Chapter 2

Issues

2.1 In this Chapter the Committee considers several issues that were raised in the evidence.

Legal considerations

2.2 The legal status of default charges is among the most significant issues.

2.3 Until April 2008, when the UK High Court handed down the decision referred to in Chapter 1, the law in Australia seemed fairly certain. The Australian Consumer Law Committee of the Legal Practice Section of the Law Council of Australia (ACLC) informed the Committee that:

> The net effect of the common law of contract is that where a contract imposes an extravagant amount as a penalty, a person who pays the penalty can claim compensation for the difference between the extravagant amount and the reasonable sum for the loss arising from the breach of contract.[1]

2.4 Because financial service providers have not made available any information about the costs they incur when a customer defaults, it is not possible to determine whether default charges are necessarily extravagant. The information that is available is based on data from the Wallis Report that is a decade or more out of date.[2] Nevertheless, the evidence submitted to the inquiry suggests strongly that some default charges, especially direct debit dishonour fees and credit card over-limit fees, are almost certainly much greater that the costs incurred by the financial service providers and could be considered extravagant.

2.5 The ABA stated that critics of default charges have used the expression 'penalty fees' to describe these fees on the false premise that these fees are penalties at law. The ABA uses the expression 'exception fees' and asserted that 'exception fees' are not penalty fees.[3]

2.6 The Committee, however, was informed that Australian case law indicates that whether a contractual term is a penalty is a matter of substance not of form. In other words, describing a default charge as an 'exception fees' or a 'fee for service' may not hold up as an argument in Australian courts:

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1 Australian Consumer Law Committee of the Legal Practice Section of the Law Council of Australia, *Submission 21*, pp [3]-[4].

2 Financial System Inquiry (the 'Wallis Committee'), *Financial System Inquiry Final Report*, March 1997.

3 Mr David Bell, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 June 2008, pp 35-36.

> … the courts have indicated that whether someone has breached the terms and conditions of their account should not be looked at merely on what the particular terms say but on the actual substance of the matter. Was there an obligation on the consumer to maintain a certain amount of money in their account or not go over the limit?
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> In this situation we would say, 'Yes, that obligation does exist in signing up to that account,' and if a consumer defaults then they have breached their account.[4]

2.7 There is no certainty, however, that an Australian court would not be guided by the UK High Court decision. Mr Ben Slade, a member of the ACLC, commented on the possible implications of the UK High Court decision as follows:

> … the High Court decision in the UK in the Office of Fair Trading v Abbey National PLC and 7 others, which was handed down on 24 April … found that, in relation to overdraft fees—fees where no previous agreement had been made between customer and institution for an overdraft, yet an overdraft was provided to the customer—those fees were fees for service. So it means that the common law of penalties does not in those circumstances apply.
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> As a consequence of that, the evil that the bill before this committee is identified as addressing—that is, unfair and exorbitant default fees—would be relatively easily avoided by banking institutions in this country by defining all their fees as service fees …[5]

2.8 Mr Slade suggested that if Australian courts were to take the same view of the distinction between default charges and service fees the bill as currently drafted would not work.[6] He also suggested that it might be necessary to define the essence of the contract between customer and bank in the bill so as to avoid the interpretation that the UK court has found.[7]

2.9 Clause 12FAA of the bill which deals with definitions reads as follows:

> **12FAA Definitions**
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> In this subdivision:
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> ***consumer default*** means a breach by a consumer of a term of a contract between a financial service provider and the customer.

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4 Mr Gerard Brody, Director, Policy and Campaigns, Consumer Action Law Centre, *Committee Hansard*, 12 June 2008, p. 8.

5 Mr Ben Slade, Member, Consumer Law Committee, Law Council of Australia, *Committee Hansard*, 12 June 2008, p. 23.

6 Mr Ben Slade, Member, Consumer Law Committee, Law Council of Australia, *Committee Hansard*, 12 June 2008, p. 25.

7 Mr Ben Slade, Member, Consumer Law Committee, Law Council of Australia, *Committee Hansard*, 12 June 2008, p. 25.

> ***default charge*** means a pre-determined fee or charge of any kind in a contract between a financial service provider and a consumer where that fee or charge is payable by the consumer in the event of consumer default.

