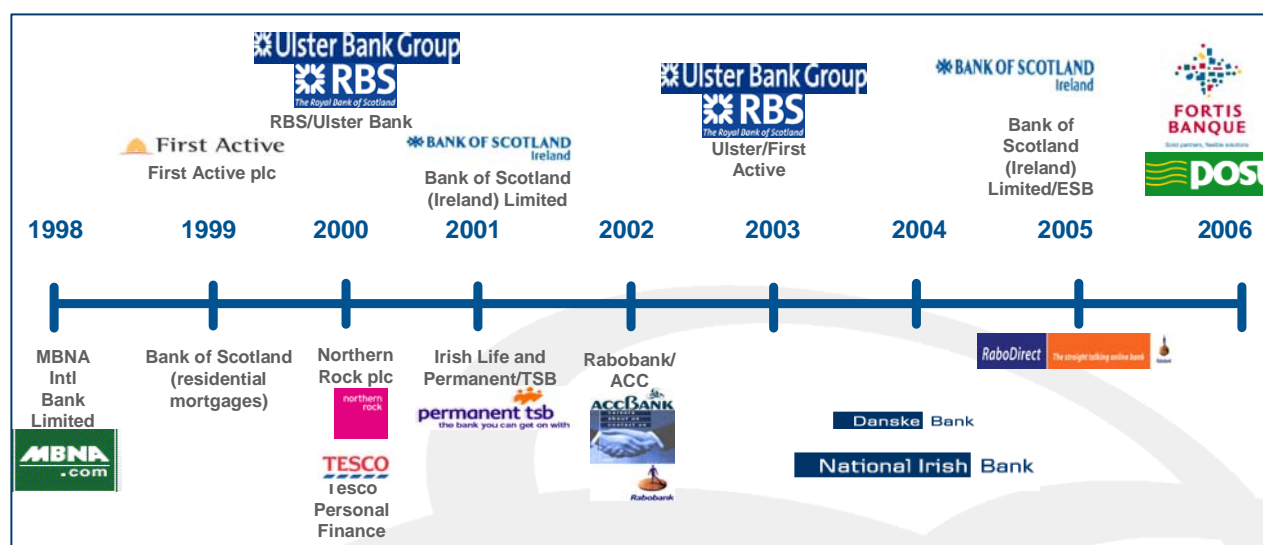
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## C. Entry barriers in retail banking

### 4. Are there other types of entry barriers in retail banking that have not been identified in the preliminary report?

Retail banking in Ireland is characterised by a broad range of service providers, in which the level of cross border market entry is high relevant to market size.

**FIGURE 6: Market Developments**





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This is further supported by a recent working paper by the Organisation for Economic Co-operation and Development (OECD) which demonstrates the following for Ireland<sup>11</sup>.

**TABLE 7: International Competition in Banking  
(2001-03)**

Measure	Ireland's score	Ireland's Rank in OECD
Share of cross-border loans in domestic borrowing	>35%	2 <sup>nd</sup>
Foreign banks' penetration of domestic loan market	>20%	8 <sup>th</sup>

The extent to which Irish service providers operate abroad demonstrates that institutions are keen to seek out profitable ventures in other markets.

Based on an analysis of Irish banks quoted on the Irish Stock Exchange, over 40% of Irish profits are generated outside Ireland<sup>12</sup>.

Whilst market barriers per se do not arise, regulatory, fiscal and legal barriers do have the capacity to constrain new and potential new entrants, making market entry more difficult than is otherwise the case.

Regulatory barriers may arise in the form of the absence of harmonised requirements, where specific requirements at the level of one member state compare unfavourably to those applying in other jurisdictions. They may also be provisions which in and of themselves impede competition, for example, by restricting market activity or new product development. In this regard, IBF would highlight that a number of non-indigenous service providers which are members, have identified Ireland as a jurisdiction having a high level of regulatory requirements impacting on market entry and business development.

Two examples of such requirements are set out below.

<sup>11</sup> "Regulation of Financial Systems and Economic Growth", Economics Department Working Papers No. 506, Alain de Serres, Shuji Kobayakawa, Torsten Sløk and Laura Vartia, OECD, 2 August 2006.

<sup>12</sup> Based on analysis of financial statements of quoted Irish banks.



