Unfair fees: A report into penalty fees charged by Australian banks

Nicole Rich
Supervising Solicitor
Consumer Law Centre Victoria

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The Consumer Law Centre Victoria is Australia's second largest and fastest growing consumer organisation. The Centre undertakes research, policy development, advocacy and education. The Centre also operates a large consumer legal practice assisting over a thousand low-income consumers each year with free legal advice and representation.

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Nicole Rich
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List of Abbreviations

The following abbreviations are used throughout this Report:

ABA	Australian Bankers Association
ACA	Australian Consumers' Association
ACCC	Australian Competition and Consumer Commission
ANZ	Australia and New Zealand Banking Group Limited
APCA	Australian Payments Clearing Association
ASIC	Australian Securities and Investments Commission
Bendigo Bank	Bendigo Bank Limited
CAV	Consumer Affairs Victoria
CBA	Commonwealth Bank of Australia Limited
NAB	National Australia Bank Limited
NCP	National Competition Policy
PIRG	American Public Interest Resource Group
PSA	Prices Surveillance Authority
RBA	Reserve Bank of Australia
St George	St. George Bank Limited
UK	United Kingdom
UKCC	United Kingdom Competition Commission
Westpac	Westpac Banking Corporation Limited

Preface

Australian banks charge a variety of fees to consumers to engage in banking, including, most commonly, account-servicing and transaction fees. Australian banks also charge a variety of penalty fees, that is, fees charged to a customer by their bank when the customer "defaults" in some way on their agreement with their bank. Common examples of penalty fees include cheque dishonour fees, account overdrawn fees and credit card late payment fees.

It is clear that penalty fees are set at a high level in comparison with other fees and charges levied by Australian banks. In the past, community and consumer groups have complained that penalty fees hurt low-income consumers by punishing them for defaults on their accounts that they cannot avoid. However, the banks have argued that customer defaults are costly and penalty fees are merely designed to recoup these costs. The nature and effect of penalty fees has never been examined in depth.

This Report constitutes a comprehensive examination of penalty fees charged by Australian banks, including their legal status, their cost to consumers and their nature as an income stream for banks. As such, this Report represents the first such examination of its kind in Australia.

With the RBA continuing to progress reforms to payment systems in Australia, and with the recent release of the Productivity Commission's review of NCP, this Report is timely. Are penalty fees a safe haven from competition for Australian financial institutions? This Report demonstrates that an investigation and review of penalty fees, akin to the investigations into interchange fees that instigated the current payment systems reforms, should form a part of continued competitive reforms to Australian consumer markets.

Structure of the Report

Chapter 1 of this Report examines the current state of Australian law with regard to the doctrine of penalties. Penalties are contractual terms that are unenforceable at law.

Chapter 2 applies the law on penalties to penalty fees charged by Australian banks. In particular, cheque and direct debit dishonour fees are examined as an example of penalty fees.

Chapter 3 analyses penalty fees in further depth, examining how much profit Australian banks may be deriving from penalty fees and whether some consumers are bearing the burden of penalty fees more than others.

Finally, recommendations are presented to tackle the problem of penalty fees.

Executive Summary

Unfair fees: A report into penalty fees charged by Australian banks

Introduction

We consider penalty fees to be any fee charged to a customer by a bank for the customer breaching, or defaulting in some way on, their contract with the bank.

Such defaults by a customer include overdrawing an account, not paying a credit card minimum payment by the specified due date, having a cheque presented by a third party against the customer's account without the customer having sufficient funds available in their account to honour the cheque, or similarly, having a direct debit payment processed in favour of a third party without the customer having sufficient funds available in their account to honour the payment. The above events would result in the charging to the customer of, respectively, an account overdrawn or honour fee, a credit card late payment fee, a cheque dishonour fee and a direct debit dishonour fee.

The Report questions the legality of penalty fees routinely charged by banks and calls for Australian banks to release sufficient data to enable the Australian public to assess the validity, or otherwise, of penalty fees. The Report also examines the increasingly high level of penalty fees charged by Australian banks and outlines the disproportionate impact of penalty fees on low-income consumers.

Penalties at law

In Australia, it is a well established legal principle that a contractual term which requires one party to a contract to pay the other "innocent" party a sum of money upon a default or breach of the contract is enforceable only if it provides for payment of a sum of money that is a genuine pre-estimate of the loss or damage suffered by the innocent party. This is sometimes called a "liquidated damages" term.

However, such a term is to be distinguished from a "penalty" term, which seeks not to compensate the innocent party but to penalise the other party for the breach or default. Penalty terms are unenforceable at law.

The Report analyses the current state of Australian law with regard to the legal doctrine of penalties and concludes that a term will be considered to impose 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, including factors such as the relative bargaining position of the 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.

Further, the Report finds that whether a contractual term is a penalty is a question of substance, not form, therefore calling a penalty a "fee for a service" will not demonstrate that the term imposing this "fee" is not a penalty.

Are Australian banks charging consumers unenforceable penalty fees?

While Australian 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, as they assert, penalty fees are simply an exercise in cost recovery.

However, the Report concludes that, 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.

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*

The Report examines cheque and direct debit dishonour fees in detail as an example of penalty fees. It 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. These figures are similar to findings regarding dishonour fees in the United States. 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 Report examines the contractual relationship between Australian banks and their customers and finds that the relationship is characterised by unequal bargaining power and a lack of ability by 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.

Are penalty fees unfair contract terms?

The Report also considers the effect of Part 2B of the Victorian *Fair Trading Act 1999*, which declares unfair contract terms to be void, on cheque and direct debit dishonour fees. By causing a significant imbalance in the rights and obligations of the bank and the consumer to the detriment of the consumer, in circumstances in which the consumer cannot negotiate the term, terms imposing penalty fees may also be void in Victoria as unfair contract terms, in addition to being unenforceable as penalties at law.

How much profit do penalty fees generate for Australian banks?

If, as the Report concludes, penalty fees are disproportionately high in comparison with the loss suffered by a bank in processing a customer's breach or default, it follows that Australian banks must be generating substantial profits from the imposition of penalty fees.

The Report examines the publicly available information in relation to Australian bank fee income in order to estimate the profit generated by Australian banks in connection with penalty fees, but notes the paucity of publicly available information available regarding penalty fees.

Market failure - competition is not restraining penalty fees

Based on the material available, the Report finds that penalty fees contribute to significant margins of revenues over costs for Australian banks.

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 the wish to change bank account. They also have very little information about the real costs of penalty fees of their own bank and even less 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 the 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.

Who pays penalty fees?

A further problem with penalty fees is that their cost is not shared fairly amongst consumers. Not only are penalty fees unacceptably high, the Report demonstrates that penalty fees are disproportionately borne by those who can least afford to pay them, namely low-income consumers. Low-income consumers are often unable to avoid penalty fees and fee waivers offered to certain low-income consumers do not exclude penalty fees. Penalty fees can have a devastating impact on low-income consumers, contributing to on-going financial exclusion.

Addressing the problem of penalty fees

The difficulties posed by the lack of information regarding penalty fees makes it difficult to tackle the problem. For this reason, it is clear that the first steps that must be taken involve obtaining accurate and comprehensive data regarding penalty fees.

The Report calls for Australian banks to release, or be forced to release, data enabling the public to determine how much revenue and profit Australian banks generate from penalty fees each year. The RBA has the legislative power to force disclosure of this information if necessary and it should undertake a comprehensive study of penalty fees charged by Australian financial institutions and report its findings in detail to the Australian public.

Recommendations

Recommendation 1

Australian banks should release sufficient data to enable the Australian public to make an accurate assessment of the costs incurred by banks in processing customer defaults.

Recommendation 2

Australian banks should release disaggregated data which identifies the amount of fee income earned from penalty fees, from penalty fees on household and on business accounts, and from penalty fees in relation to household deposits and loans (including a disaggregation into the different types of loans - housing, personal and credit card).

Recommendation 3

The RBA should undertake a comprehensive study of penalty fees charged by Australian financial institutions, using its powers under the *Payments System (Regulation) Act 1998* (Cth) to obtain information if necessary, and should report its findings in detail to the Australian public.

Recommendation 4

Australian banks should offer a truly low-cost Basic Bank Account to low-income consumers that, in particular, does not levy excessive penalty fees on customers.

CHAPTER ONE – PENALTIES AT LAW

1.1 Key findings

A contractual 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, including factors such as the relative bargaining position of the 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.

A penalty is determined by the substance of the term, not the name or form of it.

1.2 Introduction

The emergence of phone banking, EFTPOS, ATMs and Internet banking in recent years has effected a significant change in the banking patterns of Australian consumers. Australian banks have actively promoted electronic banking services as low-fee options, rendering face-to-face assistance at the bank counter almost a thing of the past. Arguably, banks stand to make savings from these advances in technologies, yet there is little evidence to show that any of the savings presumably being made by the banks are actually being passed onto consumers. Indeed, consumers appear to be paying more than ever for the services provided by banks and bank fees are increasing, rather than decreasing, at a rapid rate.

This is particularly the case with regard to the fees – in some cases, as high as $50 - being charged by banks for customer defaults, such as cheque or direct debit dishonours. Anecdotal evidence suggests that banks may be seeking to punish customers for defaults, which raises the question of whether the fees being charged by banks in these circumstances are excessive and disproportionate to the loss, if any, suffered by the bank as a result of a customer default.

It is a well-established legal principle that a contractual clause providing for the forfeiture or payment of a specified sum of money upon breach of contract is valid and enforceable only if the amount provided for is a genuine pre-estimate of the loss likely to be suffered as a result of the breach of contract.[1] Chapter 1 examines this legal principle in detail. We apply the legal principles to an examination of the fees currently charged by banks for customer defaults, which we term "penalty fees", in Chapter 2.

1.3 The legal doctrine of penalties

A contract is an agreement between two parties to do or not do various things. Contracts may contain all sorts of terms, for example that a party provide a product or services, or that a party pay another party for a product or services.

One term that may be included in a contract is 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.

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[1] See, for example, *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359 (***O'Dea***); *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 (***AMEV-UDC***); *Esanda Finance Corporation v Plessnig* (1989) 166 CLR 131 (***Esanda***).

The legal principles regarding such clauses or terms are relatively well-established.[2] Such a term is valid if it provides for payment of a sum of money that is a genuine pre-estimate of the loss or damage suffered by the innocent party. However, according to the legal doctrine of penalties, such a clause is to be distinguished from a penalty clause, which seeks not to compensate the innocent party but to penalise the other party for the breach or default. Such penalties are unenforceable at law.

1.3.1 Recovery of loss upon a breach

Generally speaking, an innocent party can recover a loss suffered as a result of a breach through one of two ways. It may bring a general action for damages upon breach of contract against the other party. Alternatively, it may recover a sum of money under a clause in the contract that provides for the payment of "liquidated damages", that is a sum that reflects a genuine pre-estimate of the loss suffered, upon the breach.

Upon a breach of contract, the innocent party is entitled to recover the *actual loss* suffered by it as a result of the other party's breach, regardless of whether a clause providing for payment upon the breach is unenforceable as a penalty.[3] However, if the clause is a penalty, the innocent party cannot rely on the clause in recovering its actual loss.[4]

This is not to say that the innocent party must first prove the actual loss it has suffered before the court can determine whether a clause providing for payment upon the breach is a penalty. However, the inclusion of the clause in question must, at the time the contract was entered into, have been a genuine, good faith attempt to pre-estimate the loss or damages that would be suffered as a result of a breach, from the point of view of all parties.[5]

The courts have held that, if it is not possible to make an estimation in advance of the loss to be suffered upon a breach, a clause providing for payment upon the breach is less likely to be a penalty.[6] However, such a clause may still be a penalty, regardless of the subjective intentions of the parties, if the clause is unreasonable or unconscionable in comparison with the loss suffered.[7]

1.3.2 A question of substance, not form

The first principle in determining whether a clause stipulating the payment of a sum of money for a breach of contract is a penalty, is that it is a question 'not of words or of forms of speech, but of substance and of things'.[8]

In *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co. Ltd*[9] (***Dunlop***), Lord Dunedin stated:

> '[t]he question of whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach'.[10]

[2] See, for example, *O'Dea*, above n 1 at 368 per Gibbs CJ.
[3] See, for example, *AMEV-UDC*, above n 1 at 215 per Dawson J.
[4] As above at 192-193 per Mason and Wilson JJ; see also *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615 (***PC Developments***) at 645 per Clarke JA; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2004) 209 ALR 32 (***Ringrow***) at 60 per Conti and Crennan JJ.
[5] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co. Ltd* [1915] AC 79 (***Dunlop***) at 97 per Lord Parker; *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 (***Clydebank***) at 17 per Lord Davey; *Esanda*, above n 1 at 142 per Wilson and Toohey JJ.
[6] *Dunlop*, above n 5 at 88 per Lord Dunedin; at 95-96 per Lord Atkinson.
[7] *O'Dea*, above n 1 at 400 per Deane J.
[8] *Clydebank*, above n 5 at 15 per Lord Davey; see also *Campbell Discount Co. Ltd v Bridge* [1962] AC 600 at 624 per Lord Radcliffe.
[9] *Dunlop*, above n 5.

Similarly, Deane J in *O'Dea v Allstates Leasing System (WA) Pty Ltd*[11] (***O'Dea***) agreed, adding that 'whether or not a provision of a contract imposes a penalty must be determined by reference to the true operation of that provision'.[12] In essence, the courts have made it clear that, just because a term for the payment of money is called a "fee", this does not demonstrate that the term is not, at law, a penalty. A penalty is determined by the substance of the term, not the name or form of it.

1.3.3 Distinguishing between liquidated damages and a penalty

Elizabeth Lanyon identifies a divergence of interpretation of the law relating to penalty clauses, resulting in two main approaches being taken by the courts to identifying penalty clauses – the "mechanical approach" and the "unconscionability approach".[13]

In *Dunlop*, Lord Dunedin drew a distinction between a clause which is penal and one which provides for a "genuine pre-estimate" of loss by way of liquidated damages. He did so in the following terms:

> '[i]t will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach'[14]

Consequently, a penalty is a sum stipulated as being 'in terrorem' of the defendant;[15] in other words, a penalty clause is one that not merely compensates a party for a breach of contract, but penalises the other party for the breach.