2.10 In answer to questions neither Mr Slade nor Ms Polczynski was able to suggest a ready solution as to how default charges might be redefined. Mr Slade suggested that the Office of Parliamentary Council might be consulted, while Ms Polczynski, speaking in her professional capacity rather than as a representative of the Law Council, suggested that it might be possible to identify the events that would trigger the fee and then to limit the fee that is trigged by those events.[8]

Price control

2.11 The ABA asserted that limiting default charges to a pre-estimate of the damage likely to be suffered by a financial institution as a result of customer default is a form of price control which has the potential for economic impact that could damage consumers.[9] Mr Gilbert quoted from the report of the Productivity Commission and from a Government Green Paper to illustrate that care needs to be exercised in intervening in a price control manner on fees and charges.[10]

2.12 Ms Polczynski informed the Committee that when the UCCC was being negotiated very substantial consideration was given to how fees should be regulated. It was decided at the time that flexibility in pricing should be allowed and that the initial consumer protection mechanism would be appropriate disclosures. This was expected to encourage flexibility in product design. Ms Polczynski stated that there was therefore a very deliberate move away from the prescriptive fees on cost recovery that then applied.[11] She suggested that an enormous amount of thought was given to the issue some 14 years ago and, while it might be time to think about it again, the same amount of thought should be given to it now.[12]

2.13 The bill could not be considered to impose a form of price control if it merely ensured that the law of contracts was applied to default charges. That would depend on whether the charge imposed was in fact for a breach of contract, ie a default charge, or was a fee for service.

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8 Mr Slade and Ms Polczynski, *Committee Hansard*, 12 June 2008, p. 25.

9 ABA, *Submission 17*, p. 2.

10 Mr Ian Gilbert, Director, Retail Policy, Australian Bankers' Association, *Committee Hansard*, 12 June 2008, pp 42-43, quoting from: Productivity Commission 2008, *Review of Australia's Consumer Policy Framework*, Final Report, Canberra, and Australian Government, The Treasury, *Financial Services and Credit Reform: Improving, Simplifying and Standardising Financial Services and Credit Regulation*, Green Paper, June 2008.

11 Ms Polczynski, *Committee Hansard*, 12 June 2008, p. 24.

12 Ms Polczynski, *Committee Hansard*, 12 June 2008, p. 25.

2.14 The ACLC suggested that a clause should be added to the bill to ensure that the legislation could not be circumvented by otherwise void 'default charges' being reformulated and imposed as 'service charges'. The proposed clause read as follows:

> A financial service provider must not include in any contract between the financial service provider and a consumer, a fee for service or any other charge relating to the account of that consumer, which is more than a genuine pre-estimate of the likely cost to the financial service provider of providing that service to the consumer.[13]

2.15 However, Mr Slade observed:

> … in spite of a suggestion made by the Consumer Law Committee… that service fees be constrained … The real concern is that defining service fees or all fees imposed by banks as fees that must be equivalent to the amount that it costs the bank to provide that service is akin to price control. … in which case more work needs to be done to identify those fees that are in effect default fees and those that are in reality service fees. There are quite clearly, according to the Consumer Law Committee at least, a number of fees that fall squarely into the service fee component, and price control is not something that we think should be exerted over those fees.[14]

A market for default charges?

2.16 CHOICE and the consumer action law centre submitted that market forces do not and cannot work to control the imposition or amount of penalty fees.[15]

2.17 That assertion is based partly on the proposition that customers, when opening a bank account or applying for a loan, do not consider the penalty charges that might apply. They do not think that they will default and are therefore concerned only about interest charges and up-front fees. The assertion is also based on the significant increase in the incidence and number of penalty charges imposed by financial institutions from 2000 to mid-2007.

2.18 The ABA submitted that the development of new products such as basic bank accounts shows that market-based solutions can work and deliver customers better outcomes.[16] Basic bank accounts have been introduced and extended during the past six years. The ABA stated that if a regulatory approach had been taken six years ago, then it is unlikely that consumers would have had the range of competitively priced options that are now available. The ABA argued that there are lessons from the experience of basic accounts that are relevant to 'exception fees'.[17]

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13 ACLC, *Submission 21*, p. [7].