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## Price control

Section 149 of the Irish Consumer Credit Act, 1995 requires providers of financial services in the Irish market to notify the Financial Regulator of any new product or service charge which it intends to introduce or of any such charge which it intends to increase. A notification fee of up to €1,750 has to be paid to the Financial Regulator with each such application and the legislation allows up to three months for the Financial Regulator to revert; in practice this can take significantly longer. This provision negatively impacts institutions entering the market with new offerings as well as the ability of incumbent institutions to develop or respond to new market offerings.

In a recent speech, the European Commissioner for Internal Market and Services, Charlie McCreevy, warned of the dangers of regulatory controls on bank charges:

“A fact that has perhaps been overlooked too is that the arrival of SEPA should make it much easier for government to dismantle, for example, some of the regulatory impositions and controls on bank charges that can currently retard innovation and should be made redundant by the more intense competition that SEPA should deliver.”<sup>13</sup>

The industry continues to actively press for the abolition of these requirements.

## Government Stamp Duties on Cards

Stamp duty is a form of taxation in Ireland, the revenue from which is payable to the Irish Revenue Commissioners. Stamp duties on plastic cards were first introduced under Section 17 of Irish Finance (No.2) Act, 1981, when a duty was imposed in credit and charge cards. Under Section 140 of Finance Act, 2003 stamp duty rates payable each year were revised to:

▪ ATM/cash card	€10 per card
▪ Debit card	€10 per card
▪ Combined ATM and debit card	€20 per card
▪ Credit card	€40 per account
▪ Charge card	€40 per card

These duties act as a barrier to competition in two ways.

Firstly they reduce the incentives to switch providers.

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<sup>13</sup> Speech by Charlie McCreevy, European Commissioner for Internal Market and Services, Preparing for MiFID, Institute for European Affairs, Dublin, 30 June 2006.



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In its report in September 2005 on competition in the retail banking sector, the Irish Competition Authority recommended that the “Minister for Finance should prepare an analysis of the costs of distorting competition (in terms of account closures and reduced account openings) imposed by the stamp duty levy on electronic cards, charge cards, and credit card accounts.”<sup>14</sup>

Economists LECG analysed the impact of stamp duties on competition in the Irish Banking market in 2004, as part of its study of competition in the market, which was commissioned by the Competition Authority. In its report, LECG concludes that the increase in the level of the stamp duty in December 2002 resulted in a large number of credit card accounts, current accounts and savings and deposit accounts being closed and in a decline in the number of new account openings.

As a consequence of the Banking Study, changes to the Finance Act removed double charging, whereby consumers would pay stamp duties twice if they switched accounts during the year. However, stamp duties on cards remain an obstacle to competition by directly penalising those who choose to hold multiple accounts or banking relationships.

Secondly by acting as a disincentive for consumers or businesses to use electronic banking methods, these stamp duties represent an obstacle to new entrants, who wish to base their entry strategies on these distribution channels, a view reinforced in the European Competition Authorities Report published in May 2005.

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<sup>14</sup> Source: p.15, *Competition in the (non-investment) banking sector in Ireland*, The Competition Authority, September 2005.



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## **D. Customer choice and mobility**

### **7. What are the main reasons for the low mobility of retail banking customers?**

#### **Market Definition**

A key issue in this regard is the definition of the relevant market. Within the definition of retail banking activities used by the Commission in its report a number of non-bank players are very active, competing with retail banks.

For example, some 530 credit unions in the Republic of Ireland and Northern Ireland affiliated to the Irish League of Credit Unions had an estimated 3 million members by the end of 2005 who had about €12.6 billion in savings and over €7 billion in loans in credit union accounts.<sup>15</sup> This compares with total (non credit union) credit institution loans to households of €15.4 billion and household deposits of €63.4 billion (Republic of Ireland).

#### **Customer Mobility Levels**

The finding that mobility rates are low is open to question – there is no optimum level of customer mobility.

There are no significant obstacles to customer mobility in the Irish banking market. A number of factors influence customer mobility levels:

- Each customer is different, will have a different set of needs and preferences, and will have differing levels of variability of those needs and preferences over time.
- The satisfied customer may realise no benefit in moving from one bank to another. According to a recent consumer survey by TNS mrbi for Irish Bankers Federation, 61% of current account holders said the main reason they had not switched over the previous 12 months was because they were happy with the service from their current bank or building society.<sup>16</sup>

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<sup>15</sup> Source: *Annual Report 2005*, Irish League of Credit Unions, 10 April 2006.

