Submission to the Senate Economics Committee Inquiry into the Australian Securities and Investment Commission (Fair Bank & Credit Card Fees) Amendment Bill 2007

Terms of reference

On 15 August 2007, the Senate referred the provisions of the *Australian Securities and Investments Commission (Fair bank and Credit Fees) Amendment Bill* 2007 to Senate Standing Committee on Economics for report by 17 September 2007.

The bill seeks to implement the following measures:

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

Executive Summary

The undersigned authors of this submission support a recommendation by the Senate Economics Committee that the problem of illegal penalty fees levied by banks be subject to strong regulation. We are not convinced that minor amendments to the *Australian Securities and Investments Commission Act* 2001 are sufficient to achieve this purpose. However, we support the general aims of the bill and encourage Senators to support a more wide-ranging regulatory regime. In this submission, we consider some legal and public policy issues before commenting on the text of the bill and drawing some conclusions.

The nature of penalty fees

It is a fundamental tenet of contract law that parties cannot insert terms into the contract that penalize one party for defaulting on their contractual obligations, and that if this does occur, the 'penalty clause' is unenforceable against the defaulting party. Parties are only permitted to insert terms that provide for the payment of a sum by the defaulting party that is a genuine pre-estimate of the loss or damage that will be suffered by the party not in default, often called a 'liquidated damages clause'. The distinction between penalty clauses and liquidated damages clauses and its legal implications remains good law in Australia, applied most recently by the Tasmanian Supreme Court in *State of Tasmania v Leighton Contractors Pty Ltd (No 3)* [2004] TASSC 132.

Penalty fees in banking contracts

Opening a bank account involves the customer entering into a contract with their bank. The ordinary principles of contract law apply to this relationship: for example, when the bank changes the terms and conditions or alters the fees of a particular account, it is obliged to notify the customer; not to do so would risk the new terms being unenforceable against the customer. However, notification of the terms of the contract is not sufficient. The existence of a penalty clause in the contract, no matter how it is characterized (eg. it might be called a 'fee for service') and no matter how well notified to the customer, renders the contract unenforceable.

What would be a genuine pre-estimate?

This submission contends that the fees referred to in the following table can be characterized as those charged on a customer for defaulting on their contract.

Table 1	
Circumstance	**Fee**
Overdrawing an account	Account overdrawn fee
Failing to pay credit card minimum by due date	Credit card late payment fee
Having cheque presented by third party against customer's account when insufficient funds in account	Cheque dishonour fee
Having direct debit payment processed in favour of third party when insufficient funds in account	Direct debit dishonour fee

It is therefore lawful for banks to charge fees for default that are a genuine pre-estimate of the loss or damages suffered by the bank in rectifying the circumstances that led to the default. Such loss or damages could conceivably include:

Table 2	
Circumstance	**Loss/damage**
Overdrawing an account	The opportunity cost of the amount of money effectively 'loaned' by the bank to the customer for the period in default. The cost of contacting the customer to request that the default be rectified.
Not paying credit card minimum by due date	The opportunity cost of the amount of money effectively 'loaned' by the bank to the customer for the period in default.
Having cheque presented by third party against customer's account when insufficient funds in account	The cost of contacting the third party and the customer to inform that insufficient funds available
Having direct debit payment processed in favour of third party when insufficient funds in account	The cost of contacting the third party and the customer to inform that insufficient funds available

Clearly, the quantum of loss or damage will vary according to the exact nature of the breach: for example, how long the customer was in default, how much the account was overdrawn, how much interest the bank could otherwise have earned on the amount if invested in the short-term money market, how difficult it was to contact the third party and/or customer to inform them of the default.

Requiring banks to determine the exact cost of each default and to effectively 'send the bill' to the customer would be unreasonable. However default fees as they are currently structured by Australian banks are flat fees, charged regardless of the cost incurred by the bank. The fee is charged regardless of whether the account was overdrawn for 1 day or 100 days, by $1 or $100, and whether the bank went out of their way to contact the customer or whether the fee was simply automatically added on to a statement that would have been sent to the customer anyway.

Dr Nick Coates, in a speech entitled 'Time to get honest on unfair bank fees' given to the BFSA Annual Conference 2006 (http://www.choice.com.au/files/f128922.pdf) discusses a number of case studies in which the cheque dishonour fee is in excess of the value of the cheque. The fact that such price gouging is legally permissible in Australia in 2007 is beyond belief.

Lack of adequate disclosure by banks

Australian banks provide no information in their publicly available reports on the true cost to them of defaults by customers, and whether they bear any relation to the amount they charge in default fees. A report by the Consumer Law Centre entitled 'Unfair fees: A report into penalty fees charged by Australian banks' (Nicole Rich, December 2004) estimates that "based on the information that is available, 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" (at 10). Any argument by the banks that such default fees might subsidise the provision of direct debit, cheque or credit card services to the customer would not make the fees legal: it is legitimate for the banks to levy separate fees for the provision of these services (and they frequently do).