14 Mr Slade, *Committee Hansard*, 12 June 2008, p. 24.

15 CHOICE and consumer action law centre, *Submission 18*, p. 1.

16 ABA, *Submission 17*, p. 4.

17 ABA, *Submission 17*, p. 5.

2.19 There is evidence that the incidence of default fees charges by the banks has declined recently. A few banks eliminated or reduced default charges for concession accounts in 2006 and in the past 12 months most banks have reduced the quantum of default fees.[18]

2.20 Mr Renouf stated that CHOICE is pleased that banks have offered reduced fees for pensioners but noted that there are still many low-income people who are not eligible for these accounts and pay the high fees still, and the fee reductions have not been made on credit card accounts, only on transaction accounts.[19]

2.21 A lower incidence of default charges coincides with a 'Fair Fees' campaign launched by CHOICE and Consumer Action in June 2007. The Fair Fees website contains information for consumers about how to seek refunds on default fees charged by financial institution and information about default charges on standard and concession accounts. Choice submitted that since launching the campaign more than 30,000 consumers have used material on the site to challenge unfair penalty fees.[20]

2.22 In answer to a question from the Committee that suggested that the market is not responding in the normal way, but is working because of community concern, Mr Bell responded:

> I think there are a number of catalysts which cause a market to work. No market is perfect. Clearly in this case there are a number of catalysts. One is that there is community sentiment out there, and we have acknowledged that quite openly for at least a year—well and truly before this particular process was even thought about—so we have been ahead of the game there. The other is the genuine view of our banks that this is an area they need to look at, and there have been discussions over the years about the need to do it.[21]

The case for regulation

2.23 One argument for government intervention in markets is market failure. As discussed earlier, the indications are that until a consumer campaign was launched to address the quantum and numbers of default charges, these charges were increasing rapidly. There is no evidence that there has been any competition in this area.

2.24 The consumer campaign apparently has had the effect of causing many of the financial institutions to reconsider these charges, and some institutions may now perceive that they may gain a market advantage by reducing default charges or by offering options for consumers to help them avoid those charges. However, the observed changes have only occurred in the past year and it is too early to say whether

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18 ABA, *Submission 17*, p. 5.

19 Mr Renouf, *Committee Hansard*, 12 June 2008, p. 3.

20 CHOICE and consumer action law centre, *Submission 18*, p. 15.

21 Mr Bell, *Committee Hansard*, 12 June 2008, p. 40.

the consumer campaign has provided the catalyst for long-term change. Not all witnesses were as optimistic as the ABA on this point. Ms Pidgeon, for example, stated that she thought that:

> … it is largely as a result of these campaigns that they are lowering fees. If these campaigns lost momentum, I do not think we would see the same response by the banks, and I think there is significant market failure that does need to be addressed.[22]

Effects on consumers

2.25 Several witnesses asserted that default charges not only greatly exceed the costs of the defaults to financial service providers but also that they are manifestly unfair.

2.26 As has been noted elsewhere in this report there is no recent information about the costs incurred by the financial institutions and so it is not possible to determine definitively whether the quantum of default charges really reflects the costs incurred. However, it would appear that, in some cases, the default charge is very much greater than the cost to the institution. This is the case particularly for default charges on direct debit accounts. The Committee asked the ABA whether it had information about costs, but it was informed that the banks would not provide this competitive information to the ABA.[23]

2.27 Witnesses' claims of unfairness related mainly to inward cheque dishonour fees, over-limit fees for credit card accounts and multiple default fees which are incurred when consumers are required to pay more than once for the same default. Witnesses submitted that it was also unfair to impose charges greatly in excess of the cost of the default.

2.28 Inward cheque dishonour fees may be incurred when a recipient of a cheque that is later dishonoured by a bank presents the cheque for payment. The Committee notes that most, but not all, financial institutions no longer impose this charge. An ABA Fact Sheet dated February 2008 shows that in November 2007 only the Adelaide Bank, BankWest and HSBC continued to impose inward cheque dishonour fees, although the application of the fee had previously been widespread.[24] The Committee is surprised that any financial institution would impose this fee, especially as those presenting such cheques can be people who can ill afford to bear the cost. As Mr Jonathan Campton, a Researcher with the St Vincent de Paul Society explained:

> The fees that are associated with these cheques bouncing are borne by, often, low-income earners, who may have to use cheques as a form of

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22 Ms Pidgeon, *Committee Hansard*, 12 June 2008, p. 50.