<sup>16</sup> Source: TNS mrbi consumer survey, commissioned by IBF, March 2006



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- Similarly, a survey of SMEs across Europe revealed that, based on responses to 5 attitude statements, “SMEs in Finland are most likely to think positively about the access to finance through banks. The average score of positive responses in this country is 65%. In Denmark (64%) and Ireland (63%), more than six in ten SMEs hold positive attitudes towards banks when it comes to access to finance.”<sup>17</sup> The average for European Union 15 countries was 51%.
- Customer loyalty is a feature of the banking market, with many customers choosing to stay with a bank, simply because that institution has looked after them over the years.
- Equally, customer retention is a key focus for banks with institutions proactively seeking to retain customers by meeting their changing needs.
- Multiple banking relationships are also a feature of the market; typically an individual will have relationships with a number of providers for different purposes. They adjust cash flows to and from the various accounts to meet their needs, rather than by opening and closing accounts.

Whilst acknowledging the many factors which contribute to consumers staying with their service providers, we recognise the importance of ensuring that customers who might wish to switch providers are facilitated in every way possible. Certain market features are important in this regard:

### **IBF engagement with the Competition Authority**

The Competition Authority (TCA) in Ireland published its Final Report on Competition in the (non-investment) banking sector in Ireland in September 2005. This report addressed many of the issues highlighted in the Commission’s Interim Report. The report also included a number of recommendations for the banking industry, the Financial Regulator and various Government Departments.

Irish Bankers Federation (IBF) and its members have actively progressed the Competition Authority’s recommendations. IBF continues to engage constructively with the Competition Authority, as well as other stakeholders, to facilitate competition and enhance customer choice.

### **Information and transparency**

In addition to the information provided by each service provider through voluntary and statutory initiatives, there is a wide range of independent information for consumers in relation to the various products offered by financial institutions. For example, the national

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<sup>17</sup> Source: Flash Eurobarometer 174 “SME Access to Finance”, European Commission, October 2005.



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newspapers play an important role in providing comparative information and highlighting new products and services.

The Financial Regulator publishes a suite of educational information about product types and features as well as regular cost surveys across the range of financial services products. The cost surveys include regular updates on fees and rates for financial products such as personal and business current accounts, credit cards and personal loans.<sup>18</sup>

### **Other market features**

The bundling or tying of retail financial services is not commonly a feature of the Irish market, compared with many other European countries.

Some product linkages, e.g. compulsory linking of a product with a mortgage loan are prohibited by law, and requirements introduced under the Statutory Consumer Protection Code, published in July 2006 prohibit making the sale of one product contingent upon the purchase of another.

Closing charges – fees or charges when accounts are closed – are not a feature of current accounts in the Irish market.

### **Switching Codes**

Irish Bankers Federation introduced a voluntary Switching Code for personal banking accounts in February 2005 and extended this code to business banking accounts in June 2006. The Code, which is highlighted on page 117 of the report, directly alleviates the potential administrative burden for a customer in moving from one provider to another. Consumer research indicates that 74% of consumers with a current account believe that switching accounts is either very easy or fairly easy (excluding “don’t know” responses).<sup>19</sup>

While still relatively new, these codes have contributed significantly to raising consumer awareness about the possibility of switching providers and some 28,000 consumers have switched under the codes up to end September 2006. This brought the effective switching rate (including both switches within the Code and outside the Code) to about 5%, according to market research.<sup>20</sup>

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<sup>18</sup> See [www.financialregulator.ie](http://www.financialregulator.ie).

<sup>19</sup> Source: TNS mrbi consumer survey, commissioned by IBF, March 2006.

<sup>20</sup> Source: TNS mrbi consumer survey, commissioned by IBF, March 2006.





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The Financial Regulator in Ireland welcomed the role of the Switching Code in its most recent Annual Report:

“We consider that the code has acted as a stimulus to competition, as evidenced by approximately 22,000 consumers that have switched their accounts from one bank to another using the switching code, as at 30 April 2006, and the number of free banking accounts now on offer. As indicated in our Public Response document on the Consumer Protection Code, we decided not to incorporate the Switching Code into it at this time. We will continue to monitor the progress of the voluntary code.”<sup>21</sup>

A report by the European Competition Authorities Financial Services Subgroup in May 2006 also states that the “benefit of the Switching Code lies not just in the numbers of consumers switching, but in the way it has changed banks’ behaviour, by forcing them to react to increased consumer mobility. Since the Code’s introduction, all the main banks have introduced some form of fee-free personal current account product.”<sup>22</sup>

IBF is also contributing actively to the dialogue on customer mobility at EU level.