The approach taken by Lord Dunedin in *Dunlop* might be termed a "mechanical approach", in the sense that it does not take into consideration notions of fairness, but instead looks only at whether the amount to be paid under the clause by the party in breach is greater than the maximum amount that could be obtained by the innocent party for the breach of contract, if the innocent party sued for damages for breach of contract. [16]

Lanyon describes this approach as follows:

> '[the Court] assesses the common law damages which could be expected to flow from the breaches which trigger the allegedly penal clause. The assessment is hypothetical because the clause must be judged by reference to matters apparent at the time the contract was entered into and not in the light of subsequent events. If the amount set out in the clause exceeds the theoretical damages then the stipulation is a penalty.'[17]

A strict mechanical approach would therefore simply analyse whether the sum of money to be paid under the clause is in excess of the maximum amount of damages which could be obtained.[18] If it is, the clause is a penalty.

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[10] As above at 86-87.
[11] *O'Dea*, above n 1.
[12] As above at 400; see also *Ringrow*, above n 4 at 44 per Beaumont J and at 60 per Conti and Crennan JJ.
[13] Elizabeth Lanyon, 'Equity and the Doctrine of Penalties' (1996) 9 *Journal of Contract Law* 234 at 237; see also *PC Developments*, above n 4 at 650 per Meagher JA.
[14] *Dunlop*, above n 5 at 86-87.
[15] As above at 86.
[16] See *PC Developments*, above n 4 at 650 per Meagher JA; Lanyon, 'Equity and the Doctrine of Penalties', above n 13 at 238.
[17] Lanyon, 'Equity and the Doctrine of Penalties', above n 13 at 238.
[18] *PC Developments*, above n 4 at 650 per Meagher JA, citing Mason J in *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507 at 519 and *Citicorp v Australia Ltd v Hendry* (1985) 4 NSWLR 1 (***Citicorp***).

Generally, however, courts recognise the principle of "freedom of contract", namely that parties are free to enter into a contract of whatever terms and conditions they choose. As a consequence, the courts have been reluctant to interfere with a contract, such as by striking out a clause as a penalty. For example, in *AMEV-UDC Finance Ltd v Austin*[19] (***AMEV-UDC***), the High Court of Australia demonstrated an appreciation of the importance of allowing parties to a contract to determine the terms of their contract.[20]

This perspective has led the courts away from a strict mechanical approach as to whether a clause that provides for a payment of a sum that is in excess of a genuine pre-estimate of loss, is a penalty. In order to justify the interference with the contract, the courts have tended to prefer an approach that examines not only whether the sum to be paid is higher than a genuine pre-estimate of loss, but whether it is "out of all proportion" or "unconscionable" in comparison with the loss or damage suffered.[21]

Indeed, Lord Dunedin in *Dunlop* did not simply state that a clause is a penalty if the sum stipulated for is greater than the greatest loss that could be proved to have followed from the breach. Rather, he held that it will be a penalty if the sum stipulated for is *extravagant and unconscionable* in amount in comparison with the greatest loss that could be proved to have followed from the breach.

As Lanyon states, this emphasis on the "unconscionability" of the amount to be paid has led the courts to develop a different approach with, potentially, an equitable discretion in identifying penalties.[22]

1.3.4 The unconscionability approach

Lord Dunedin's analysis in *Dunlop*, while above termed a "mechanical approach", might rather be termed an "unconscionability approach" to identifying penalties. This is because Lord Dunedin had regard to whether the amount to be paid was extravagant or unconscionable.

In the leading Australian penalties case of *O'Dea*[23], the High Court's judgment reflected both the mechanical approach and the unconscionability approach.

In *O'Dea*, Gibbs CJ cited Lord Dunedin's judgment in *Dunlop* with approval, concluding that in circumstances where an agreement is terminated by reason of a breach committed by one party, the sum payable by that party will be a penalty unless it is a genuine pre-estimate of the loss suffered by the other party by reason of the breach.[24]

However, Murphy J observed that penalties 'are a trap for an unwary or unfortunate lessee. They are unenforceable because, by modern standards, they are *unconscionably harsh*' [our emphasis].[25] Deane J held that, even if the parties genuinely intend that a clause provide for a pre-estimate of damages in the event of breach, the clause will still be a penalty if the pre-estimate is either *extravagant and unconscionable* in amount…or…*unreasonable* in the burden which it imposes in the circumstances which have arisen [our emphasis].[26] In other words, it is not the amount of the payment provided for alone that makes a clause a penalty, it is the fact that the payment is not compensatory (a genuine pre-estimate of loss) but rather is unreasonable and harsh in nature, with the effect of *punishing* a party for the breach.

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[19] *AMEV-UDC*, above n 1.
[20] As above at 193 per Mason and Wilson JJ.
[21] See, for example, *Esanda*, above n 1 at 141 per Wilson and Toohey JJ.
[22] Lanyon, 'Equity and the Doctrine of Penalties', above n 13 at 239.
[23] *O'Dea*, above n 1.
[24] As above at 368.
[25] As above at 375.
[26] As above at 400.

The unconscionability approach to identifying a penalty has developed further in subsequent Australian cases. Australian courts have become more willing to characterise a clause as a penalty if the clause is, *in all the circumstances*, unconscionable, having regard both to whether the amount to be paid is extravagant given the loss or damage suffered by the innocent (non-breaching) party, *and* to other factors.

For example, in *Citicorp Australia Ltd v Hendry*[27] (***Citicorp***), Kirby P (as he then was) stated that, although the law on penalties did not yet provide authority for it, the courts should be free to develop a 'more sensitive and discriminating principle' by which courts would be able to 'pay regard to the relative bargaining positions of the parties'.[28] Kirby P added that it 'would be no misfortune if the High Court of Australia were to take an early opportunity to reconsider this body of law'.[29]

The High Court did just that shortly afterwards. In *AMEV-UDC*, the leading judgment of Mason and Wilson JJ (as Mason J then was) applied an "unconscionability approach" to determine whether the clause in question was a penalty. Mason and Wilson JJ stated that courts should not strike down a term simply because it provides for payment of an amount that might exceed the amount of damages a party could obtain at general law; parties are free to agree on such terms, which may be mutually beneficial, for example by allowing the parties to avoid costly litigation. Rather, a penalty clause was one that was *unconscionably* or oppressively harsh.

Mason and Wilson JJ held that whether a term is a penalty is a question of *degree*.[30] They stated that this question will depend on a number of circumstances, explicitly identifying two important factors:

1. 'the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant'; and
2. 'the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term.'[31]

In fact, in *AMEV-UDC* Mason and Wilson JJ then went so far as to state that:

> '…the doctrine of penalties answers…an important aspect of the criticism often levelled against unqualified freedom of contract, namely the possible inequality of bargaining power. In this way the courts strike a balance between the competing interests of freedom of contract and protection of weak contracting parties'.[32]

In other words, in addition to examining whether the amount to be paid is extravagant or oppressive given the loss or damage suffered by the innocent party, Mason and Wilson JJ also thought that the nature of the relationship between the parties was a relevant factor in determining whether a clause is a penalty.

This application by Mason and Wilson JJ of the concept of unconscionability accords to some degree with the general equitable concept of unconscionability, the leading case on which is *Commercial Bank of Australia v Amadio*[33] (***Amadio***).[34] In *Amadio*, the High Court indicated that, as Mason and Wilson JJ's judgment in *AMEV-UDC* later also identified, the question of unconscionability will

[27] *Citicorp*, above n 18.
[28] As above at 23.
[29] As above.
[30] *AMEV-UDC*, above n 1 at 193.
[31] As above.
[32] As above at 194.
[33] *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447 (***Amadio***).
[34] Cf Lanyon, 'Equity and the Doctrine of Penalties', above n 13 at 247-249.

include an examination of the relationship between the contracting parties, including any unequal bargaining power between the parties.[35]

Subsequent cases have followed this approach in determining whether a term is a penalty. Wilson and Toohey JJ clarified in *Esanda Finance Corporation Ltd v Plessnig*,[36] that the mere possibility of unfairness is not sufficient to characterise a clause as a penalty.[37] However, Wilson and Toohey JJ did confirm that 'the character of a clause as penal or compensatory is a matter of degree depending on all the circumstances, including the nature of the subject-matter of the agreement.'[38] They also reiterated that 'the payment of an agreed sum is a penalty only if it is "out of all proportion" or "extravagant, exorbitant or unconscionable";[39] they emphasised this point as they felt that the lower court's judgment had placed 'too much emphasis on the superior bargaining position' of one of the parties.[40] In doing so, Wilson and Toohey JJ did not state that it was wrong to take the relative bargaining positions of the parties into account. Rather, it appears that Wilson and Toohey JJ agreed this was a relevant factor, albeit not the only factor to take into account.

In the case of *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd*[41], Clarke JA applied Mason and Wilson JJ's judgment in *AMEV-UDC*, holding that it struck a fair balance between freedom of contract principles and 'the public interest…in a protecting a weaker party from oppressive burdens or the unconscientious use of power by a stronger party'.[42] Mahoney JA explicitly rejected the mechanical approach in *PC Developments Pty Ltd v Revell*.[43] Instead, Mahoney JA also referred to Mason and Wilson JJ's judgment in *AMEV-UDC* and took into account negotiations and agreement between the parties regarding the clause in question.[44] He did so as he held that this was 'relevant in considering, for example, the "relationship" between the parties [and] the context – commercial or otherwise – in which the provision was adopted'.[45]

In *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd*,[46] Cole J also agreed with the above approach and added:

> '[t]here is, in my view, a qualitative difference of which the law is able to take account between a clause freely negotiated between major commercial organisations, in respect of a substantial contract, where the major commercial organisations have available and receive competent legal advice regarding the meaning, purpose and likely consequence of the clause, from a clause attacked as a penalty in a contract of adhesion between a major organisation and an individual or small company who has, in reality, no opportunity to negotiate the contract.'[47]

Cole J continued by explaining that:

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[35] *Amadio*, above n 33 at 459 per Gibbs CJ; 460, 463-464 per Mason J; 479 per Deane J.
[36] *Esanda*, above n 1.
[37] As above at 141-142.
[38] As above at 142.
[39] As above at 141.
[40] As above at 141.
[41] *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564 (***AMEV Finance***).
[42] As above at 577.
[43] *PC Developments*, above n 4 at 628.
[44] As above at 629 to 631.
[45] As above at 631; see also at 647-8 per Clarke JA; contra Meagher JA at 651-652; see also *Deputy Commissioner of Taxation of the Commonwealth of Australia v Advanced Communications Technologies (Australia) Pty Ltd* [2003] VSC 487 (unreported) at ¶147 per Healey J, who took into account the negotiations between the parties when determining whether a particular contractual provision was a penalty, noting that 'acting through lawyers, and upon their advice, the sale deed was freely and voluntarily negotiated and agreed. There was no mistake, no equitable fraud, no undue influence, no surprise, or any other factor relevant to unconscionability.'
[46] *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504.
[47] As above at 513.

> '[t]hat is not to say that the latter form of contract containing such a clause would be struck down: it is rather to recognise that, quite apart from whether the clause fails because it lacks a compensatory character, it may also fail as being penally imposed in circumstances rendering enforcement of the clause unconscionable. The degree of contractual freedom afforded to parties to determine a measure of damages departing from strict compensation will, in my view, be affected by those matters constituting aspects of the relationship between the parties…to which I have referred.'[48]

The matters constituting aspects of the relationship between the parties to which Cole J referred, and which he considered affected whether the court should interfere in the contractual freedom of the parties to strike down a clause as a penalty, included:

- The relationship between the parties at the time of the contract;
- The genesis of the clause;
- Discussions concerning the clause;
- The bargaining position of the parties;
- Whether each party was fully advised; and
- Whether the party claiming that the clause is ineffective as a penalty appreciated the likely imposition under the clause at the time of the contract yet nonetheless agreed to the clause because the contract was perceived to be beneficial to them notwithstanding the existence of the clause.[49]

Cole J's statements are in tune with Mason J's earlier comments in *Amadio*, that an examination of any unconscionability may include an inquiry as to whether one party has entered into a standard form contract dictated by another party whose bargaining power is greatly superior.[50] They also accord with Kirby P's comment in *Citicorp* that, were the law on penalties improved by taking into account the relative bargaining position of the parties:

> '…the endeavour by a finance house, in a printed form, to impose conditions for breach upon a consumer borrowing a small sum, without the benefit of legal advice, would be treated differently to a commercial enterprise borrowing large sums for a business venture upon which it has the advantage of legal advice.'[51]

These statements also recall Lord Denning's comments in the earlier case of *Campbell Discount Co. Ltd v Bridge*[52] that:

> '[i]s not this, then, a classic case for equity to intervene? The contract is contained in a printed form. Not one hirer in a thousand reads it, let alone understands it. He takes it on trust and signs it. It is binding at law but when it comes to be examined it is found to contain a penalty which is oppressive and unjust. It seems to me that such a case comes within the very first principles on which equity intervenes to grant relief.'[53]

1.3.5 Bank customers and banks

The unequal bargaining position of a bank vis-à-vis a consumer, particularly a low-income consumer is clear. A bank customer applying for a transaction account, cheque account or credit card account is not able to negotiate the terms and conditions of the account, rather they are presented with the bank's standard terms and conditions for the product in question. In fact, consumers may find it difficult to obtain a copy of a standard terms and conditions for a product or service until after the consumer has actually applied for, or obtained, the particular product or service.

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[48] As above.
[49] As above; Cole J's judgment is approved by Rolfe J in *CFA Group v Mars Trading* [2001] NSWSC 112 (unreported) at § 71-74.
[50] *Amadio*, above n 33 at 462 per Mason J.
[51] *Citicorp*, above n 18 at 23; see also *AMEV Finance*, above n 41 at 577 per Clarke JA.
[52] *Campbell Discount Co. Ltd v Bridge*, above n 8.
[53] As above at 629.

Given the nature of the relationship between banks and their customers, and the nature of contracts between them, a term in such a contract stipulating that the customer pay a large fee to the bank for a default under the contract clearly has the potential to be a penalty. Chapter 2 explores this in detail.

This does not mean that a bank is not entitled to recover the *actual loss* suffered by it as a result of a customer's default. However, if the term imposing the fee is a penalty, the bank cannot rely on the term to recover its actual loss caused by the customer's default.

1.4 Conclusion

Australian law holds that 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, including factors such as the relative bargaining position of the 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'.[54] 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.

[54] *Clydebank*, above n 5 at 15 per Lord Davey.

CHAPTER TWO – PENALTY FEES CHARGED BY AUSTRALIAN BANKS

2.1 Key findings

- We estimate that Australian banks could be charging between 5 to 16 times what it costs them to process a cheque dishonour.
- We estimate that Australian banks could be charging between 64 to 92 times what it costs them to process a direct debit dishonour.
- Cheque and direct debit dishonour fees charged by Australian banks are out of all proportion and extravagant, exorbitant and unconscionable in comparison with the cost incurred by Australian banks in processing cheque and direct debit dishonours.