23 Mr David Bell, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 12 June 2008, p. 36.

24 Australian Bankers' Association Inc., Fact Sheet 'Exception Fees November 2007', Attachment to *Submission 17*.

> receiving income for casual or occasional work. They have no knowledge of it and, in some cases, have carried out work or services, only to find out that they have to bear the cost of trying to present a cheque to the bank.[25]

2.29 Over-limit credit card fees were also said to be blatantly unfair. Mr Renouf pointed out that most people believe that the limit on their accounts is the limit and that they should be stopped at the limit.[26] Mr Renouf also stated that over-limit fees were only invented in the early 2000s and increased rapidly to 2007.[27] The St Vincent de Paul Society asserted that default does not rest with the customer because credit card limits do not actually limit the use of the card, allowing people to exceed their 'limits'.[28]

2.30 The Committee also received evidence that financial institutions may charge multiple penalties for one case of default. This can occur when financial institutions impose more than one default charge under the same contract or when the imposition of a default charge leads to other charges, for example, when a late payment fee on a credit card account leads to an over-limit fee. Ms Wakeford provided an example of this practice:

> We had a client who received in a two-day period on the one account a late charge of $25 on her credit card and then an over-the-limit charge of $25. It makes it difficult for an individual to see their way out of financial difficulties if they just keep getting slogged.[29]

2.31 Ms Wakeford also gave an example in which the imposition of an account keeping fee caused a welfare recipient to incur a default charge. She stated that in one case a client checked the balance of her account to determine whether her Centrelink payment had been deposited and in so doing incurred a fee which caused her account to be overdrawn. She thereupon incurred a penalty of $40.[30]

2.32 An associated problem for low income groups is that, in the case of some defaults, both the merchant and the financial institution impose a fee. The Smith Family informed the Committee that:

> The experiences of participants in our financial literacy courses are consistent with research that indicates that they are unfairly penalised by financial fees and charges. In some cases these can constitute as much as 20% of their weekly income. The unfairness of bank fees and penalties is a key theme consistently expressed by participants in our financial literacy

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25 Mr Jonathon Campton, Researcher, St Vincent de Paul Society, *Committee Hansard*. 12 June 2008, pp 16-17.

26 Mr Renouf, *Committee Hansard*, 12 June 2008, p. 2.

27 Mr Renouf, *Committee Hansard*, 12 June 2008, p. 2.

28 St Vincent de Paul Society, *Submission 29*, p. [3].

29 Ms Michelle Wakeford, *Committee Hansard*, 12 June 2008, p. 30.

30 Ms Michelle Wakeford, *Committee Hansard*, 12 June 2008, p. 30.

> courses. The most common charges that are of concern are direct debit fees. Our families are particularly concerned about the double penalty of an overdrawn fee from the bank (typically $45-60) coupled with a dishonour fee from the merchant ($25- $60).[31]

2.33 Dr Falzon also commented on this issue, suggesting that this was not a fair impost, 'especially on a low economic resource household, which of course many of these products target'.[32]

2.34 The evidence indicated that in some cases the quantum of default fees caused great hardship. One client of the Brotherhood of St Laurence who incurred a charge as a result of a misunderstanding of the direct debit system was quoted as saying that:

> Fifty dollars is food for the whole week for my kids. That extra $50 that they charged has just shattered me.[33]

Are default fees avoidable?

2.35 Mr Bell stated that default charges are avoidable.[34]

2.36 Most customers most of the time no doubt can avoid paying penalty charges, but the statement does not appear to be universally true. In the preceding section the Committee has considered the difficulties that arise in relation to inward cheque dishonour fees and over-limit fees.

2.37 In relation to over-limit fees, Ms Wakeford informed the Committee that many banks provide an option for their customers to switch off the ability to overdraw their account or credit card. She stated that the Brotherhood of St Laurence considers that this should be the default option and that customers should be able to request the additional service of being able to overdraw their account and, with this, the acceptance of the fees that go with that service. Ms Wakeford also suggested that most people do not realise that there might be the option to switch off the ability to overdraw their account. [35]

2.38 In order to avoid penalty charges customers must know of their existence. As has been discussed elsewhere in this report, disclosure of these charges is mandatory. However, the information concerning default charges may not be easily found. Ms Pidgeon observed that:

> Disclosure is a huge problem. More often than not, bank customers are handed a standard form contract that they have no ability to negotiate and

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31 The Smith family, *Submission 10*, p. 2.