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<sup>21</sup> Source: p. 32, *Protecting Consumers through Effective Regulation*, Annual Report of the Financial Regulator 2005, Financial Regulator, July 2006.

<sup>22</sup> Source: pp. 21-22, *Competition Issues in Retail Banking and Payments Systems Markets in the EU*, ECA Financial Services Subgroup, Public Version, Nice, May 2006.



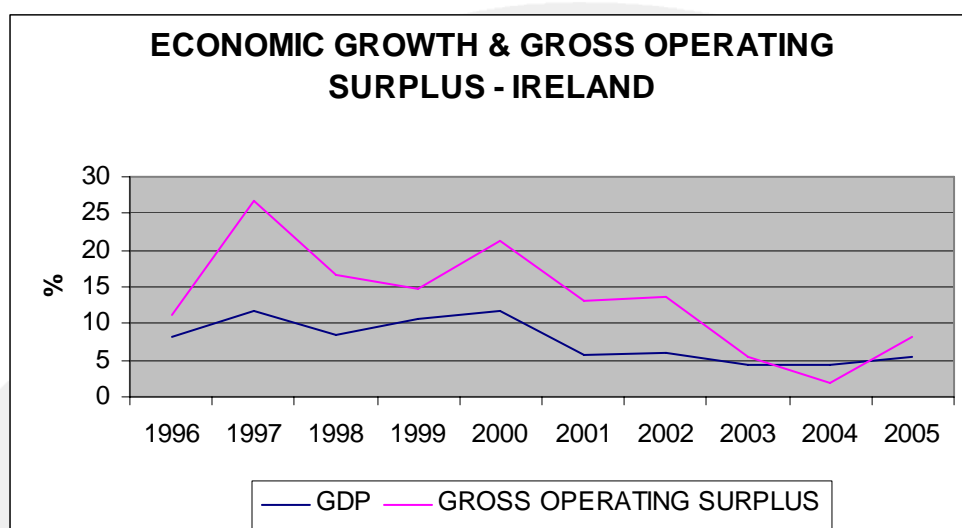
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## 4. Appendices

### Appendix I

#### Economic Growth & Profitability

The graph shows a strong correlation between growth in the Irish economy and the gross operating surplus for the Irish banking sector.





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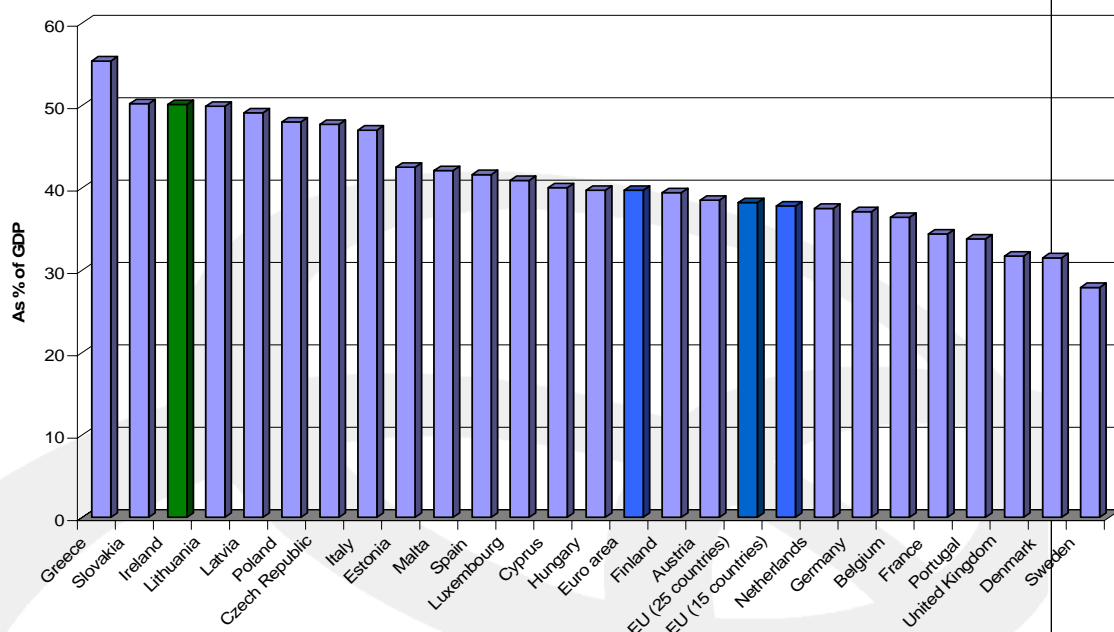
## Appendix II