Requiring disclosure to assess legality

In order to determine whether default fees charged by banks are penalty clauses or liquidated damages clauses, it is therefore necessary to require the banks to disclose the true costs of such defaults. The Reserve Bank of Australia (RBA) is empowered under the *Payments System (Regulation) Act* 1998 to obtain such information. Once this information is revealed, an accurate assessment could be made as to which fees are legal and which are not. The banking industry would need to be consulted about how fees might be changed so that they are in compliance with the law. One option might be an automatic formula using the variables listed in Table 2 and the factors discussed on page 2 that could legitimately be deducted from a customer's account. The customer should have the right to be able to challenge the basis on which the assessment of the fee was made, but disclosure on a statement need be no more complicated that the listing of an interest payment for a particular time period at a specified rate.

Inadequate regulation of bank fees

The current system of banking regulation in Australia is defective to the extent that the issue of the legality and/or conscionability of bank fees does not fall within the jurisdiction of any government body. The RBA is responsible for the setting of interest rates and the regulation of payment systems, the Treasury is responsible for macro-economic and monetary policy, the Australian Prudential Regulation Authority is relevantly responsible for ensuring the solvency of banks and the Australian Competition and Consumer Commission's (ACCC) responsibility for consumer protection does not, by its own admission, extend to bank customers.

The issue of bank fees is predominantly a consumer rights issue, and therefore logically belongs within the jurisdiction of the ACCC. In conjunction with the RBA, it could require continuous disclosure of both fees and costs by the banks. With such information, the ACCC could be empowered to declare void terms which are a given level in excess of the true costs of default. The ACCC should be given more resources to defend the decisions in the face of banks that might seek judicial or merits review of the decisions.

What banks should do

We also believe that the onus is on the banks themselves, as ethical corporate citizens, to modify their own practices regarding the charging of penalty fees. We support the current campaign by Choice Magazine to:

> Introduce systems to provide a greater range of options and real-time information to consumers where there are insufficient funds to make a due payment. These might include simply declining payments without charging a fee, an automated system to notify consumers by email or text message (or perhaps for concession card holders without electronic facilities, by phone), or by automated message via the ATM or EFTPOS system, before the payment is processed.

We are encouraged by St Georges Bank's decision to drop its $10.50 inward cheque dishonour fee on 12 June 2007. We are also encouraged by ANZ's recent decision to drop "exception fees from $30 to $10 on its no-frills Basic Access account" (Marc Moncrief and Misha Schubert, "Bank fees no help, says ANZ chief", *The Age*, July 18, 2007) and to give its customers the option to avoid penalty fees by disabling the ability of their account to go over limit on electronic purchases and cash transactions (Choice website, accessed 30 August 2007).

The fact that St Georges and ANZ have made these decisions is testament to the hard work of organisations like the Consumer Action Law Centre and Choice and the publicity through Crikey.com.au and the Sunrise program. However there is every reason to believe that these banks are the exception rather than the rule. The first duty of banks is to their shareholders, and cutting fees affects their bottom line. This is why government regulation must play a role.

Consonance with contemporary Australian values

The reforms we support are by no means a radical intervention into the banking system in Australia. What we propose is a piecemeal reform that would improve the lives of ordinary Australians, particularly those on lower incomes and those whose financial management skills are less developed. We support the Federal Government's and Federal Opposition's recently announced policies to improve financial literacy, and believe that such a reform would be consistent with such efforts.

We believe the proposed reforms are consonant with contemporary Australian values, such a belief in egalitarianism and a 'fair go for all'.

Private banks in 2007 are making enormous profits for their shareholders, and it is likely that a sizeable proportion of these profits are due to fees of questionable legality. The spirit of Ben Chifley should be drawn upon without the radical or divisive consequences of bank nationalisation. Instead of nationalizing them, it is proposed to require their profits to be derived by more conscionable means. The spirit of Lionel Murphy's pursuit as Attorney-General of reforms in the area of trade practices and consumer protection would also continue to resonate in these proposed reforms.

The deregulation of the banking industry under the Hawke/Keating government (and supported by the current Prime Minister when he was Opposition Leader) was based on the premise that competition would improve the delivery of banking services to consumers. There is much merit to this argument: consumers have greater choice in 2007, and access to a greater range of banking products. However, there is no evidence that increased competition has restrained banking fees: indeed, the evidence points to cartel-like behaviour between the banks. Non-disclosure of default costs is only one example of this collusion. As Rich notes, what we are confronted with is a market failure of significant magnitude:

> Competition in the banking market appears to be less than effective with regard to restraining penalty fees. Consumers are faced with substantial switching costs and difficulties in accessing information about penalty fees if they wish to change bank account. They also have very little information about the real costs of penalty fees of other banks. In this situation, it is very difficult for consumers to make an informed choice about which bank's product is best for them. For this reason, it is likely that penalty fees represent economically inefficient or supra-competitive profits, available to Australian banks only because competition is not fully effective in the personal banking market.

Finally, the tradition of pursuing the goal of social justice would be fulfilled by conducting a campaign against illegal bank fees. The reality is that these fees are not means-tested and have a disproportionate impact on those with a lower socio-economic status.