- Consumers do not have any effective practical options to negotiate or shop around for a better deal from the banks.
- Consumers need a bank account to receive salary or welfare payments.
- Banks do not provide adequate disclosure of fees, particularly dishonour fees, making it difficult for consumers to compare products.
- Dishonour fees continue to rise, indicating market failure.

- Cheque and direct debit dishonour fees are penalties at law. If Australian banks continue to assert that dishonour fees are enforceable as liquidated damages, they should release the data that proves this to Australian consumers.
- In Victoria, cheque and direct debit dishonour fees may also be void as unfair under Part 2B of the *Fair Trading Act 1999* (Vic).

2.2 Introduction

In the previous Chapter, we discussed the way in which the law distinguishes between a clause that provides, upon a breach of a contract, for payment of a sum of money as a genuine pre-estimate of loss suffered and a clause that, upon a breach of a contract, provides for a penalty to be paid. Penalties are, at law, unenforceable. This Chapter analyses current Australian bank fees in light of the legal principles that hold penalties unenforceable. In particular, we examine cheque and direct debit dishonour fees as an example of penalty fees charged by banks.

It is important to note at the outset that a lack of transparency on the part of many banks makes it difficult to assess whether certain fees charged by banks, which we term "penalty fees", are, in fact, penalties at law. Conversely, however, it also makes it difficult for the banks to assert that the penalty fees they charge are *not* penalties at law, given their failure to demonstrate what the genuine loss suffered by them is when a penalty fee is levied.

2.3 Current penalty fees charged by Australian banks

Australian banks charge many different fees in relation to the various products and services they offer. This Report focuses on what we call "penalty fees". We consider penalty fees to be any fee charged to a customer by a bank for the customer breaching, or defaulting in some way on, their contract with the bank.

Such defaults by a customer include overdrawing an account, not paying a credit card minimum payment by the specified due date, having a cheque presented by a third party against the customer's account without the customer having sufficient funds available in their account to honour the cheque or, similarly, having a direct debit payment processed in favour of a third party without the customer having sufficient funds available in their account to honour the payment.

Monthly account service fees and transaction fees, for example ATM, EFTPOS or Internet withdrawal or transfer fees, are not considered by us to be penalty fees. As such, while much has been written about these sorts of bank fees, they are not the subject of this Report.

In particular, we consider penalty fees to include:

Table 1 – Penalty Fees

Fee	Description
Cheque Dishonour* or Cheque Dishonour – Outbound	Charged by the bank when the customer writes a cheque and, at the time the cheque is presented for payment and processed, the customer does not have sufficient funds in their account to satisfy the amount of the cheque; consequently, the cheque is dishonoured.
Deposited Cheque Dishonour or Cheque Dishonour - Inbound	Charged by the bank when the customer presents a cheque for deposit into their account and the cheque is subsequently dishonoured by the drawer's bank.
Stop Cheque	Charged by the bank to stop payment on a cheque that the customer has already signed.
Periodic Payment Dishonour*	Charged by the bank when the customer has authorised their bank to make an electronic transfer of funds from their account to a third party's account and, at the time the payment is processed, the customer does not have sufficient funds in their account to satisfy the amount of the payment; consequently, the payment is dishonoured.
Direct Debit Dishonour*	Charged by the bank when the customer has authorised a third party to take an electronic transfer of funds from their account to the third party's account and, at the time the payment is processed, the customer does not have sufficient funds in their account to satisfy the amount of the payment; consequently, the payment is dishonoured.
Honour or Account Overdrawing (where no approved overdraft facility or facility is exceeded)	Charged by the bank when the customer writes a cheque or authorises an electronic transfer of funds from their account to a third party's account and, at the time the payment is processed, the customer does not have sufficient funds in their account to satisfy the amount of the payment, however the payment is nevertheless honoured by the bank and the account is overdrawn.

Fee	Description
Credit Card Late Payment	Charged by the bank when the customer fails to make payment of the minimum monthly payment due on their credit card account's outstanding balance by the due date for the minimum monthly payment.
Credit Card Over Limit	Charged by the bank when the amount that the customer spends on their credit card exceeds the customer's credit card account maximum limit.

* Some banks have only one "Dishonour Fee" that applies to cheque and electronic transfer dishonours, while other banks have different fees for cheque, direct debit and/or periodic payment dishonours.

The fees in Table 1 are all payable upon a default of some sort by the customer. This distinguishes penalty fees from other fees such as transaction fees, monthly account service fees, the annual card fee on a credit card account or the provision of a replacement card or duplicate account statement. These other fees are imposed as a fee for a product or service provided by the bank. Penalty fees, on the other hand, are only imposed if a customer "defaults" on their agreement with the bank.

For example, NAB's *A Guide to Fees and Charges: Personal Banking Fees* states that a fee is payable for a periodic payment not made due to lack of funds[55] or for a cheque dishonoured due to lack of funds.[56] St George's *Bank Accounts: Fees and Charges and How to Minimise Them* states that a Payment Honour Fee is a fee for each transaction that overdraws a customer's account or increases the amount already overdrawn[57] (when there is no previously agreed overdraft facility). Westpac's Product Disclosure Statement for its personal deposit accounts states that the customer should not make a withdrawal transaction which takes their account into negative/debit balance and provides for an Account Overdrawn Fee to be payable if this does occur.[58] ANZ's *ANZ Personal Banking Account Fees and Charges* states that a Late Payment Fee is charged on a customer's credit card account if the "Monthly Payment" plus any "Amount Due Immediately" shown on the statement of account is not paid within 28 days of the statement date.[59]

The amounts charged by various Australian banks for the fees detailed in Table 1 are set out in Appendix A.

2.4 The use of cheques and direct debits in Australia

Below, we examine cheque and direct debit dishonour fees as an example of penalty fees charged by Australian banks. Before analysing the fees charged upon the dishonour of cheques and direct debit payments, it is useful to place the discussion within context, namely by setting out current usage levels for these payment methods in Australia.

Australian consumers traditionally have been keen users of cheques for non-cash payments. However, the number of cheques written annually in Australia has fallen by 29% over the last five years, from 3.1 million cheques per business day in 2000 to only 2.2 million cheques per business day in 2004.[60] The value of these cheques has fallen by 27%, from $9.7 billion per business day in 2000 to only $7.1 billion in 2004.[61]

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[55] NAB, *A Guide to Fees and Charges: Personal Banking Fees*, 13 September 2004 at 18.
[56] As above.
[57] St George, *Bank Accounts: Fees and Charges and How to Minimise Them*, 30 August 2004 at 29.
[58] Westpac, *Deposit Accounts: For Personal Customers: Product Disclosure Statement – incorporating Terms and Conditions for using your account*, 4 October 2004 at 48-49.
[59] ANZ, *ANZ Personal Banking Account Fees and Charges*, November 2004 at 9.
[60] APCA, *Annual Report 2004: Opening Doors* at 20.
[61] As above.

This fall in cheque usage has coincided with the advent and popularity of new technologies such as ATMs, Internet banking, EFTPOS and direct entry payments. The number of direct entry credits (for example, direct electronic payments such as salaries) has increased from 2.3 million per business day in 2000 to 3.2 million per business day in 2004, an increase of 39%.[62] In the same period, the number of direct entry debits (for example, direct debit payments such as monthly insurance payments) has increased by 66%, from only 900,000 per business day in 2000 to 1.5 million per business day in 2004.[63] The value of direct entry credits over this period has more than doubled, from $6.5 billion per business day in 2000 to $13.7 billion in 2004.[64] The value of direct entry debits has also more than doubled, from $5 billion per business day in 2000 to $10.5 billion in 2004.[65] The use of ATMs and EFTPOS transactions has also increased considerably.[66]

Despite its fall in popularity, the cheque clearly remains a popular payment option for many consumers. In 2003, cheques accounted for $2010.517 billion in transaction value, compared with $2601.236 billion for direct debits and $141.788 billion in credit and charge card transactions.[67] From 1 January 2004 to 30 September 2004, 395.5 million cheque payments have been made, compared with 330.012 million direct debit payments.[68] This may be for several reasons. For example, cheques are a convenient way to make unplanned or *ad hoc* payments. In addition, cheques provide a convenient way to maintain a record of payments made. Cheques also remove the need to keep large amounts of cash on hand (although direct debits also do this).

These figures demonstrate that, although the number of direct debit payments being made is still less than the number of cheque payments being made, the value of these direct debit transactions now exceeds that of cheque payment transactions. The number and value of direct credit payments also exceeds that of cheques.[69] The RBA stated in July 2003 that, although 'the most important payment systems for consumers and businesses in Australia…are the electronic direct entry system and the familiar paper cheque', the cheque's importance has fallen over the past two decades from over 85% to less than 30% of the value of non-cash payments made in Australia.[70] The RBA now states on its website that '[a]lthough over 2 million cheques are still written each business day, they account for just 5 per cent of the value of non-cash payments'.[71]

Notwithstanding these trends, Australia has seen low levels of usage of direct debit payments relative to other comparable countries.[72] The RBA website states that 'there has been a traditional reluctance on the part of consumers to use direct debits for bill payments. This appears to be disappearing with

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[62] As above.
[63] As above.
[64] As above.
[65] As above.
[66] As above.
[67] RBA, *Bulletin Statistical Table C3 – Cheques and Direct Entry Payments*, www.rba.gov.au and RBA, *Bulletin Statistical Table C1 – Credit and Charge Card Statistics*, www.rba.gov.au. Cf. APCA, *Annual Report 2004: Opening Doors*, above n 60, and APCA website at www.apca.com.au – Payments Information - Payment Statistics, which have different figures for the month APCA counted payments (May). We asked APCA if it could provide an explanation of why there were differences, however it did not answer our inquiry, despite several requests. This highlights the difficulties of obtaining information in this area.
[68] As above.
[69] As above.
[70] RBA, 'The Changing Australian Retail Payments Landscape', *Reserve Bank of Australia Bulletin*, July 2003 at 1-2.
[71] RBA website at http://www.rba.gov.au/PaymentsSystem/AustralianPaymentsSystem/about_the_australian_payments_system.html, accessed 25 November 2004.
[72] RBA, 'The Changing Australian Retail Payments Landscape', above n 70, at 3 - Table 1; Bank for International Settlements, Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries, *Retail Payments In Selected Countries: A Comparative Study*, September 1999 (**BIS Comparative Study**) at 9, Chart 4 at 22, Chart 9 at 25-27.

direct debit payments growing strongly in recent years'.[73] Clearly, while the direct debit facility is gradually becoming more popular among Australian banking consumers, it has yet to be fully embraced. This is especially so when one considers that higher transaction fees have traditionally been charged for the use of cheques than for direct debit transactions, providing yet greater incentive to use direct debits rather than cheques.[74]

In his review of the Code of Banking Practice, Richard Viney concluded that the present direct debit scheme 'is not user friendly'.[75] Furthermore, his research found that there were:

> '…serious flaws from the customers' perspective which need addressing. In devising the scheme the priorities appear to have been "efficiencies" from the viewpoint of all parties except the consumers.'[76]

Problems arising from public distrust of the direct debit system, and the need to promote direct debit as a cheap and efficient alternative to cash and cheque payments, were noted by the Assistant Governor (Financial Systems) of the RBA in 1999:

> '[o]ur research confirms that direct debits are the most economical way of paying routine bills…While all major countries are embracing this means of payment more and more, Australia is moving backwards. Australian consumers appear reluctant to utilise direct debit because they fear a lack of control over the payment, or because they may face large penalties on deposit accounts for dishonour due to lack of funds. Other countries have found imaginative ways of enhancing the attractiveness of direct debit and are actively promoting the instrument. Australia could do much better.'[77]

The RBA has encouraged financial institutions to offer a more attractive direct debit product in light of the reluctance felt by consumers in using direct debit payments. As implied by the Assistant Governor (Financial Systems), if consumers are to be encouraged to trust direct debit facilities, attention must be paid to current, and continually increasing, dishonour fees.

2.5 Are penalty fees penalties at law?

This section examines cheque and direct debit dishonour fees as an example of penalty fees charged by banks. We analyse whether they may, in fact, be penalties at law. If so, they would be unenforceable by banks against consumers (see Chapter 1).

2.5.1 The customer's contract with their bank

A customer enters into a contract with a bank when they open an account with a cheque and/or direct debit facility. With respect to either a cheque or a direct debit facility, the customer effectively agrees to ensure that they will have enough funds in the account to satisfy a cheque or direct debit payment when it is presented by, or processed in favour of, a third party.

If the customer does not have sufficient funds in the account at the time a cheque is presented or a direct debit payment is processed, the bank subsequently charges the customer a fee based on this breach of the contract by the customer - the rationale being, presumably, that the bank considers the

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[73] RBA website, above n 71.
[74] See, for example, NAB, *A Guide to Fees and Charges: Personal Banking Fees*, above n 55 at 6, 9-13; Bendigo Bank, *Schedule of Fees, Charges and Transaction Account Rebates* at 13; Westpac, *Deposit Accounts: For Personal Customers: Product Disclosure Statement – incorporating Terms and Conditions for using your account*, above n 58 at 24; see also RBA, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, May 2004 at 59 - Table 3.
[75] Richard Viney, *Review of the Code of Banking Practice Issues Paper*, February 2001 at 76.
[76] As above at 77.
[77] Dr J.F. Laker, 'The Role of the Payments System Board', *Reserve Bank of Australia Bulletin*, July 1999 at 13-14.

dishonour fee to be liquidated damages payable by the customer for the cheque or direct debit dishonour. Similarly, the bank may honour the cheque or direct debit payment and overdraw the customer's account instead, charging a fee for this breach of the contract by the customer in not having sufficient positive funds in the account to satisfy the payment themselves.

If dishonour fees represent a genuine pre-estimate of the loss incurred by a bank when a customer defaults on a payment, they will be enforceable as liquidated damages. However, if dishonour fees are not, in all the circumstances, compensatory in nature, but instead are intended to penalise a customer for their default, dishonour fees will be penalties at law. In particular, applying the approach formulated by the courts discussed in Chapter 1, if:

- the dishonour fee is out of all proportion or extravagant, exorbitant or unconscionable in comparison with the loss incurred by the bank in processing the dishonour; and/or
- the bank is in a significantly stronger bargaining position than the customer at the time of opening the account, particularly with regard to the negotiation of the term providing for the dishonour fee to be payable, and/or there exist other factors characterising the relationship between the bank and the customer, such that it would be unconscionable for the bank to enforce the term,

the dishonour fee will, in fact, be a penalty at law and, therefore, unenforceable against the customer.

As it is a question of substance and not form, the fact that banks describe penalty fees as "fees" for "services" does not demonstrate that they are not penalties.