### Evidence of Profitability in Economy

The rapid rise in the profitability of Irish business is reflected in the sharp rise in corporation tax net receipts from €1,458.2 million in 1995 through €3,885.3 million in 2000 to €5,503.2 million in 2005, according to the Revenue Commissioners. This is despite the fact that the standard corporation tax rate declined from 40% in January 1995 to 12.5% in January 2003

The chart below illustrates the relative profitability of Irish businesses compared with those in the rest of the European Union. It uses gross operating surplus as a proxy for profitability, as the European Commission did in 2003/7: *SMEs in Europe 2003*.<sup>23</sup>

**Gross operating surplus and gross mixed income (as % of GDP), 2003**



Source: Eurostat

<sup>23</sup> Operating surplus is the surplus (or deficit) on production activities before account has been taken of the interest, rents or charges paid or received for the use of assets. Mixed income is the remuneration for the work carried out by the owner (or by members of his family) of an unincorporated enterprise. This is referred to as 'mixed income' since it cannot be distinguished from the entrepreneurial profit of the owner.



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## Appendix III

### Growth in volume of banking business

**TABLE 1: Growth in Business Volumes**

Amounts outstanding	Loans to Households		Loans to NFCs	
	Ireland	Euro area	Ireland	Euro area
Q4 2002 (€, bn)	59,954	3,327,041	54,912	2,965,101
Q2 2006 (€, bn)	130,866	4,388,658	134,659	3,643,227
Change (%)	118.3%	31.8%	127.0%	22.9%
Source: Statistical Data Warehouse, European Central Bank				

**TABLE 2: Growth in Domestic Banking Volumes (1996-2005)**

	Household Lending	Household Deposits	Business Lending
1996	18.1	20.4	23.8
2005	115.4	63.4	138.5
% change 1996-2005	538%	211%	482%
Source: Central Bank of Ireland			



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## **Appendix IV**

### **Economic factors driving bank profitability**

One economic factor that may have a particular impact on bank performance is growth in the property market.

A Working Paper<sup>24</sup> published by the Bank for International Settlements (BIS) in 2005 indicates that higher economic growth encourages banks to lend more, improves the quality of bank assets and increases the profitability of the banking sector.

The Working Paper finds further that “commercial property prices have a major impact on a wide range of bank performance variables, ranging from risk indicators to profitability and lending activity – an impact omitted from most of the existing literature. The signs found are consistent with a view that commercial property provides an important form of collateral that is perceived by banks to reduce risk and encourage lending.”

This is important in the Irish context because figures compiled by the BIS show that Irish commercial property prices rose by 12.1% between 1996 and 2004, the highest rate in the 15 countries surveyed.<sup>25</sup>

In the residential property market too, prices in Ireland rose by more during the 1996-2004 period than in any other country surveyed by the BIS.

Growth in the lending for residential property purposes also boosts bank incomes and profitability, as does improvement in asset quality.

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<sup>24</sup> Source: Commercial property prices and bank performance, BIS Working Papers No. 175, E. Philip Davis and Haibin Zhu, Monetary and Economic Department, Bank for International Settlements, April 2005.

<sup>25</sup> 76<sup>th</sup> Annual Report, Bank for International Settlements, 26 June 2006.

