

DEBT BEFORE DISHONOUR?

Penalty fees & the Australian consumer



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INTRODUCTION

Bank fees equal big bucks.

The RBA's May 2007 banking fees survey disclosed a 10% increase in fee income derived from households, taking the 2006 total to \$4.03 billion: 41% of total bank fee income for that financial year.¹ And further:

The largest component of banks' fee income from households is fees on deposit accounts, accounting for more than 40 per cent of the total. Fee income from this segment grew by 9 per cent in 2006, mainly reflecting the growth in the number of accounts and transactions.

Reserve Bank of Australia, May 2007²

This paper examines a category of bank fees – penalty fees – that puts a whole lot of extra cash into the pockets of already cashed up Australian banks.

Is this massive revenue stream a massive price gouging exercise perpetrated on the Australian consumer?

At law, a *penalty* is an amount of money payable upon breach of contract that recovers more than the amount of damage incurred as a result of that breach. There is an abundance of legal principle in support of the argument that various fees imposed by banks – cheque dishonour fees, direct debit dishonour fees, credit card over-limit fees – are penalties at law.

If this is the case, the banks will be prevented from charging these penalty fees and Australian consumers will be entitled to refunds of any penalty fees they have already paid.

In Victoria, unfair contract terms laws enshrined within the *Fair Trading Act 1999* - and mooted for nationwide extension – make an even more compelling case for determining penalty fees to be illegal.

Banks, of course, deny any illegality, but have refused to release internal data that would shed light on the topic.

Banks have urged governments to maintain a non-interventionist stance, and to allow market forces to set the amounts of fees and charges. But on this issue market forces can not and will not deliver the competitive benefits to which consumers are entitled.

While excessive and unfair bank fees are something that effects the whole community, low-income earners not only most keenly feel the impact of paying a penalty fee, but are also more likely to be slugged with such fees.

Recent developments both in Australia and the United Kingdom have made the banks' position increasingly untenable in the court of public opinion.

¹ RBA Bulletin – May 2007: 'Banking Fees in Australia', www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_may07/banking_fees_austr.html

² Above, n1.

All that remains to be resolved is the banks' position in a court of law – if policy makers don't get there first.

PENALTY FEES: THE LEGAL ARGUMENTS³

What is a 'penalty' at law?

Any contract may include a term that, if a party breaches the contract or defaults in some way, that party must pay the other "innocent" party a sum of money. The legal principles regarding such clauses or terms are relatively well-established.⁴

Whether a contractual term for the payment of money is a penalty is a question of degree which turns on all the circumstances of the case. In particular, a term is likely to be a penalty if:

1. The sum to be paid under the term by the party in breach is out of all proportion or extravagant, exorbitant or unconscionable in comparison with the loss suffered by the "innocent" party; and/or
2. The relationship between the contracting parties and whether there was any opportunity to negotiate the term, is such that it would be unconscionable for the "innocent" party to enforce the term.

In addition, it is important to remember that the question is one 'not of words or of forms of speech, but of substance and of things'.⁵ In other words, although banks describe various payments as "fees", for example cheque or direct debit dishonour fees or late payment fees, this does not demonstrate that they are not, in fact, penalties.

If such fees are, in fact, penalties at law, they are unenforceable by the banks against their customers.

Are banks charging penalty fees?

While banks are entitled to recover costs incurred by them upon default by a customer, they are not entitled to use a penalty term to do so.

There is insufficient public data available to make an accurate and conclusive assessment of whether penalty fees are liquidated damages or penalties. For this reason, there is a need for effective disclosure of costs incurred by banks in processing customer defaults. Banks should not be troubled by this if penalty fees are simply an exercise in cost recovery.

However, from the information that is currently available, it is very likely that penalty fees charged by Australian banks are penalties at law and therefore unenforceable.