<u>Should Senator Fielding's private member bill be supported?</u>
In our view, the *Australian Securities and Investments Commission (Fair bank and Credit Fees) Amendment Bill* 2007 deserves serious consideration by the Senate. In its current form, it is not perfect. We are by no means convinced that the Australian Securities and Investments Commission (ASIC) is the appropriate body to monitor the levying of penalty fees by banks. As discussed above, the RBA is empowered under the *Payments System (Regulation) Act* 1998 to obtain information from banks that may enable an assessment to be made as to whether a fee is lawful. As also discussed above, as this is at core a consumer rights issue, it makes sense for the task of monitoring and enforcement to be given to the ACCC. Certainly ASIC should play a role, but solely amending its empowering legislation is insufficient. Below we consider the clauses of the bill in more detail.

<u>Actual or constructive knowledge that a transaction will fail</u>
Clause 12FA is aimed at cheque dishonour fees, and prohibits banks from charging the fee where "the customer had no actual or constructive knowledge that the transaction would fail", ie that the cheque would be dishonoured.

It seems that the provision would encompass direct debit dishonour fees, although these are not explicitly mentioned in clause 12FA(2). We suggest an amendment to this on the following lines: at the end of line 17, insert the words "or the signing in good faith of a direct debit agreement providing for the regular debiting of an account".

<u>Confusion over the use of the term 'penalty fees'</u>
One problem with clause 12FA is its ambiguous relationship with clause 12FB, and the loose employment of the term 'penalty fees'. Under the common law, any

provision in a contract that is deemed to be a penalty clause, rather than a liquidated damages clause, is unenforceable.

Clause 12FA, in specifying the circumstances under which a clause imposing penalty fees is void (ie. where the customer had no actual or constructive knowledge that the transaction would fail), has the effect that penalty clauses are otherwise enforceable. This is unsatisfactory, and inconsistent with the common law.

Further, it is potentially unfair to banks, which incur expenditure in informing their customers that a cheque has been dishonoured or a direct debit payment has failed. It is surely legitimate for banks to charge customers fees at a level proportionate to the cost of informing customers of the transaction failure event.

<u>Inconsistency between clauses 12FB and 12FA</u>
Clause 12FB is potentially inconsistent with clause 12FA. Clause 12FB provides that a fee must not be imposed by a bank on a customer unless it "represents a reasonable estimate of the loss suffered by the supplier as a result of the conduct by which the consumer incurs the penalty". It is unclear whether this exception applies even if the fee is imposed in the circumstances described by clause 12FA (ie. cheque presented by person in good faith is dishonoured).

For the reasons outlined above, our view is that the exception should still apply in 12FA circumstances. But the wording of clause 12FB means that this conclusion is by no means assured. It is our view, therefore, that clause 12FA is either otiose or unfair.

Given the substantial body of common law principles that have developed around penalty clauses, it is misleading to provide in clause 12FB for circumstances in which penalty fees are enforceable. Under the common law, they are only enforceable if they are contained in liquidated damages clause, in which case they are not 'penalty fees'. Clause 12FB should therefore be amended to replace 'penalty fees' with 'fees'.

<u>Scope of clause FB is excessively wide</u>
In addition, in our view, the scope of clause 12FB is excessively wide. The fees referred to are those levied " in connection with the supply or possible supply of financial services". Does this include monthly account-keeping fees or one-off mortgage fees? These fees are of a general nature and cannot be linked to specified "conduct by which the consumer incurs the penalty fee". And yet it is not clear that these types of fees are excluded.

<u>A voluntary regime is not the answer</u>
Clause 12FC is entirely unsatisfactory in relying on undertakings voluntarily made by banks to ASIC. Given that the banks can voluntarily bring themselves within the regime, but once in the regime, can only amend their undertakings with the consent of ASIC, no rational bank would bring itself within the regime in the first place.

Clause 12FC adopts completely the wrong approach to enforcement, particularly given the strong provisions contained in clause 12FB. Clause 12FB is toothless without imposing a requirement on banks to disclose information which allows ASIC to determine whether a "fee represents a reasonable estimate of the loss suffered by the supplier as a result of the conduct by which the consumer incurs the … fee". Without such information, customers and ASIC are powerless to enforce clause 12FB.

Conclusion: An alternative regime

We support an alternative regime that calculates whether a fee is a "reasonable estimate of the loss suffered by the supplier as a result of the conduct" according to a formula. The formula would be prescribed by regulation, including time, interest rate and cost of communication with customer. The formula would be akin to scale costs in various courts, and could be adjusted by the Minister following an inquiry. The elements of the formula would be revised on a regular basis, or upon the initiative of the Minister, following representations by banks or customers. The responsible Minister would also be granted the power to exempt certain banks from the scale if satisfied, upon evidence submitted by that bank, that their costs differ from the scale by more than a given percentage.

We do not pretend to be experts in bank regulation. We have been inspired by the work of Choice and the Consumer Action Law Centre and rely on the submissions that they will undoubtedly make to this inquiry regarding the sort of regulatory regime that needs to be put in place. As concerned citizens, we would be profoundly disappointed if this bill 'died' in the committee because it is not perfect. In our view, it is a good start.

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