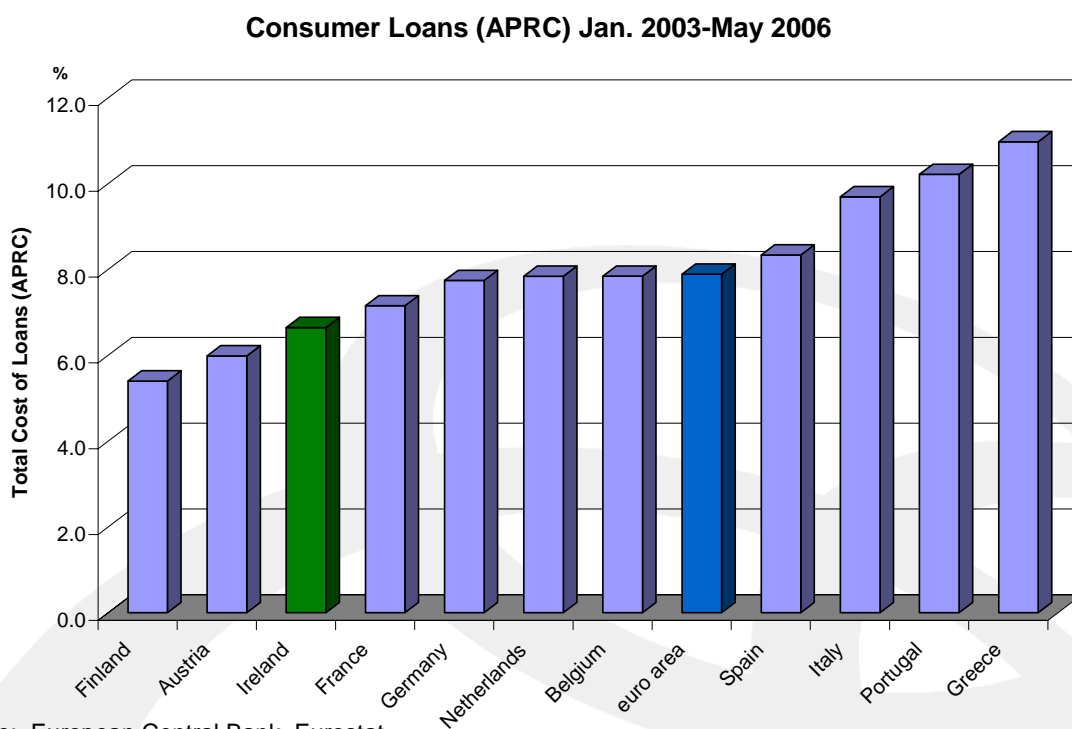


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## Appendix V

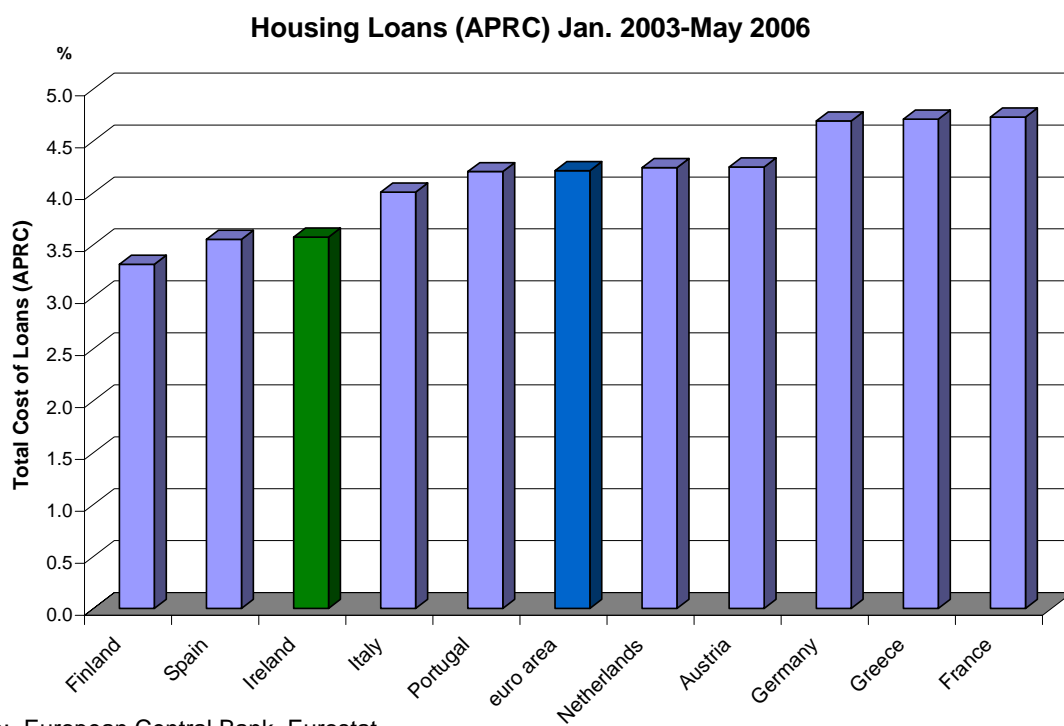
### Comparing the Cost of Borrowing

A report published by the ECB analysed cross-country interest rate differences in the euro area. Highlighting the relevance of focussing on APRC, this data confirms that APRC's in Ireland for consumer loans and housing loans (the two categories in respect of which APRC's are collated) have been very competitive.





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Source: European Central Bank, Eurostat