³ The text under this heading is largely derived from Nicole Rich's report 'Unfair fees: a report into penalty fees charged by Australian banks' (2004, Consumer Law Centre Victoria) (***the Rich Report***).

⁴ See, for example, *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359 at 368 per Gibbs CJ.

⁵ *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 at 15 per Lord Davey.

1. Penalty fees are out of all proportion or extravagant, exorbitant or unconscionable in comparison with the loss suffered by the bank in processing a customer default

Using publicly available data obtained from the Reserve Bank of Australia, and from the Wallis Committee's Final Report of the Financial System Inquiry (March 1997), the Rich Report concludes that Australian banks could be charging consumers cheque dishonour fees between 5 to 16 times what it costs them to process a cheque dishonour and direct debit dishonour fees between 64 to 92 times what it costs them to process a direct debit dishonour.

Applying the first limb of the legal test as to when a term will be a penalty at law, such cheque and direct debit dishonour fees are clearly out of all proportion or extravagant, exorbitant or unconscionable in comparison with the loss suffered by the bank in processing a dishonour.

2. The relationship between the bank and the customer, including the relative bargaining position of the parties and the lack of opportunity to negotiate penalty fees, is such that it would be unconscionable for the bank to enforce penalty fees against customers

The relationship between banker and customer is characterised by unequal bargaining power and a lack of ability by most consumers to negotiate any terms, let alone dishonour fees, with banks. Applying the second limb of the legal test as to when a term will be a penalty at law, it is unconscionable for a bank to enforce such a fee against the consumer in these circumstances.

THE FAILURE OF COMPETITION

Calls for government intervention to curb excessive bank fees have been met with a evocation of the free market forces which will correct any inequities that may have arisen.

But when it comes to bank fees, competition has not delivered the benefits to which consumers are entitled.

Lack of choice

Champions of free market forces may posit that consumers are free to ditch their bank if they are not happy with the fees being charged. However, precisely because of the lack of genuine competitive forces operating on fine print terms like penalty fees, it is difficult for consumers to find financial institutions that are not imposing hefty fees and charges.

Complex contracts

The contracts which govern the operation of banking facilities are lengthy and complex. They are difficult for lawyers to understand, let alone members of the laity.

Inability of consumers to negotiate terms

It is a trite point but an important one: due to the imbalance of power inherent in the relationship, the average customer does not have an opportunity to negotiate for the modification or removal of objectionable terms in banks' standard form contracts. They are presented to the customer on a take-it-or-leave-it basis.

The inefficacy of disclosure

As the behavioural economists are always happy to inform us, consumers do not always act ideally and rationally. Where it can be expected that a person will *not* read the 30 page terms and conditions booklet attached to their new bank account, it is disingenuous to argue that disclosure effected by that same booklet absolves a bank of a wide variety of apprehended evils.

Further, even where consumers do make sure they inform themselves of all the fees chargeable under a banking facility, it is not likely that a decision to take up that facility will be based upon an assessment of the potential cost of penalty fees.

We are generally inclined to consider that we will not engage in conduct that might trigger liability for fees: cheques won't bounce and direct debits won't be dishonoured.

Disclosure is not going to activate the purely rational, self-interested consumer upon which classical economics is predicated.

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Accordingly, competitive forces do not penetrate the fine print jungle at the back end of credit contracts, and particularly, do not engage the dangerous threat of penalty fees.

Nevertheless, banks may argue that the move to an increased reliance upon fee revenue, and the user-pays philosophy which underpins it, has paved the way for reducing interest rates in the consumer lending market. Bank interest rate margins have fallen considerably in the post-Wallis environment, and this is ascribed to the user-pays flexibility of the fee revenue stream, and its alleviation of the cross-subsidisation of transactional account operating costs by home loan borrowers.

However, a closer look at the mechanics reveals that the offending cross-subsidies appear not to have been removed, but simply moved. Most bank customers with home loans obtain the benefit of fee waivers, leaving the remainder of an institution's account holders to pay the fees and charges associated with running a day to day transaction account.