2.5.2 The cost of cheque and direct debit dishonours to the banks

The first step in attempting to determine whether a dishonour fee should properly be considered as a penalty or liquidated damages is to examine it against the cost to the bank in processing a dishonour. This assists in determining whether the fee is a genuine attempt to pre-estimate the loss suffered by the bank when a cheque or direct debit is dishonoured, or whether it in fact punishes a customer for a cheque or direct debit dishonour, being unreasonable or unconscionably harsh in comparison with the cost incurred.

Failure by the banks to disclose the true cost of dishonours

We are unable to undertake an accurate analysis of the cost to banks in processing dishonours. There is no publicly available information regarding the costs Australian banks incur in processing cheque or direct debit dishonours. There is also no publicly available information regarding the total amount of fee income Australian banks receive from dishonour fees each year. In fact, there is not even any publicly available information regarding the number of cheques or direct debits that are dishonoured in Australia each year.

The Final Report of the Financial System Inquiry (the "Wallis Committee") in March 1997 (the **Wallis Report**)[78] noted that:

> '…comprehensive data on the costs and efficiency of the payments system are not publicly available in Australia. This reflects both the structure of the Australian payments system and the absence of a transparent framework against which to benchmark costs and efficiency.'[79]

Even PricewaterhouseCoopers, in its "Survey of retail banking fees – an independent analysis", stated that detailed information was not available,[80] despite the fact that its report was commissioned

[78] Financial System Inquiry (the "Wallis Committee"), *Financial System Inquiry Final Report*, March 1997 (the **Wallis Report**).
[79] As above at 223.

by the ABA and was based on data provided by the ABA as sourced from the ABA's member banks. PricewaterhouseCoopers acknowledged that its analysis was constrained because of data limitations, including that 'information separating transaction fees from penalty fees is not available'.[81] The absence of relevant data is discussed further in Chapter 3.

However, the Wallis Report did estimate that the cost of cheque processing was $1.50 to $3.00 per cheque.[82] The Wallis Report is discussed later in this Chapter.

It is interesting to note that, in their joint report into interchange fees and access in relation to Australian debit and credit card payment networks (the **Interchange Fees Report**),[83] the RBA and the ACCC also observed that 'interchange fees are not transparent' despite their importance for efficiency and competition in the retail payments system.[84] Although interchange fees were ultimately passed through to and borne by merchants and cardholders, not financial institutions, only the financial institutions knew the amounts of interchange fees.[85] The Interchange Fee Report noted that the lack of transparency made it difficult to assess the implications of interchange fees and, as a result, the objectives of the study included to:

- 'obtain information on interchange fees'; and
- 'clarify the basis on which interchange fees are set, looking particularly at the role of costs'.[86]

The Interchange Fees Report is discussed in more detail below.

The Interchange Fees Report

As there is not much publicly available information regarding cheque and direct debit dishonour fees, it is useful to turn to a brief examination of interchange fees as an example of bank fees that were not transparent but have been carefully scrutinised in the last few years and have subsequently been the subject of extensive reforms.

In October 2000, the RBA and the ACCC released the Interchange Fees Report.[87] Interchange fees:

> '…are "wholesale" fees, which are paid between financial institutions when customers of one institution are provided with card services by another financial institution. Customers do not see these fees directly but the fees affect the incentives [to use one payment instrument over another] they face.'[88]

Interchange fees are paid for the use of ATM, credit and debit card payment networks. They are not paid when a customer makes a payment by cheque, direct credit or direct debit; in the case of these payment options, the consumer is (or is not) charged directly by the bank for their use.

The analysis undertaken in the Interchange Fees Report is of interest in an examination of dishonour fees, as the aim of the Interchange Fees Report was to examine whether interchange fees were encouraging efficient provision of debit and credit card services.[89] As discussed above, another aim was to obtain information regarding interchange fees and cost data, as this information was, before

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[80] PricewaterhouseCoopers, *Survey of retail banking fees – an independent analysis*, April 2003 at 2.
[81] As above at 8.
[82] Wallis Report, above n 78 at 227.
[83] RBA and ACCC, '*Debit and Credit Card Schemes in Australia. A study of interchange fees and access',* Joint Report, October 2000 (the **Interchange Fees Report**).
[84] As above at 1.
[85] As above.
[86] As above at 4.
[87] Above n 83.
[88] As above at i.
[89] As above at 4.

the Interchange Fees Report, unavailable other than to participating financial institutions. Indeed, in some instances the RBA found it difficult to obtain.[90]

The Interchange Fees Report stated that an interchange fee regime should meet two broad tests:

> '[i]nterchange fees should:
>
> - not overcompensate financial institutions for the costs that they incur; and
> - be subject to regular review as costs and other conditions in the relevant payment network change.'[91]

The Interchange Fees Report concluded that the interchange fee regime in Australia did *not* meet these two tests. Instead, interchange fees in the ATM, credit card and debit card networks provided, or contributed to, revenues above the average cost of the relevant service, particularly in the ATM and credit card networks.[92]

In other words, interchange fees did not represent cost recovery by the banks, but instead provided the banks with another revenue stream. In the case of ATM services, interchange fees were around *double the average cost* of providing ATM services and were passed on fully or *more than fully* to consumers.[93]

The Interchange Fees Report also concluded that interchange fees were not regularly reviewed, despite significant changes in the underlying costs of the payment networks.[94] This was largely due to a lack of competitive pressure on the financial institutions to review interchange fees, given that the fees are set 'at one step removed' from those who ultimately bear the fees, namely merchants and consumers, and that the fees are a significant revenue source for the financial institutions, particularly the larger banks.[95] Connelly and Hajaj also remark that the Interchange Fees Report found that 'the current system of fees and charges does not properly betray the real cost of the provision.'[96]

Following the comprehensive analysis of interchange fees conducted in the Interchange Fees Report, the RBA has implemented extensive reforms to credit card schemes and is embarking on reforms to the EFTPOS debit card payment system, as well as continuing to monitor voluntary reform to the ATM system by the ATM industry.[97]

Dishonour fees charged by banks should also meet the two broad tests set by the Interchange Fees Report for interchange fees. However, this is not only for the reason that overly high dishonour fees may distort the use of cheque and direct debit payments, for example, because consumers fear negative consequences from using these payment methods. It is also because, unlike interchange fees, which are fees for services, dishonour fees are payable upon a default by the consumer. This means that if the dishonour fees overcompensate a bank for the costs the bank incurs in processing dishonours, they are too high in comparison with the loss suffered by the bank and may therefore be penalties at law. In addition, if they are not subject to regular review as underlying costs and other conditions change, the dishonour fees cannot be a genuine attempt by a bank to pre-estimate its loss and, again, may therefore be penalties at law.

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[90] As above at 2, 5.
[91] As above at 73.
[92] As above at 74.
[93] As above at 73.
[94] As above at 74.
[95] As above at 74-75.
[96] Chris Connelly and Khaldoun Hajaj, *Small Business Banking Issues Paper*, Financial Services Consumer Policy Centre, University of New South Wales, April 2002 (**Small Business Banking Paper**) at 18.
[97] See the Payments Systems reforms section of the RBA website for more information, at http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/Reforms/index.html, accessed on 29 October 2004.

Differences in dishonour fees between banks

Although we do not know the underlying costs that Australian banks incur in processing cheque or direct debit dishonours, we do know what costs consumers are currently being charged by banks for cheque or direct debit dishonours. These are set out in Appendix A.

There are large discrepancies between the fees charged by different banks for cheque and direct debit dishonours. This makes it all the more difficult to determine what a bank's loss is when a cheque or direct debit payment is dishonoured. For example, the loss incurred by a bank when a cheque is dishonoured may be around $35, the minimum fee currently charged by the CBA to its customers, or may be as high as $50, as charged by the NAB. Similarly, when a direct debit payment is dishonoured, a bank may incur a loss of $35 (CBA), of $40 (Bendigo Bank and Westpac), of $45 (ANZ and St George) or of $50 (NAB).

For the banks to assert that dishonour fees cover their costs of processing dishonours means that the banks must differ substantially in their efficiency and costs. This is unlikely to be the case for three reasons. First, the amount of the fees does not vary in proportion to the size of the bank. For example, the NAB charges the highest cheque dishonour fee despite being one of the largest two banks in Australia, with consequent economies of scale. Secondly, all Australian banks use the same payments clearing systems to process cheque and direct debit payments,[98] making it less likely that costs would differ substantially between banks. Thirdly, the amount of the fees differs by a significant amount, up to $15 in the case of the CBA's and the NAB's cheque dishonour fees. Even if the banks' costs did differ, a gap of $15 between the fees charged by Australia's two largest banks is an enormous difference, especially given the size of the banks and consequent economies of scale.

The effects of technology on the cost of processing dishonours

The Wallis Report strongly advocated for the substitution of electronic forms of payment for paper-based transactions as a means of achieving substantial gains in efficiency, which would translate into lower costs for consumers.[99] In relation to interchange fees, the PSA raised concerns as early as 1992 that fees had not changed, particularly in light of technological improvements which were expected to result in a lowering of banks' transaction costs.[100]

The processing of cheques, while still a paper-based process, has been substantially revised in recent years. In the past, a cheque had to be physically conveyed to the paying bank before it could be processed. If it was dishonoured, it would then be physically returned to the depositor's bank.[101] Today, cheques are still physically conveyed to the paying bank (apparently warranting the three day clearance period), but the information regarding a deposited cheque is transmitted to the paying bank electronically, in an electronic file containing details from the cheque's magnetic ink character recognition line.[102] This means that the banks can process the cheque quickly and settlement between banks is calculated based on the electronic information exchanged, not on the physical exchange of cheques.[103] The banks now establish whether there are sufficient funds available in the drawer's account to honour the cheque as soon as the electronic transmission is made.[104] In other

[98] See Bank for International Settlements, Reserve Bank of Australia and Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries, *Payment Systems in Australia*, June 1999 (**BIS Australian Study**).
[99] Wallis Report, above n 78, at 199-200, 223-233.
[100] PSA, *Inquiry into Credit Card Interest Rates*, October 1992; cited in the Interchange Fees Report, above n 83 at 2.
[101] See BIS Australian Study, above n 98 at 14-15; ABA, *Cheque clearance*, Fact Sheet, http://www.bankers.asn.au/Default.aspx?ArticleID=612#, June 2004 at 1, accessed 25 November 2004.
[102] ABA, *Cheque clearance*, above n 101 at 1; BIS Australian Study, above n 98 at 15.
[103] BIS Australian Study, above n 98 at 15; Wallis Report, above n 78 at 392.
[104] ABA, *Cheque clearance*, above n 101 at 1.

words, cheque dishonours due to lack of funds, once a labour intensive and paper-based process, are now processed via electronic notification.[105] Indeed, the dishonour appears on a customer's Internet-viewable account statement within 24 hours of presentation of the cheque, demonstrating that the dishonour is processed upon electronic transmission of the cheque information, not after the cheque is physically conveyed to the paying bank.

Arguably, this ought to reduce the time and cost to the banks of the cheque dishonour process. Certainly, the Wallis Report thought so, although the Wallis Report identified further means to reduce the costs of cheque processing, which the banks have not adopted.[106] However, not only have the banks failed to review and lower cheque dishonour fees, dishonour fees have, in fact, been steadily increasing. For example, in January 1995 the NAB charged a customer $35 for a dishonoured cheque due to lack of funds. The NAB now requires a customer to pay $50 to "cover its costs" of processing a dishonoured cheque. Similarly, in February 2003, Westpac increased its dishonour fees from $25 to $40.[107]

It would also be expected that the cost of processing a dishonoured direct debit payment would be less than that of processing a dishonoured cheque, due to the technology involved. Indeed, as discussed above, direct debit facilities in general are being promoted as a cheaper and more efficient payment method than cheques. For example, Westpac's submission to the Wallis Committee stated that '[t]echnology is reducing the cost of doing banking business'.[108] Direct debit payments are not paper-based; in Australia, banks bulk direct entry credits and debits into electronic files and exchange them electronically with other financial institutions.[109] Direct debit dishonours due to a lack of funds in the payer's account are returned electronically almost immediately.[110]

The Wallis Report stated that '[e]vidence provided to the Inquiry indicates that transaction costs per [direct entry payment] are low'.[111] Further, the Wallis Report highlighted that direct entry payments are significantly cheaper than cheques, and identified that there would be substantial cost savings to the banks if consumers migrated from cheques to direct entry payments.[112] In fact, the Wallis Report contained a table, sourced from confidential information, that identified the comparative cost of various payment methods.[113] The cost of direct credit payments was calculated to be between 3.75% to 9% of the cost of cheque payments.[114]

However, many banks do not distinguish in their dishonour fees between cheque dishonours and direct debit or periodic payment dishonours. For example, none of the six banks we examined charged different fee amounts for a cheque and a direct debit dishonour. The ANZ and St George charge a customer $45 for a dishonoured payment, Westpac $40 and the CBA $35, regardless of the payment method. This indicates that little attempt has been made by the banks to assess the true costs incurred by them in processing direct debit dishonours, as opposed to the costs incurred in processing more familiar cheque dishonours. By contrast, the NAB charges a customer $50 for a cheque or direct debit dishonour and $35 for a periodic payment dishonour, and Bendigo Bank

[105] BIS Australian Study, above n 98 at 15. Note that cheques may still be dishonoured after they have been physically conveyed to the paying bank, for example because the cheque has been stopped, is forged or has been reported lost or stolen, however a dishonour due to lack of sufficient funds is processed upon electronic transmission of the cheque information – see ABA, *Cheque clearance*, above n 101 at 1-2.
[106] Wallis Report, above n 78 at 229-230, 392. Indeed, the banks were hesitant to adopt the current measures; see Laker, 'The Role of the Payments System Board', above n 77, at 13.
[107] Christine Long, 'Red alert on fees', *The Age*, 24 March 2003, at Money Manager 7.
[108] Westpac, *Submission to the Financial System Inquiry by the Westpac Banking Corporation*, September 1996 at 48, available at http://fsi.treasury.gov.au/content/submissions.asp.
[109] BIS Australian Study, above n 98 at 10, 15.
[110] As above.
[111] Wallis Report, above n 78 at 231.
[112] As above at 226-227.
[113] As above at 226 - Table 6.4: Delivery Channel Cost Comparisons.
[114] As above.

charges $40 for a cheque or direct debit dishonour and $35 for a periodic payment dishonour – although cheaper, the periodic payment dishonour fees of the two banks are still 70% and 87.5% respectively of the cost of their cheque and direct debit dishonour fees, hardly reflective of the relative cost of processing cheque and direct credit payments as calculated by the Wallis Report.