32 Dr Falzon, *Committee Hansard*, 12 June 2008, p. 19.

33 Ms Wakeford, *Committee Hansard*, 12 June 2008, p. 30.

34 Mr Bell, *Committee Hansard*, 12 June 2008, p. 39.

35 Ms Wakeford, *Committee Hansard*, 12 June 2008, p. 31.

> the fees are in the middle of that standard form contract in very small print, which most customers do not generally read. The disclosure could certainly be improved.[36]

2.39 The Committee is aware that the ABA has attempted to address concerns in this area by publishing a Fact Sheet that aims to inform customers about penalty charges and how they may be avoided.[37] It is not known whether this publication has been effective, but it would probably not be as effective as would a direct communication from a financial institution to a customer which warned about a potential default. This is apparently done by some institutions and was a course recommended by Mr Renouf.[38]

2.40 Few people can avoid having at least one bank account, even if that account is used only for depositing and withdrawing money received from Centrelink. People in that unfortunate situation need to manage accounts that in many cases will have little money in them and, in so doing, hopefully not become overdrawn and incur default charges. This will be difficult and that difficulty is likely to be exacerbated when people managing their money cannot use the internet and therefore do not know what their account balances are at any given time. As Ms Wakeford observed:

> However, many low-income people do not have access to secure computers and they rely on statements produced—and often the default is quarterly or half-yearly—so they are not getting up-to-date tools to help them to manage their accounts. This obviously makes it difficult to keep track of balances, and even more difficult to avoid fees.[39]

Dispute resolution

2.41 Individuals who incur default fees in effect do not have ready access to an external agency for the resolution of disputes. The Banking and Financial Services Ombudsman considers that it does not have jurisdiction in these matters. This contrasts with the view taken by the Credit Ombudsman who is reported to have indicated its willingness to investigate complaints about penalty fees.[40]

2.42 The ABA in evidence referred to the current revision of the Banking Code of Practice. The Code may address the issue of default charges, but it is not known whether that will give any comfort to those adversely affected by the charges. It is of interest that the draft Code of Practice for Credit Unions and Mutual Building Societies includes the following:

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36 Ms Pidgeon, *Committee Hansard*, 12 June 2008, p. 52.

37 Mr Bell, *Committee Hansard*, 12 June 2008, p. 37.

38 Mr Renouf, *Committee Hansard*, 12 June 2008. p. 14.

39 S Wakeford, *Committee Hansard*, 12 June 2008, p. 30.

40 CHOIC and consumer action law centre, *Submission 18*, p. 11.

> **(4.5)** We will make sure any exception fees we charge (including credit card late payment fees, account overdrawn or dishonour fees, direct debit dishonour fees, cheque dishonour fees, and ATM failed transaction fees) are:
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> - Reasonable, having regard to our costs
> - Clearly disclosed, and
> - Fairly applied.[41]

2.43 While it theoretically possible to take action in the courts, high legal fees and the possible legal costs are so disproportionate to the amount of any default charges that this has not been done. Also, as discussed earlier, the uncertainty of the law following the UK High Court case might dissuade anyone from taking such action, especially because if a case is lost costs might be awarded against the plaintiff.

2.44 It is of interest, however, that some matters have been taken to the Victorian Civil and Administrative Tribunal under that State's Fair Trading Act. The Committee was informed that these cases were settled subject to confidentiality provisions, which suggests that the Tribunal found in favour of the plaintiffs. When asked about these cases, and the assumption that the findings implied that the fees were not legal or sustainable, Mr Gilbert stated:

> That was my assumption also: that for a tribunal or whatever to entertain a claim, you would have to start with the basis that the fee is not valid at law, and that is an issue that will arise if this bill is passed into law as well. There will be litigious disputes about what is costs … what is a default, and whatever else may arise under the bill's provisions. For example, what if an organisation disagrees with ASIC's analysis of the situation, based on the evidence and the information that the bank has provided to ASIC? Is the bank going to take ASIC to court under judicial review legislation?[42]

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41 ASIC, *Submission 12*, p. 5.

42 Mr Gilbert, *Committee Hansard*, 12 June 2008, p. 46.