In this model, the non-borrowing account holders cross-subsidise the cost of providing accounts to the borrowing account holders. The Reserve Bank has pointed to the potential inequities of this arrangement:

At the level of the individual, the amount paid in bank fees depends on a range of factors, including the type of account held, how often the account is used, the balance in the account, and the payment methods used. Most banks waive or reduce account-servicing fees and transaction fees for students, people with a disability, pensioners and customers in rural locations who are unable to access ATM facilities. Similarly, a range of fees is typically waived if the customer has a 'significant' relationship with the bank. Overall, individuals that maintain high balances and make few transactions can avoid many of the fees

introduced since the mid 1990s. In contrast, customers with low balances who make frequent transactions using non-electronic channels are paying considerably more in fees than was the case in the mid 1990s.⁶

The ACCC has also weighed into the debate:

The bank fees and charges imposed need to reflect the costs relating to such accounts without imposing an artificially inflated barrier to the purchase of basic and less profitable classes of products and service. Specifically, it would be undesirable for there to be reverse cross-subsidisation of more profitable classes of service or products from basic-type accounts.⁷

IMPACT ON CONSUMERS

The strength of the community response to this issue is a reflection of the fact that, when almost every Australian has a bank account, almost every Australian is a potential victim of unlawful penalty fees.

Nevertheless, the injustice of penalty fees is felt most keenly by those who are least able to afford it. Given that the trigger for most penalty fees is a lack of funds, it flows as a matter of logic that low-income earners are more likely to be the ones incurring such fees.

Most troublingly, penalty fees can create a debt spiral from which there can be no escape. A direct debit dishonour leads to a dishonour fee, which places an account further into debit. The charging of the fee leads to the customer's account remaining overdrawn when otherwise there would have been sufficient funds to remedy the unauthorised overdraft. Thus, a dishonour that might turn on only a \$1 deficiency in an account balance may lead to hundreds or even thousands of dollars of fees.

As the ACCC is quoted above as observing, such individual instances of hardship could contribute to a market trend towards lack of access to financial services for low-income earners.⁸

Case studies set out at the end of this paper provide individual examples of the sort of hardship that can be suffered as a result of penalty fees.

THE TIDE IS TURNING

Since the release of the Rich Report in 2004 the Australian political and business establishment appears to have given close thought to the issue of penalty fees, resulting in a number of promising developments.

⁶ 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, April 2003, at 3-4.

⁷ ACCC, *Second Submission to the Financial Services Inquiry*, September 1996.

⁸ See Connolly, Chris & Hajaj, Khaldoun, *Financial Services and Social Exclusion*, Financial Services Consumer Policy Centre, University of New South Wales, Chifley Research Centre, March 2001; and

In May of this year, the RBA Bulletin's Banking Fees survey for the first time adopted the term 'penalty fees' while publishing a detailed breakdown of such fees across the household sector⁹ - an acknowledgment of the importance of the issue. As detailed above, the RBA concluded that fees on deposit accounts was the largest component of bank fees derived from households in the 2006 financial year. The survey also shows a five-fold increase in the average over-limit fee on a credit card from \$6 in 2001 to \$30 in 2006.

In July of this year, ANZ CEO John McFarlane was reported as saying that fees targeted the least financially literate in the community, and that those already in financial strife were unlikely to come up with the money to pay bank fees:

If you charge a fee to somebody who doesn't have much money in their bank account, then you charge the same fee again when they present another cheque and so forth, eventually they build up a negative balance that is unsustainable.