The high amount of dishonour fees

Dishonour fees are noticeably higher than other bank fees, for example transaction fees or interchange fees.[115] None of these fees approach even the lowest cheque or direct debit dishonour fee we found ($35 at CBA); over the counter withdrawal fees are generally recognised to be high at an average of $2.50 per withdrawal.[116] While it is recognised that some transaction fees may not represent the true cost of providing a service, they are still remarkably lower than dishonour fees. In light of the cost of transaction fees charged by banks, it seems almost impossible that there could be a cost difference of $15 between the cost to one bank and to another in processing a dishonoured cheque.

North American studies have revealed a similar situation. Non-sufficient fees (fees for a dishonour due to lack of funds) are becoming more costly. Nationwide, the average fee in the United States for a bounced cheque increased by 2.4% in a *six-month period* from US$23.87 to US$24.45.[117] The average non-sufficient fee has continued to increase and had reached US$25.82 in 2003, an increase of 19% since October 1998.[118] In a 1998 American study on cheque dishonour fees by the Consumer Federation of America, entitled *Bounced Checks: Billion Dollar Profits II* (the **US Check Fees Report**),[119] it was estimated that it cost a bank between US$0.50 and US$1.50 to process a dishonoured cheque and between US$0.48 and $0.65 to process a dishonoured direct debit.[120] This meant that banks were charging between 11 and 32 times what it actually cost them to process dishonoured cheques, and between 9 to 11 times what it cost them to process dishonoured direct debit payments.[121] After cost recovery, the large remainder of the fee represented profit to the bank.

The US experience with respect to dishonour fees is discussed in further detail in Chapter 3.

Dishonour fees – punishing Australian bank customers

Given the remarkably high dishonour fees charged by Australian banks, the experience in the US and the large differences in the amounts of the dishonour fees charged by various Australian banks, it appears likely that the amount of dishonour fees is significantly higher than the costs incurred by Australian banks in processing the dishonours. In other words, dishonour fees overcompensate a bank for the costs the bank incurs in processing the dishonour. Australian banks should demonstrate otherwise, if we are not correct, by releasing data regarding the costs they incur in processing dishonours.

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[115] See, for example, the fee guides of various banks, above n 74; PricewaterhouseCoopers, *Survey of retail banking fees – an independent analysis*, above n 80 at 10.

[116] PricewaterhouseCoopers, *Survey of retail banking fees – an independent analysis*, above n 80 at 10; Chris Connolly and Khaldoun Hajaj, *Financial Services and Social Exclusion*, Financial Services Consumer Policy Centre, University of New South Wales, Chifley Research Centre, March 2001 (**Financial Exclusion Paper**) at 63.

[117] Laura Bruce, 'Non-sufficient funds fees bouncing higher', *www.bankrate.com/nsc/news/chk/20010508a.asp*, May 2001.

[118] Laura Bruce, *Dig deeper into your wallet to open an account*, *www.bankrate.com/nsc/news/chk/chkstudy/20030327a1.asp*, March 2003.

[119] Janice C. Shields, *Bounced Checks: Billion Dollar Profits II*, Consumer Federation of America, June 1998 (**US Check Fees Report**).

[120] As above at 2.

[121] As above.

The only cost figure we do have is the estimate in the Wallis Report (presumably based on confidential information submitted to the Inquiry by financial institutions) that the cost of cheque processing was $1.50 to $3.00 per cheque.[122] We accept that the processing of a cheque dishonour may involve additional costs to the processing of a cheque, for example staffing and computer system costs. However, given that dishonours are processed in the course of processing cheques generally, we do not consider that such additional costs would amount to more than double the cost of processing a cheque. We therefore estimate that, being generous to Australian banks, the cost of processing a cheque dishonour is between $3.00 to $6.00.

If a cheque dishonour costs $6.00 to process, the CBA (with the lowest cheque dishonour fee) could be charging nearly 6 times, and the NAB (with the highest cheque dishonour fee) over 8 times, what it costs them to process a cheque dishonour. If a cheque dishonour costs $3.00 to process, the CBA could be charging nearly 12 times, and the NAB over 16 times, what it costs them to process a cheque dishonour. These figures are similar to those in the US, as found by the US Check Fees Report, discussed earlier. It should also be noted that the Wallis Report's estimate was based on the old method of cheque processing, whereby cheques had to be physically transported to the paying bank before they could be processed. It should now cost banks less to process cheques and cheque dishonours.

We estimate that Australian banks could be charging between 5 to 16 times what it costs them to process a cheque dishonour.

As discussed above, the Wallis Report calculated that direct entry payments, such as direct debits, cost between 3.75% to 9% of the cost of processing a cheque (which they estimated to be between $1.50 to $3.00). Taking the higher figures, a direct debit payment would cost $0.27 to process (9% of $3.00). Again, we do not consider that the processing of a direct debit dishonour would cost more than double the cost of processing a direct debit payment; we therefore estimate that the cost of processing a direct debit dishonour may be $0.54.

If a direct debit dishonour costs $0.54 to process, the CBA (with the lowest direct debit dishonour fee) could be charging over 64 times, and the NAB (with the highest direct debit dishonour fee) over 92 times, what it costs them to process a direct debit dishonour.

We estimate that Australian banks could be charging between 64 to 92 times what it costs them to process a direct debit dishonour.

Further, we consider that the clear failure of the banks to review their dishonour fees in light of technological changes to payments systems, or to review direct debit dishonour fees as compared with cheque dishonour fees, demonstrates that dishonour fees cannot now be (if they ever were) a genuine attempt by a bank to pre-estimate its loss in processing a dishonour. In fact, it does not appear that the banks make *any* attempt to estimate their losses; the fees are set arbitrarily high enough to cover any possible costs and more. Again, if we are not correct, Australian banks should release data that proves otherwise.

In our view, it is therefore highly probable that banks use dishonour fees to punish customers for not having sufficient funds in their bank accounts, and generate income from dishonour fees.

As evidenced by the 2001 Labor Members Report of the inquiry by the Parliamentary Joint Statutory Committee on Corporations and Securities into fees on electronic and telephone banking (the **Labor Members Report)**[123], the Labor members of that inquiry would probably agree with us:

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[122] Wallis Report, above n 78 at 227.

[123] Labor Members Report, 'Bank Fees: Up, Up and Away', *Inquiry into Fees on Electronic and Telephone Banking*, Joint Parliamentary Committee on Corporations and Securities, February 2001 (**Labor Members Report**).

> '[s]ubstantial evidence was presented to the Committee from the ACCC and RBA that bank fees are not efficient and competitive. Bank fees are based, not upon aligning charges with marginal costs, but with extracting obscene levels of profit.'[124]

The use of this sort of pricing strategy is far from unlikely – for example, PricewaterhouseCoopers considered that the continued increase in cheque and over the counter transaction fees (relatively high, but still much lower than dishonour fees) suggested either an increase in underlying costs or that the banks were actively discouraging customers from using costly banking channels.[125] Connelly and Hajaj also note that a motivation for banks in setting fees is to discourage certain types of customers through high prices, something openly acknowledged by overseas banks and occasionally conceded by Australian banks.[126]

Cheque and direct debit dishonour fees charged by Australian banks are out of all proportion and extravagant, exorbitant and unconscionable in comparison with the cost incurred by Australian banks in processing cheque and direct debit dishonours.

2.5.3 The failure of competition

The second step in attempting to determine whether dishonour fees should properly be considered as penalties or liquidated damages is to examine the relationship between Australian banks and consumers. In particular, it is important to determine the relative bargaining positions of a bank and a customer.

Lack of consumer choice and the inability to switch banks

In the US Check Fees Report, it was noted that, when criticised about bank fees, banks reply that the fees must be acceptable because consumers pay them.[127]

However, as the US Check Fees Report points out, there are other reasons why consumers pay bank fees, for example in order to keep their bank accounts or to avoid developing a bad record with reporting companies such as Chextra.[128] In an Australian context, consumers do not want to be listed with a credit reporting agency such as Baycorp Advantage or Dun & Bradstreet for not having paid a debt. In addition, low-income consumers who rely on Centrelink welfare payments need a bank account to receive their payments via direct credit electronic payment, as Centrelink no longer issues cheques. In fact, most Australians must have a bank account to receive salary or welfare payments. A survey conducted by the ACA in 2002 reported that a clear 95% of those surveyed considered banking to be an essential service.[129] In May 2003 the *ANZ Survey of Adult Financial Literacy in Australia*, prepared by Roy Morgan Research for the ANZ, found that 97% of the consumers surveyed had an everyday banking account.[130]

A related argument would propound that consumers can always switch banks if they are unhappy with the bank fees they are being charged. This theoretical ability of consumers to switch banks is supposed to place competitive pressure on banks to lower their fees in order to retain and compete with other financial institutions for customers.

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[124] As above at 20; see also at 1, 14, 18.
[125] PricewaterhouseCoopers, *Survey of retail banking fees – an independent analysis*, above n 80 at 10.
[126] Financial Exclusion Paper, above n 116 at 12.
[127] US Check Fees Report, above n 119 at 2.
[128] As above.
[129] ACA, 'Banks: bad and getting worse', *Choice Online*, November 2002, www.choice.com.au.
[130] Roy Morgan Research, *ANZ Survey of Adult Financial Literacy in Australia: Final Report*, ANZ, May 2003 at 3.

This argument is also flawed. As Connelly and Hajaj note, Australia has one of the most concentrated banking markets in the world.[131] The big four banks[132] dominate – for example, in the small business banking market they have around 80 to 90% market share.[133] Mergers in the Australian banking sector have also left Australia with one of the world's most concentrated markets for retail transaction products[134] – in 2001, only 11 banks were offering retail transaction accounts.[135] In July 2003 the RBA also stated that '[t]he four major Australian banks dominate the provision of most types of payment services.'[136] For example, in 2002 the four major banks accounted for 70% of debit card transactions and around 60 to 70% of personal cheques, both payment instruments associated with the holding of a retail account with the bank.[137]

The degree of market concentration, combined with a 'club' culture between the big four banks, as acknowledged by the chief executive officer of ANZ,[138] means that consumers are not left with many alternatives:

> 'Australia performs very poorly when the market share of the top three or top five banks is considered. This leads to a situation where this top tier of banks does not compete with each other, and develops as a barrier to competition by new entrants.
>
> This level of concentration leads to opportunities for the big four players to (wittingly or unwittingly) distort normal price competition.'[139]

Given this situation, it is not surprising that the Interchange Fees Report found that competition between financial institutions that would ordinarily be expected to put pressure on margins in card payment networks had not worked effectively.[140] In other words, the banks were not subject to competitive pressures to induce them to lower interchange fees. If the Interchange Fees Report was able to make such conclusions in relation to interchange fees, why would there be reason to believe that there are effective competitive constraints on banks in relation to the setting of cheque or direct debit dishonour fees or any other bank fees? Indeed, we argue that a lack of competition between the major Australian banks has affected the level of dishonour fees. Individual banks set their dishonour fees, and consumers do not have a direct influence on the amount or nature of the fees set.

The perceived lack of competition between banks, and a lack of substantial differences between products and services offered by banks to consumers, is undoubtedly a further disincentive for consumers to switch between banks in order to pay less in fees. If consumers are not switching banks, this further limits the competitive pressure on banks to lower fees.

A study examining this issue was undertaken by the UKCC in 2002. The UKCC completed a detailed study on the supply of banking services to small and medium sized business customers in the UK (the **UKCC Report**).[141] The UKCC Report emphasised the importance of improving the ability of banking customers to switch banks as a key to creating a more competitive banking market by allowing customers to shop around for better prices and services.[142] The UKCC Report found a very high reluctance on the part of small and medium business customers to switch banks, due to the

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[131] Small Business Banking Paper, above n 96 at 7-8; Financial Exclusion Paper, above n 116 at 9.
[132] ANZ, CBA, NAB and Westpac.
[133] Small Business Banking Paper, above n 96 at 6, 12.
[134] Financial Exclusion Paper, above n 116 at 33, citing D Ralston*, Bank mergers in Australia: Implications for competition policy*, Centre for Australian Financial Institutions, Brisbane 2000.
[135] Financial Exclusion Paper, above n 116 at 33.
[136] RBA, 'The Changing Australian Retail Payments Landscape', above n 70 at 6.
[137] As above at 6-7.
[138] Jason Clout, 'Bank 'club' fair comment: Fels', *Australian Financial Review*, 15 April 2002.
[139] Small Business Banking Paper, above n 96 at 8.
[140] Interchange Fees Report, above n 83 at 74.
[141] UKCC, *The supply of banking services by clearing banks to small and medium-sized enterprises*, London 2002 (**UKCC Report**); cited in Small Business Banking Paper, above n 96.
[142] Small Business Banking Paper, above n 96 at 29-30. UKCC Report, above n 141 at 5.

perceived complexity of switching coupled with little financial benefit flowing to customers from switching banks.[143]

The UKCC Report found that nearly one third of small and medium business customers had considered switching banks in the last three years but had not done so.[144] Customers feared the practical difficulties and negative consequences of switching and, as a result, only 4-6% of small and medium businesses did actually switch banks each year.[145] In addition, the UKCC Report found that 77% of small and medium businesses had *never* switched banks.[146] The UKCC Report identified several factors which affected a customer's decision regarding whether to switch banks or not. One of the negative consequences feared by customers was that there would be a disruption to standing orders and direct debit arrangements if they switched banks, including the incurring of penalty fees if payments from the old account were not met.[147] Customers also felt that the benefit of switching banks was marginal given the lack of competition between banks.[148]

UK economist Michael Waterson's 2001 paper on the role of consumers in competition and competition policy also examined consumer switching and searching behaviour between suppliers across various industries in the UK.[149] One of the case studies in the paper compared UK consumers' switching behaviour across the car insurance and the current account banking industries. The paper sets out figures demonstrating that over a five year period, 53% of consumers switched car insurance whereas only 6% switched bank account.[150] Waterson explored why this might be the case, discussing the 'relative ease with which a consumer may change their motor insurer' compared with the 'cumbersome procedure embarked upon only by the very determined consumer' to change bank.[151] For example, a major problem for consumers in switching bank account is the transfer of direct debits:

> 'UK banks have shown a very considerable reluctance to make transfers easy; if anything, they have made it difficult and have placed the onus firmly on the customer to ensue things run smoothly.'[152]

Given the strong similarity between the Australian and United Kingdom banking markets, it is likely that Australian consumers also fear negative consequences as a result of switching banks and perceive little benefit from switching due to the lack of competition. Connelly and Hajaj note that 'the UK banking system is the one which most closely resembles the Australian market in set up, size and market penetration of the largest four banks.'[153] Connelly and Hajaj also refer to a survey completed in 1999 that estimated only 7% of Australian small business customers switch banks each year, around the same small number as the UKCC Report identified in relation to UK customers.