All you do is write it off. So what is the point of upsetting everybody by charging it when you're actually on balance not going to collect it?¹⁰

In August, ANZ announced that it would cut over limit fees on its credit cards for low income earners from \$35 to \$10.¹¹

On 15 August 2007 the Senate Standing Committee on Economics announced an inquiry into the provisions of the *Australian Securities and Investments Commission (Fair bank and Credit Fees) Amendment Bill 2007*. The inquiry will focus on the appropriateness and efficacy of proposed measures to:

- prohibit penalty fees imposed on failed transactions in circumstances beyond the knowledge or control of customers;
- ensure penalty fees reflect the actual cost of administering the customer's breach; and to
- enable ASIC to enforce undertakings from financial institutions with respect to penalty fees.

Further, the Fair Fees campaign¹² run by Choice and Consumer Action has received resounding public support across Australia, with more than 15,000 people actively participating in the fight to obtain refunds for illegally charged fees.

This month, NAB led the way with the launch of an account featuring a \$6 monthly service fee (that is avoidable for consumers earning less than \$45,000) and no penalty fees, and the removal of over-limit fees on credit cards held by Concession Card Account customers.¹³

⁹ Above, note 1.

¹⁰ Moncrief, Marc & Schubert, Misha, 'Bank fees no help says ANZ chief', *The Age*, Wed 18 July 2007.

¹¹ 'ANZ cuts credit card penalty fees', *The Age*, 28 August 2007.

¹² www.fairfees.com.au.

¹³ NAB News Release, *NAB moving away from exception fees with smart everyday banking*, 4 September 2007.

Pressure on financial institutions is mounting both here and overseas.

In the UK, popular outrage over bank fees has resulted in significant developments in the campaign to stamp out penalty fees. A £100,000 fighting fund has been set up by a group of consumer advocates including moneysavingexpert.com and the Consumer Action Group.¹⁴

Financial institutions have received tens of thousands of claims for refunds of unfair fees and one of Britain's biggest banks, HSBC, has repaid £116 million in bank fees in the first six months of 2007 alone.¹⁵

In April 2006, the UK Office of Fair Trading (*the OFT*) announced that it considered that financial institutions were setting credit card default fees at excessively high and unfair levels.¹⁶ As a result of the OFT's statement of principles on this issue, credit card issuers in Britain agreed to reduce their default fees – the majority by almost half.¹⁷

Earlier this year the OFT launched an investigation into the fairness of unauthorised overdraft charges and dishonour fees.

Most recently, the OFT reached agreement with eight of Britain's biggest financial institutions to conduct a test case to resolve the legal issues upon which the penalty fee debate turns.¹⁸ Proceedings were issued in the High Court on 27 July 2007. The catch for consumers is that the Financial Services Authority has allowed banks to put a hold on processing complaints in relation to penalty fees, pending the outcome of the litigation.

One of the critical distinctions however between the UK and Australian regulatory landscapes is the application in the UK of the Unfair Terms in Consumer Contracts Regulation 1999. Apart from Victoria and its unfair contract terms legislation,¹⁹ Australia does not presently have recourse to similar principles at law.

CASE STUDIES

Case Study One

¹⁴ McCormack, Helen, '£100,000 fund will help bank customers fight unfair charges', *The Independent*, 30 May 2007.

¹⁵ Hickman, Martin, 'HSBC spends £116m refunding customers for unfair charges', *The Independent*, 31 July 2007.

¹⁶ Office of Fair Trading (UK), *Press Release – Current credit card default charges too high*, 5 April 2006 (www.of.gov.uk)

¹⁷ Office of Fair Trading (UK), *Press Release – Following success on credit card default charges - OFT turns attention to bank current accounts*, 7 September 2006 (www.of.gov.uk)

¹⁸ The respondents to the OFT's High Court action are Abbey, Barclays, Clydesdale, HBOS, HSBC, Lloyds TSB, Nationwide and Royal Bank of Scotland, together representing about 90% of the UK's retail banking market.

¹⁹ Part 2B of the *Fair Trading Act 1999* (Vic), which is based largely upon the UK's *Unfair Terms in Consumer Contracts Regulation 1999*.