There is little to indicate that individual consumers are willing or able to switch banks any more than small business consumers. As stated earlier, Australia has one of the world's most concentrated markets for retail transaction products and, based on statistics from late 1998 and 1999, the top 5 Australian banks had over 70% market share in general, one of the worst market share rates amongst

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[143] Small Business Banking Paper, above n 96 at 30; UKCC Report, above n 141 at 29-30.
[144] UKCC Report, above n 141 at 30.
[145] Small Business Banking Paper, above n 96 at 10; UKCC Report, above n 141 at 28, 30.
[146] Small Business Banking Paper, above n 96 at 10; UKCC Report, above n 141 at 28.
[147] Small Business Banking Paper, above n 96 at 10; UKCC Report, above n 141 at 29.
[148] Small Business Banking Paper, above n 96 at 11; UKCC Report, above n 141 at 30.
[149] Michael Waterson, 'The role of consumers in competition and competition policy' (2003) 21 *International Journal of Industrial Organisation* 129.
[150] As above at 135.
[151] As above at 136-137.
[152] As above at 137.
[153] Small Business Banking Paper, above n 96 at 29.

comparable countries.[154] It is also clear that, as a general rule, individual consumers will have less bargaining power than business customers and less ability to shop around for a better deal. Indeed, the unequal bargaining position of various parties in relation to negotiating financial services with a bank was recognised in a study undertaken by the PSA in 1995 on fees and charges on retail transaction accounts,[155] a precursor to the Interchange Fees Report. As the Interchange Fees Report states, the study concluded that:

> '…it was unlikely that interchange fees were efficiently priced and [the PSA] expressed concern that inequalities in bargaining power between participants in debit card schemes were resulting in market distortions'.[156]

The Labor Members Report noted, in relation to Australian consumers generally, that:

> '[i]n a competitive market we would expect that consumers who were dissatisfied with their banking services would change banks.
>
> And yet, according to a survey conducted by the Australian Consumers Association in March 2000 despite the fact that only 13% of customers were satisfied with the larger banks, only 22% had changed institution in the last 5 years. Over 50% of respondents to the ACA survey had had their accounts at the same institution for 11 years or more.'[157]

The ACA conducted another survey of its members in July 2002[158] and reported that 70% of the customers of the big four banks thought they were somewhat or very unlikely to change to another institution.

As Connolly and Hajaj have observed, individuals and households are also subject to other constraints on their ability to switch banks or access financial services. For example, conditions attached to products, such as limited transactions, expensive cheque accounts and prohibitive fees and charges, may inhibit consumers' choices.[159] The Labor Members Report also recognised that various reasons make the relationship between a bank and a customer 'sticky'.[160]

Interestingly, Waterson, in the paper discussed above, argued that a result of the difference in consumer switching behaviour across the car insurance and the current account banking industries was the relative profitability of the two industries, with the personal banking industry enjoying excessive profitability compared to very low returns in the motor insurance industry.[161] Waterson also states that:

> 'any policy designed to render banking (for domestic and small business customers) more competitive will need to address both the ease of switching and the opacity of banks' charging structures.'[162]

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[154] Financial Exclusion Paper, above n 116 at 34 - Table 2; Bank for International Settlements, Group of Ten, *Report on Consolidation in the Financial Sector*, January 2001 at 3, 46-47, 54, 417 - Table B.4.
[155] PSA, *Inquiry into Fees and Charges Imposed on Retail Accounts by Banks and Other Financial Institutions and by Retailers on EFTPOS Transactions*, June 1995.
[156] Interchange Fees Report, above n 83 at 2, citing the PSA, *Inquiry into Fees and Charges Imposed on Retail Accounts by Banks and Other Financial Institutions and by Retailers on EFTPOS Transactions*, above n 155. See the PSA, *Inquiry into Fees and Charges Imposed on Retail Accounts by Banks and Other Financial Institutions and by Retailers on EFTPOS Transactions*, above n 155, at XLI, 273-276.
[157] Labor Members Report, above n 123 at 12.
[158] ACA, 'Banks: bad and getting worse', above n 129.
[159] Financial Exclusion Paper, above n 116 at 9, referring to Joseph Rowntree Foundation, *Understanding and Combating 'Financial Exclusion'*, UK, March 1999.
[160] Labor Members Report, above n 123 at 12-14.
[161] Waterson, 'The role of consumers in competition and competition policy', above n 149 at 135-136.
[162] As above at 137.

As with difficulties in switching, an opacity in the charging structures of banks is evident in Australia. This is discussed below.

Lack of disclosure of information to consumers and the inability to negotiate terms

Implicit in the finding that the terms and conditions of financial products and services act as constraints on a consumer's ability to switch banks, is the fact that consumers are not able to individually negotiate those terms and conditions, including the fees attached to the products and services offered by banks. A bank customer applying for a transaction account, cheque account or credit card is generally given a standard form contract, in the form of the bank's standard terms and conditions for the product or service in question, often only *after* the consumer has applied for, or obtained, the particular product or service and always with *no opportunity to negotiate* amendments to those terms and conditions.

Another constraint noted by Connelly and Hajaj as inhibiting consumer choice is the fact that banks do not want low-income consumers as customers and therefore do not market their more affordable products.[163] The Labor Members Report also noted that banks do not market low cost banking products to their customers.[164] This "passive" lack of disclosure is compounded by the fact that banks actively constrain the disclosure of the terms and conditions of their products and services. Consumers are less likely to switch banks if they are unaware of better choices in the "competitive" market. It is impossible for consumers to shop around for the best deal in banking products if they cannot access information about the products available in the market before actually applying for one of them.

The Wallis Report stated that '[f]inancial markets cannot function effectively unless participants act with integrity and there is adequate disclosure to facilitate informed judgments.'[165] The Wallis Report went on to recommended that disclosure requirements for retail financial products:

- 'be comprehensive and sufficient to enable a consumer to make an informed decision relating to the financial product'; [and]
- 'be consistent with that for similar products regardless of which institution offers them'.[166]

A 1999 survey by PIRG examined several banks' methods of fee disclosure. Summarising the survey result, PIRG found that:

> '…comparisons are still difficult and additional remedial legislation may be necessary…Disclosure of terms of bank accounts differs dramatically. Many brochures appear designed to confuse, rather than assist, consumers. Some banks even place some account terms in one brochure, and other key terms in another, or even a third. Additionally, the language used in brochures to describe the same fee often varies from bank to bank.'[167]

Similarly, Louise Sylvan stated in 2001 in relation to Australian financial services that:

> '[w]e continue to face a lack of transparent, comparable information; disclosure regimes that seem unable to deliver clear information to consumers – in fact, sometimes, are more confusing or burdensome than not; and an unwillingness on the part of industry to consistently provide clear fee information to customers.'[168]

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[163] Social Exclusion paper at 9.
[164] Labor Members Report, above n 123 at 8-9.
[165] Wallis Report, above n 78 at 17.
[166] As above at 34.
[167] PIRG, *Big Banks, Bigger Fees: The 1999 PIRG Bank Fee Survey* at 10.
[168] Louise Sylvan*, Focussing on the Consumer in Financial Services Regulation: Address to the 2001 ASIC Summer School'*, 22 February 2001 at 14.

This was certainly our experience with Australian banks. When we visited bank branches over a year ago, we were given very little information regarding penalty fees and this information was not available on the websites of many banks. However, we noticed a difference in the extent of disclosure of fees and charges, particularly penalty fees, between early 2003 and late 2004. When we visited bank branches recently, we were given more information regarding fees and charges. In addition, most banks (although not all) now make information regarding fees and charges available on their website (usually as part of the Product Disclosure Statement for the relevant product).[169]

Despite these improvements, disclosure remains inadequate. First, information regarding penalty fees is not always easy to find. Product Disclosure Statements consist of several different documents and contain very large amounts of information. They also tend to refer to the same matter in several places – for example, the terms and conditions relating to dishonoured payments is usually separated from information regarding the fees charged in such circumstances. Further, each bank produces their Product Disclosure Statements in different formats. All of this makes it very difficult for consumers either to find and process the information they need or to compare penalty fees across accounts offered by different banks.

For these reasons, we found it difficult to compile a full list of the current amounts charged by each bank for the various penalty fees (Appendix A). It involved visiting bank branches to obtain information, searching the banks' websites (sometimes to no avail, as some banks still do not publish penalty fee information on their websites) and telephoning the banks' information numbers (sometimes several times before comprehensive and accurate information could be obtained).

For example, one of our staff members visited a large CBA branch in November 2004 to obtain comprehensive information regarding an everyday transaction account with a cheque facility. She was given a brochure. The brochure, *Transaction, Saving and Investment: Deposits*, contained almost no information regarding fees and charges and informed us in a footnote only that 'Full terms and conditions are available on application'. Certainly, no mention of dishonour fees was included. The same staff member received varying amounts of information when she visited branches of other banks, however it was rare that all relevant information regarding terms and conditions, as well as all fees and charges, were contained in one document.

Secondly, the banks use different terms for penalty fees. For example, the ANZ charges a 'Dishonour fee' for cheque and direct debit dishonours and a periodical payment 'Non-payment fee'.[170] The NAB charges a 'Dishonour Fee – inward' and a 'Dishonour Fee – outward' for 'Dishonoured items', and also charges for 'Payment not made due to lack of funds' for periodical payments.[171] St George charges a 'Periodical Payment/Direct Debit dishonour fee', as well as an 'Outward Cheque dishonour fee' and an 'Inward Cheque dishonour fee'.[172] Bendigo Bank charges separately for a 'Direct debit dishonour fee' and a 'Periodical payment dishonour'.[173] Again, this makes it difficult both to find information on penalty fees and to compare information across different banks.

The ACCC summed up the situation facing consumers with regard to disclosure in its second submission to the Financial System Inquiry in 1996.[174] Given the above discussion, we consider that the following excerpt from that submission continues to apply:

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[169] Australian banks are now required to produce Product Disclosure Statements for financial products for retail clients: see *Corporations Act 2001* (Cth) section 1012A.
[170] ANZ, *ANZ Personal Banking Account Fees and Charges*, above n 59 at 6.
[171] NAB, *A Guide to Fees and Charges: Personal Banking Fees*, above n 55 at 18.
[172] St George, *Bank Accounts: Fees and Charges and How to Minimise Them*, above n 57 at 29-30.
[173] Bendigo Bank, *Schedule of Fees, Charges and Transaction Account Rebates*, above n 74 at 30-31.
[174] ACCC, *Second Submission to the Financial Services Inquiry*, September 1996.

> '[i]n the financial services sector, the most significant market failure on the demand-side relates to information imperfections and asymmetries between consumers and suppliers…
>
> Not only does the underlying nature of financial products and their purchase impose a significant information burden on consumers, but the information is not always clearly, coherently or easily presented. Consumers of financial services products often face difficulties in processing information and making informed choices because the necessary information is:
>
> · insufficient, and explanations are inadequate;
> · inaccessible due to complexity, language, style, or unavailability;
> · difficult to compare with information from other suppliers;
> · constantly changing; and/or
> · inaccurate, misleading, or in some cases, plainly wrong.
>
> …developments [that have shifted the information and search costs toward the customer] have clear advantages of time and convenience for more sophisticated customers, but for less sophisticated customers it can place an increased burden in searching for and analysing the relevant financial information. Given the high opportunity and transactions costs involved in acquiring the necessary information, many of these less sophisticated, and often poorer customers, may make costly financial mistakes.'[175]

The failure of competition to restrain bank fees

The lack of competition identified in the UK business banking industry led the UKCC to criticise UK banks for excessive fees.[176] As Connelly and Hajaj report, the UKCC Report found that:

> '…a number of specific practices of the four largest clearing bank groups…restrict and/or distort price competition and result in the charging of excessive prices to SMEs [small and medium enterprises] in England and Wales to an extent that would not be expected in a fully competitive situation.'[177]

As noted above, Waterson also discussed a link between sub-optimal competition and excessive profits in the UK personal banking market.[178]

In the retail banking market for individuals and households, Australian bank fees render Australian bank accounts much *more* expensive than UK bank accounts. The 2000 Cruickshank review of competition in UK banking found that a standard[179] Australian retail transaction account cost £124.77 per year in fees, compared with only £1.68 per year for a UK account.[180] Australian accounts cost more than accounts in almost all other comparable countries. Connelly and Hajaj note that, while the Australian amount may not have taken into full account the effect of fee waivers available on some accounts, and that international comparisons are inherently difficult, this is probably balanced by the fact that Australian banking fees have since increased dramatically, while UK fees have remained low.[181]

In its 2001 Report on Fees on Electronic and Telephone Banking,[182] the Parliamentary Joint Statutory Committee on Corporations and Securities noted that Australian financial institutions increased fees for electronic banking substantially once customers moved to new electronic forms of banking.[183] The Committee found that the fact of these fee increases in electronic banking indicated market

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175 As above at 75-76.
176 Small Business Banking Paper, above n 96 at 29; UKCC Report, above n 141 at 4.
177 Small Business Banking Paper, above n 96 at 29, referring to the UKCC Report, above n 141.
178 Waterson, 'The role of consumers in competition and competition policy', above n 149 at 135-6.
179 300 EFTPOS transactions, 100 cheques, 60 direct debits, 100 ATM withdrawals and 50 credits annually.
180 Don Cruickshank, *Competition in UK banking: A Report to the Chancellor of the Exchequer*, London, 2000; cited in the Financial Exclusion Paper, above n 116 at 63-64.
181 Financial Exclusion Paper, above n 116 at 64.
182 Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on Fees on Electronic and Telephone Banking*, February 2001.
183 As above, Chapter 7 at 7.4.

failure.[184] The Labor Members Report agreed.[185] As discussed earlier, dishonour fees also continue to increase. In addition, dishonour fees are significantly higher than electronic banking transaction fees, and direct debit dishonour fees are often the same as cheque dishonour fees, despite the different technology involved in processing direct debit payments. It certainly seems that, as with transaction fees, the market has failed to constrain dishonour fees.

The weak bargaining position of Australian bank customers

It is evident that "competition" in the Australian banking market has failed to deliver consumers lower, competitive fees, particularly dishonour fees.

- Consumers do not have any effective practical options to negotiate or shop around for a better deal from the banks.
- Consumers need a bank account to receive salary or welfare payments.
- Banks do not provide adequate disclosure of fees, particularly dishonour fees, making it difficult for consumers to compare products.
- Dishonour fees continue to rise, indicating market failure.

The extraordinarily unequal bargaining position of a consumer, particularly a low-income consumer, in dealing with a bank is patently obvious.