Mr X is a 39 year old Disability Support Pensioner living on \$630 per fortnight. Between 4 June 2004 and 27 March 2007 he was charged \$830 in penalty fees by an ABA member bank for overdrawing his account on 26 separate occasions.

Spread over some years, this may not seem like much, but note that between 10 January 2006 and 14 January 2006, approximately 10% of Mr X's fortnightly income was consumed by these penalty fees.

Case Study Two

Between 2005 and 2007 Ms Y was charged by an ABA member dishonour fees, overdrawn account fees, credit card late payment fees and credit card over-limit fees of between \$25 and \$50, totalling \$3,460.

Case Study Three

Paul, SA (published on fairfees.com.au)

Paul's wife had her handbag stolen from a cafe recently and the perpetrators withdrew \$1,000 from her Westpac Visa card in separate \$900 and \$100 transactions. They managed to withdraw the money despite only having about \$600 available credit on the card.

As a consequence of the transactions being allowed, the card went over their credit limit and they were charged an over limit fee by Westpac. When Paul contacted us, Westpac had reimbursed the fraudulent transactions but not the over the limit fee. After Paul's wife wrote to Westpac for an explanation how the thieves were able to access the account and why the card was able to go over the credit limit, Westpac apologised and refunded the fees.

"The same account was recently put into over limit by the annual card fee!

"Isn't that why a credit limit is set - to keep to a budget and to keep the card going over limit? Why bother having a credit limit if that limit can be exceeded? – Why? To generate fees of course!"

Case Study Four

Lauren, QLD (published on fairfees.com.au)

Lauren, who receives a pension, has paid hundreds of dollars in penalty fees. For example, she was recently charged \$90 for being \$25 overdrawn.

"I had written a cheque for \$20 but by the time it was processed my account had insufficient funds – so I was charged \$45," she says. "I also made a \$5 voluntary contribution to my super fund – a second \$45 fee was the result."

"Having one third my pension payment go on penalty fees this week was a lot," Lauren says. "And this often happens. I might forget a payment is coming out or think I've left enough

money in my account, and so I get overdrawn, and get charged \$45 for something as little as being \$5 overdrawn. I am fed up with this and have paid hundreds in fees. I wouldn't mind a \$10 or \$20 fee, but \$45 is a lot to someone on a limited income."

Referring to recent legal actions by UK regulators to reduce penalties and allow consumers to reclaim some fees, Lauren says:

"My sister, who is living in England, got about \$500 back after complaining about being charged high fees for overdrawing her account."

Case Study Five

Henry, WA (published on fairfees.com.au)

Henry's account slipped into the red when an ATM withdrawal caused an overdraft of \$5. The penalty for overdrawing his account was \$38, and when he checked his balance a few days later, he discovered that he'd been charged a further \$90 in 'periodic debit dishonour' fees.

"I called the customer enquiry line and was told that all these fees are detailed in my terms and conditions," Henry says. "I was informed that staff didn't have to explain to me why it costs them \$38 to send me a one-page letter reminding me I'd overdrawn my account by \$5, or why this entitled them to issue two further \$45 penalties for direct debit dishonours. I was charged the \$45 fee twice in the same day."

A further twist to Henry's situation was that he was the holder of a student account.

"This was supposedly a fee-free, discounted account that's marketed to tertiary students as a cheap way to manage typical everyday transactions such as direct debits."

Henry sent a letter of complaint to the bank about the penalties he was charged, but didn't receive a response.

Case Study Six

Garry, QLD (published on fairfees.com.au)

Garry left \$40.35 in his ANZ account for an insurance direct debit which was \$38.55, but the monthly insurance went up a couple of dollars to \$41.65 which he was unaware of. This meant when the direct debit was made he was \$1.35 short and was charged an overlimit fee of \$35.

"I am not mad that I have been charged a fee but I am mad at the amount," Garry says.

After complaining to the bank Garry had the fee reversed.