2.5.4 Dishonour fees are penalties

From the information that is currently available to the Australian public, it is very likely that:

1. Cheque and direct debit dishonour fees are out of all proportion or extravagant, exorbitant or unconscionable in comparison with the loss suffered by the banks in processing dishonours; and
2. Banks are in a significantly stronger bargaining position than consumers, with consumers unable to negotiate dishonour fees or exercise any other means to force a better deal from Australian banks. Australian banks take advantage of this situation by punishing consumers for dishonours.

Australian banks may tell us that dishonour fees are fees for the service of processing a dishonoured cheque or direct debit payment. However, given the above conclusions, in our view they are penalties at law. This would mean that consumers are not legally obliged to pay these fees, and that banks will be unable to enforce them in Australian courts.

Cheque and direct debit dishonour fees are penalties at law. If Australian banks continue to assert that dishonour fees are enforceable as liquidated damages, they should release the data that proves this to Australian consumers.

2.6 Penalty fees and unfair contract terms legislation

On 9 October 2003, a new Part 2B of the Victorian *Fair Trading Act 1999* came into force. The provisions of Part 2B of the *Fair Trading Act* render void any term in a consumer contract that is unfair.[186] At the time of writing, Victoria is the only Australian jurisdiction that has enacted unfair contract terms legislation.

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[184] As above at 7.5.
[185] Labor Members Report, above n 123 at 18.
[186] The provisions also render void any term in a standard form consumer contract that is prescribed as unfair by regulations made under the *Fair Trading Act*: section 32Y(2). At the time of writing, however, no terms have been prescribed as unfair.

If a contract term which imposes a cheque or direct debit dishonour fee is unfair under Part 2B of the *Fair Trading Act*, it will be void in Victoria, quite apart from whether or not it is also unenforceable as a penalty at law.

2.6.1 Definition of 'unfair term'

Section 32W of the *Fair Trading Act* provides that:

> 'A term in a consumer contract is to be regarded as unfair if, contrary to the requirements of good faith and in all the circumstances, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer.'

Section 32X provides further guidance as to whether a term may be considered unfair. It provides that:

> 'Without limiting section 32W, in determining whether a term of a consumer contract is unfair, a court or the Tribunal may take into account, among other matters, whether the term was *individually negotiated*, whether the term is a prescribed unfair term and whether the term has the object or effect of –
>
> …(c) *penalising the consumer but not the supplier for a breach* or termination of the contract;
>
> …(h) *permitting the supplier unilaterally to determine whether the contract had been breached* or to interpret its meaning' [our emphasis].

The provisions set out above leave some room for interpretation, particularly as Part 2B of the *Fair Trading Act* has not yet been considered in a court judgment. For example, the concept of 'good faith' is not defined in the *Fair Trading Act*. Some guidance in relation to the meaning of 'good faith' can be found in the New South Wales Supreme Court decision of *Renard Constructions (ME) Pty Ltd v Minister for Public Works*,[187] in which Priestly JA equated a duty of good faith and fair dealing to standards of fairness.[188] Similarly, Finn J, in the Federal Court of Australia decision of *GEC Marconi Systems Pty Limited v BHP Information Technology Pty Limited*,[189] stated that the duty of good faith and fair dealing, if applied to a contract, would require the contractual parties to 'act honestly, fairly and reasonably'.[190] In the context of Part 2B of the *Fair Trading Act*, CAV, the Victorian government agency charged with responsibility for consumer protection laws, has adopted the following definition of 'good faith' in its preliminary guidelines to the Victorian unfair contract terms legislation (the **CAV Guidelines**):

> 'A principle of fair and open dealing; that is 'playing fair', especially when one party is in a position of dominance over a consumer who is vulnerable relative to that dominance or power.'[191]

2.6.2 Dishonour fees may be unfair contract terms

Despite some uncertainty as to the manner in which a court might apply Part 2B of the *Fair Trading Act*, it is possible to analyse contractual terms in light of the new provisions. For example, in our view, a term in a contract between an Australian bank and a customer that imposes a cheque or direct debit dishonour fee does cause a significant imbalance in the parties' rights and obligations to the detriment of the consumer. Such a term explicitly provides for the customer, but not the bank, to be automatically penalised upon a breach of the contract, with the bank having the sole power to

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187 *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234.
188 As above at 268.
189 *GEC Marconi Systems Pty Limited v BHP Information Technology Pty Limited* (2003) 128 FCR 1.
190 As above at 208.
191 CAV, *Preventing unfair terms in consumer contracts*, Guidelines, November 2003 at 4.

determine when this has occurred. As set out above, these factors are explicitly listed as relevant under section 32X.

In addition, the term is highly unlikely to have been individually negotiated, as mentioned earlier in the Report, another factor listed by section 32X as relevant to determining whether the term is unfair. The issue of whether the term is individually negotiated may also be relevant to any consideration of whether the term has its effect 'contrary to good faith', particularly if the definition of 'good faith' adopted by CAV is applied.

Further, such a term is likely to impose an excessively high penalty on the consumer, as discussed at length earlier in this Chapter. The CAV Guidelines specifically list 'terms that impose a penalty' as one category of unfair term.[192] Three types of penalty terms are discussed in further detail in the CAV Guidelines, including:

> 'Terms that require a consumer who fails to fulfil their contractual obligations to pay a disproportionately high sum in compensation or in cancellation penalties or charges
>
> This includes the following types of terms.
>
> - A requirement to pay more in compensation for a breach than a reasonable estimate of the loss caused to the supplier…'[193]

We therefore consider that terms in contracts between Australian banks and their customers that impose cheque and direct debit dishonour fees may be void in Victoria as unfair. However, as stated above, we consider that these terms are unenforceable in any case, as penalties at law.

2.7 Conclusion

This Chapter has used the legal framework discussed in Chapter 1 to analyse penalty fees charged by Australian banks, in particular cheque and direct debit dishonour fees.

In the absence of further data, we can only conclude that it is most likely penalty fees are, in fact, penalties at law. This renders such fees unenforceable by banks against consumers. While banks are still entitled to recover costs incurred by them upon a default by a customer, they are not entitled to use penalty fees to do so, thereby generating income on top of recovering their costs. Further, we also consider that, in Victoria, penalty fees may be void as unfair under Part 2B of the *Fair Trading Act*.

Until the banks disclose the true cost of customer defaults, for example cheque and direct debit dishonours, both consumers and regulatory authorities will be unable to make an accurate and conclusive assessment of whether dishonour fees are liquidated damages or penalties. Clearly, there is a need for effective and fair disclosure of costs incurred by banks. Banks should not be troubled by this, if, as they assert, dishonour fees are simply an exercise in cost recovery.

Given the difficulties that would be faced by an individual consumer, particularly a low-income consumer, in opposing penalty fees levied on their account by a bank,[194] it is imperative that regulators take proactive steps to protect consumers and prevent the banks from punishing their customers by charging legally unenforceable penalties. As Louise Sylvan has stated:

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[192] As above at 9, 11.
[193] As above at 11.
[194] For example, even if a consumer were to take action in a low-cost jurisdiction such as the Victorian Civil and Administrative Tribunal for repayment of the fee, this could expose them to a potential appeal to the Supreme Court of Victoria and the associated costs of such legal proceedings, including the risk of an adverse costs order.

> '[i]f neo-liberal tendencies to favour self-regulation over other models are to continue, then a commitment and willingness by regulators to 'step in' and take action when consumer outcomes are inadequate or threatened is essential'.[195]

Regulators should be as concerned about penalty fees as they are about interchange fees charged by banks. Overly high penalty fees have the ability to distort the market for payment methods, as noted by the Assistant Governor (Financial Services).[196] Further, in an environment in which bank income is increasingly derived from non-interest sources and consumers are facing a confusing array of transaction fees, effective disclosure by banks of fees and charges gains even more importance. Without proper disclosure, consumers are unable to compare products and services. This in turn leads to the failure of the de-regulated, "competitive" Australian banking market to deliver the benefits of full competition. As American consumer advocates have noted:

> '[t]he future holds many concerns. The rapid rise in electronic banking – computer home banking, smart cards, and Internet commerce – offers opportunities for banks to lower costs. Will they pass those savings on to consumers?'[197]

A detailed examination of penalty fees is required and is clearly in the public interest. The RBA should exercise its powers under the *Payments System (Regulation) Act 1998* (Cth) to force disclosure by Australian banks of sufficient data regarding penalty fees and to undertake a full examination of penalty fees for consideration by the Australian public, either alone or jointly with other regulators, as it did in relation to interchange fees.

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[195] Sylvan, *Focussing on the Consumer in Financial Services Regulation: Address to the 2001 ASIC Summer School'*, above n 168 at 11.
[196] Laker, 'The Role of the Payments System Board', above n 77.
[197] PIRG, *Big Banks, Bigger Fees: The 1999 PIRG Bank Fee Survey*, above n 167 at 10.

CHAPTER THREE – PENALTY FEES AND PROFITS

3.1 Key findings

- Publicly available information suggests that penalty fees contribute to significant margins of revenues over costs for Australian banks.
- It is likely that Australian banks are generating substantial profits from penalty fees.
- Profits derived from penalty fees most likely represent supra-competitive profits to Australian banks.
- Australian banks must release, or be forced to release, data enabling the public to determine how much revenue and profits Australian banks generate from penalty fees each year.

- Penalty fees are disproportionately borne by those who can least afford to pay them, namely low-income consumers.
- It is difficult for low-income consumers to avoid penalty fees.
- Penalty fees contribute to preventing low-income consumers escaping their state of financial hardship.

3.2 Introduction

In the previous Chapter we examined penalty fees charged by Australian banks, particularly cheque and direct debit dishonour fees, in light of the legal principles that hold penalties unenforceable. We concluded that penalty fees are penalties at law, and therefore unenforceable.

We came to this conclusion because it is highly likely that penalty fees charged by Australian banks are out of all proportion to the costs incurred by them in processing the corresponding customer default, and because banks take advantage of the weak bargaining position of customers to impose penalty fees under their contracts. Both of these elements require further examination. In particular, they lead us to a concern that Australian banks are deriving considerable income and profits from penalty fees and that particularly vulnerable consumers, namely low-income consumers, may be bearing the burden of this income stream for the banks.

It would be unacceptable, from a social policy viewpoint and in light of notions of Australian society as fair and equitable, to have those who can least afford to pay high fees bearing a disproportionate amount of the penalty fees charged by Australian banks.

3.3 The need for a bank account

It is important to begin by noting that, in Australia today, the use of banking and the holding of a bank account are effectively mandatory for participation in society.

Most working Australians need a bank account to receive their salary payments. In addition, those who rely on Centrelink welfare payments *must* hold a bank account to receive their payments, as Centrelink deposits payments into recipients' accounts via direct credit electronic payments. The ACCC acknowledged the importance of financial services for all consumers in its second submission to the Financial Services Inquiry:

> '[i]n many regards, access to financial services is an essential requirement for participation in modern society. The ability to receive payments, store wealth and make payments through bank accounts is an important attribute in the lives of most Australians. In this sense, basic

banking services have much in common with essential utilities services like electricity, gas and water.'[198]

We agree, and would call banking services "essential services" in today's Australia. This means that consumers are largely constrained to accept the terms and conditions that accompany bank accounts, including the level of fees imposed on accounts by the banks. (The inability of consumers to negotiate these terms and conditions was discussed in detail in Chapter 2.)

3.4 Profits derived from penalty fees

It would be difficult to have missed the raging debate regarding increases in Australian bank fees over the past decade. Certainly, there is no doubt that bank fees have increased, although the reasons and justifications for these increases are disputed. While the general debate surrounding increasing bank fees is not within the ambit of this Report, the increase in penalty fees specifically is highly relevant.

3.4.1 Penalty fees - cost recovery or profits?

In Chapter 2 we noted that cheque and direct debit dishonour fees continue to rise, despite the introduction of new technology that was supposed to lower the cost of providing payment services. The same could be said of other penalty fees such as honour fees/account overdrawn fees and credit card penalty fees. Penalty fees are now significantly higher than other fees charged by banks, and appear to be much higher than the cost to banks in processing the corresponding default. For these reasons, we concluded in Chapter 2 that penalty fees do not represent mere cost recovery. If this is the case, it follows that penalty fees must not only be generating significant revenue for Australian banks but, by definition, considerable profits.

Cheque and direct debit dishonour fees

Chapter 2 discussed the Wallis Report,[199] which estimated that the cost of cheque processing was \$1.50 to \$3.00 per cheque.[200] With generosity to Australian banks, we estimated that the cost of processing a cheque dishonour would amount to no more than double the cost of processing a cheque, namely \$3.00 to \$6.00. We calculated that, if a cheque dishonour costs \$6.00 to process, the CBA's cheque dishonour fee of \$35 could be nearly 6 times, and the NAB's cheque dishonour fee of \$50 over 8 times, what it costs those banks to process a cheque dishonour. If a cheque dishonour costs only \$3.00 to process, the CBA could be charging nearly 12 times, and the NAB over 16 times, what it costs them to process a cheque dishonour. Either way, it seems clear the cheque dishonour fees must be generating significant income for banks relative to the cost of the corresponding activities of the bank.

The situation with regard to direct debit dishonours was even more marked. The Wallis Report calculated that the processing of a direct entry payment (such as a direct debit) cost between 3.75% to 9% of the cost of processing a cheque. Taking the higher figures, we calculated that a direct debit payment would cost \$0.27 (9% of \$3.00) to process. We again doubled this figure to account for any additional costs involved in processing a dishonour. Taking the amount of 54 cents, we calculated that the CBA (with the lowest direct debit dishonour fee of \$30) could be charging over 64 times, and the NAB (with a direct debit dishonour fee of \$50) over 92 times, what it costs them to process a direct debit dishonour.

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198 ACCC, *Second Submission to the Financial Services Inquiry*, above n 174 at 78.
199 Wallis Report, above n 78.
200 As above at 227. Moreover, this estimate was made before changes to the Australian Paper Clearing System administered by APCA made the cheque clearing process more efficient (discussed in Chapter 2).

These calculations demonstrate that cheque and direct debit dishonour fees most likely represent more than cost recovery for banks and instead are potentially delivering large profits to Australian banks.

Cheque and direct debit honour fees / account overdrawn fees

Australian banks charge similar fees to those discussed above for the honouring of a cheque or direct debit payment (and the consequent overdrawing of the customer's account). Honour fees are also, therefore, likely to represent an element of over-recovery of costs. Across the six banks we surveyed, Bendigo Bank charged the lowest honour fee at $27.50 and St George the highest at $38.00. These amounts are clearly well above our estimated cheque and direct debit processing costs, even if we double these costs to take account of additional costs involved in honouring a payment and overdrawing the account. For example, even using the higher estimate that a cheque payment costs $6.00 to process, Bendigo Bank could be charging over 4 times its costs to process a cheque honour and St George over 6 times its costs.

The banks may argue that, in honouring a cheque or direct debit payment despite there being insufficient funds in the payer's account to cover the payment, the bank takes a "risk" in advancing or lending funds to the customer, as the customer's account becomes overdrawn. However, the overdrawn funds are charged a high level of interest, meaning that the banks cover this risk by other means. The honour fee also bears no relationship to the amount overdrawn or honoured and is not designed to recover this amount - there is an assumption that the overdrawn amount will eventually be repaid, with interest (otherwise, the bank would have other legal avenues to recover the debt). Indeed, the honour fee is *added* to the overdrawn amount owed on the account.

It therefore appears that honour fees more than fully compensate a bank for processing a customer's payment and overdrawing their account. Instead, they too are potentially delivering profits to banks.

Credit card penalty fees

Penalty fees are also charged by banks in relation to credit cards. For example, customers are charged for exceeding the maximum limit on their credit card and for failing to make payment of the minimum monthly payment due on their credit card account's outstanding balance by the due date.

Across the six banks we surveyed, Bendigo Bank charged the lowest credit card late payment fee at $15, while the ANZ charged the highest such fee at $35. For exceeding the limit on a credit card account, three of the banks charged $25, ANZ charged $35 and St George charged the lowest fee of $15.

Again, on the assumption that the customer eventually repays the amount owing on their credit card, it is difficult to see why such high fees are added to the customer's outstanding balance. Indeed, the levying of an additional fee is not relevant to whether or not the bank recovers an outstanding balance – if a customer did not repay the amount owing on their credit card, the bank would have to pursue the debt, regardless of whether a penalty fee had also been charged. Further, banks already charge interest on outstanding amounts on credit card accounts, covering the bank's risk in advancing the amount to the customer. This interest is charged on the entire amount outstanding, including the amount exceeding the limit or the minimum monthly payment amount.

What, then, is the purpose of a late payment fee or an over the limit fee? It is hard to believe that the automatic generation of an additional line on the customer's credit card account statement stating that the account is over the limit or that payment is late costs a bank $15, let alone $25 or $35, to process. It seems much more likely that the banks generate a profit from their customers by charging credit card penalty fees.

Penalty fees generate profits for Australian banks

It is not fanciful to suggest that Australian banks may be using fees to generate revenue over and above cost recovery. After all, the RBA and the ACCC found in the Interchange Fees Report[201] that this was *precisely* what banks were doing with interchange fees. The Interchange Fees Report stated that:

> 'interchange fees in all three card networks provide, or contribute to, revenues above the average costs of the relevant card services, particularly in the ATM and credit card networks. Although financial institutions were generally unable to supply data in this area, preliminary figuring by the study suggests that these margins are not needed by financial institutions to earn their required return on capital.'[202]

The Interchange Fees Report found that interchange fees for debit card payments contributed to margins of revenues over average costs of around 23% for card acquirers.[203] Credit card interchange fees contributed to margins of revenues over average costs of around 39% for card issuers and around 67% for card acquirers.[204] In the case of ATM services, interchange fees were around double the average cost of providing the services. Worse, ATM interchange fees between financial institutions, already set at double the average cost, were then passed on to consumers fully or *more than fully*.[205]

We must again make clear that the calculations of cheque and direct debit processing costs used earlier in this section (3.4) are based on estimates of the banks' costs only. As noted in Chapter 2, this is necessitated by the fact that there is no publicly available information regarding the costs Australian banks incur in processing customer defaults. As noted by the Wallis Report:

> 'comprehensive data on the costs and efficiency of the payments system are not publicly available in Australia. This reflects both the structure of the Australian payments system and the absence of a transparent framework against which to benchmark costs and efficiency.'[206]

However, on the basis of the only information available to the public, it is highly likely that Australian banks generate profits from penalty fees.

Publicly available information suggests that penalty fees contribute to significant margins of revenues over costs for Australian banks.

For this reason, we turn to examine the total amount of income that Australian banks may be deriving from penalty fees.

3.4.2 Penalty fee income generated by Australian banks

Australian data

Last financial year, the four major banks[207] made a combined after tax profit of $10.916 billion dollars.[208] Non-interest income was a significant source of revenue to the banks, at $13.918 billion

[201] Interchange Fees Report, above n 83.
[202] As above at 74.
[203] As above.
[204] As above at 73.
[205] As above.
[206] Wallis Report, above n 78 at 223.
[207] ANZ, CBA, NAB and Westpac.
[208] ANZ, *Annual Report 2004*; CBA, *Annual Report 2004*; Westpac, *Annual Report 2004*; NAB, *Results for the Year Ended 30 September 2004: Financial Summary*. The banks' financial year was to 30 September 2004, with the exception of CBA which was to 30 June 2004.

accounting for over 38% of the four banks' total net operating income in the financial year 2003-2004.[209]

However, we are unable to undertake an accurate analysis of the amount of income that is generated by Australian banks from penalty fees. This is because there is simply no publicly available information regarding the amount of fee income Australian banks derive specifically from penalty fees each year.

The closest source of information we have are the RBA's yearly *Banking Fees in Australia* articles. These articles survey 19 institutions accounting for over 90% of the total assets of the Australian banking sector, regarding their fee income derived from taking deposits, making loans and providing payment services.[210]

The RBA's Bulletin of April 2003 (the **RBA 2003 Fees Bulletin**) identified that, in total, Australian banks' fee income in 2002 amounted to $7.8 billion, an increase of 10% from the previous year.[211] The RBA 2003 Fees Bulletin disaggregated the total fee income amount of $7.8 billion into fee income derived from households and from business. Households accounted for $2.699 billion in fee income in 2002, an increase of 17% from 2001.[212] The amount of household fee income is further disaggregated in Table 2 of the RBA 2003 Fees Bulletin as follows:

Table 2 – Banks' Household Fee Income in 2002[213]

Source	Amount ($ million)
Deposits	943
Loans	1,397
- Housing	563
- Personal	395
- Credit card	440
Other fees	358
Total	2,699

Last year we asked the RBA to provide us with further disaggregated data to enable us to identify how much of this household fee income is derived from penalty fees. The RBA informed us that it did not have this level of disaggregated data. However, it was able to provide us with further data (Appendix B) that disaggregated the above data as follows:

[209] As above.
[210] See, for example RBA, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, May 2004 (**RBA 2004 Fees Bulletin**) at 57.
[211] RBA, 'Banking Fees in Australia', *Reserve Bank of Australia Bulletin*, April 2003 (**RBA 2003 Fees Bulletin**) at 1-2.
[212] As above at 2.
[213] As above at 3.

Table 3 – Banks' Household Fee Income in 2002 - Disaggregated[214]

Source	Amount ($ million)
Deposits	943
- Account-servicing	224
- Transaction	602
- Other	117
Loans	1,397
- Account-servicing	911
- Transaction	173
- Other	314
Other fees	358
Total	2,699

The RBA informed us that penalty fee income would be contained within the three "Other" categories. This means that penalty fees made up part of $789 million in "other" fee income that Australian banks generated in 2002. The amount of $789 million is an increase from $688 million in 2001 and $665 million in 2000 in "other" fee income.[215]

We therefore know that in 2002 Australian banks generated $789 million in household fee income that was unrelated to account fees or transaction fees. This represents a significant amount of income for unspecified fees. It is more than the amount of income Australian banks earned from transaction fees on household accounts ($775 million), bank fees commonly complained about. Penalty fee income must also have contributed to the $5.104 billion in fee income earned by Australian banks from business accounts. However, we cannot state with any certainty the exact amount of income Australian banks derived from penalty fees. Appendix C contains a copy of a letter from the RBA confirming that it does not collect this level of data.

In 2003, the ABA commissioned PricewaterhouseCoopers to produce its own report regarding the revenue earned by Australian banks from fees,[216] released prior to the RBA 2003 Fees Bulletin. However, even PricewaterhouseCoopers stated that its analysis was constrained because of data limitations, including that 'information separating transaction fees from penalty fees is not available',[217] despite the fact that its report was based on data provided by the ABA as supplied by the ABA's member banks and was commissioned by the ABA.

The RBA's Bulletin of May 2004 (the **RBA 2004 Fees Bulletin**) reported a further increase of 12% in Australian banks' fee income in 2003, to $8.7 billion.[218] Household fee income in 2003 was $3.039 billion, an increase of 15% from 2002.[219] It is highly likely that penalty fee income again contributed to this increase. Indeed, in the RBA 2004 Fees Bulletin, the RBA highlighted the considerable increase in credit card fee income, with banks earning almost as much from households in credit card fees as from fees on home loans. The RBA specifically identified higher charges for overdrawn accounts and late payments as contributing to this increase in credit card fee income.[220]

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[214] See Appendix B.
[215] As above.
[216] PricewaterhouseCoopers, *Survey of retail banking fees – an independent analysis*, above n 80 at 2.
[217] As above at 8.
[218] RBA 2004 Fees Bulletin, above n 210 at 57-58.
[219] As above.
[220] As above at 58.

The US Check Fees Report

Fee income from cheque dishonour fees must contribute significantly to the total amount of fee income derived from penalty fees. The US Check Fees Report, [221] a 1998 American study on cheque dishonour fees by the Consumer Federation of America, looked at the amount of revenue and profits that US banks were generating from bounced cheques.

The US Check Fees Report calculated that banks in the US were generating more than US$5.6 billion in annual revenue and US$5.2 billion in annual profits from cheque dishonour fees. This was added to annual revenue of over US$1.1 billion in revenue and US$918 million in annual profits from deposited cheque dishonour fees. The US Check Fees Report stated that, even after deducting annual losses for cheque fraud of US$600 million, US banks were still generating over US$5.5 billion in profits each year.[222]

The US Check Fees Report calculated the amount of revenue earned from cheque dishonour fees by determining the number of bounced cheques that would be assessed a fee and multiplying this number by the average bounced check fee. It obtained data on the number of cheques that are cashed and the number that bounce from a report of the American Bankers Association and from court cases. It obtained data on the average cheque dishonour fee and the percentage of banks assessing the fee from the US Federal Reserve Board's Annual Report to the Congress on Retail Fees and Services of Depository Institutions.[223]

Applying the methodology of the US Check Fees Report to Australia

We are unable to follow the methodology of the US Check Fees Report to calculate the amount of fee income Australian banks generate from cheque dishonour fees.

While the RBA and the Payments System Board do prepare annual reports to the Australian parliament,[224] these reports do not contain the level of data in the US Federal Reserve Board's annual reports to Congress on retail banking fees. For this reason, it is difficult to obtain Australian data on the average cheque dishonour fee. However, across the six banks we surveyed, the average cheque dishonour fee (unweighted) is $42.50.

Even if we were to use this estimate of $42.50 as our average cheque dishonour fee, we would be unable to determine the amount of revenue earned by Australian banks from levying cheque dishonour fees, as there is no publicly available information regarding the number of cheques that are dishonoured in Australia each year. Indeed, the US Check Fees Report only obtained some of its information after court cases were initiated against US banks, leading to discovery of internal bank documents. We attempted to obtain this information from the RBA, the ABA and various other organisations, but to no avail.

If Australian banks are not generating profits from cheque dishonour and/or other penalty fees, they should have no qualms in releasing data that demonstrates this. Australian banks should release data that enables us to calculate the amount of revenue and profits they do or do not generate from cheque dishonour and other penalty fees.

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[221] US Check Fees Report, above n 119.
[222] As above at 1.
[223] As above at 8.
[224] See, for example, Reserve Bank Board, *Report and Financial Statements 2004* and Payments System Board, *Annual Report 2004*.

Disclosure of penalty fee income and profits

Given the amount of profits earned by US banks from cheque dishonour fees, and our calculations that Australian banks could be charging between 5 to 16 times what it costs them to process cheque dishonours, it is imperative that data be disclosed enabling the public to calculate how much revenue and profit Australian banks are generating from cheque dishonour fees. Clearly, it is likely that Australian banks are earning substantial profits from cheque dishonour fees.

Further, Australian banks generated $789 million in "other" fee income from households in 2002. This amount is an increase of over 50% from the amount of "other" household fee income Australian banks generated only six years earlier.[225] Household fee income again increased significantly in 2003. It is essential that disclosure be made of the fee income and profits Australian banks are earning from penalty fees in general.

3.4.3 Penalty fees – inefficient profits

As discussed above, not only it is likely that Australian banks are generating profits from penalty fees, in addition it is likely that these profits are substantial.

In Chapter 2, we discussed work undertaken by UK economist Michael Waterson examining consumer switching behaviour across the car insurance and the current account banking industries.[226] It appeared likely that the difficulties faced by consumers in switching bank account was a cause of the low rates of switching evident in the personal banking market. This in turn led to sub-competitive outcomes in the personal banking market, with the personal banking industry enjoying excessive profitability.[227] Indeed, Waterson quotes from the 2000 Cruickshank review of competition in UK banking,[228] which considered that the returns for shareholders of the big four banks in UK were abnormal given that they substantially exceed nearly all other sectors of the UK stock market.[229]

In other words, the lack of effectiveness of competition in the UK banking market allowed UK banks to generate supra-competitive profits. As discussed in Chapter 2, the similarities between the UK and Australian environments suggest that similar outcomes are occurring in the Australian banking market, with Australian consumers also unlikely to switch banks. Further, it is clear that fees, particularly penalty fees, have continued to rise and consumers are unable either to access information regarding penalty fees or to negotiate these fees.

If we are correct, then penalty fees not only represent excessive profits for Australian banks, they are also inefficient profits, able to be generated only in a market that does not enjoy fully effective competition. The benefits of introducing competition to Australian markets, including the banking market, have recently been highlighted by the Productivity Commission's review of NCP reforms (discussed further below).[230] If Australia is to continue to gain from these reforms, we must ensure that instances of market failure are properly addressed and inefficient and supra-competitive fees and charges are appropriately investigated and eliminated.

As stated in Chapter 2, we consider that the RBA should undertake a comprehensive study of penalty fees charged by Australian banks, using its powers under the *Payments System (Regulation) Act 1998* (Cth). That penalty fees may represent a safe haven from competitive reforms is yet another reason why such an investigation is required.

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[225] See Appendix B.
[226] Waterson, 'The role of consumers in competition and competition policy', above n 149.
[227] As above at 135-137.
[228] Cruickshank, *Competition in UK banking: A Report to the Chancellor of the Exchequer*, above n 180.
[229] Waterson, 'The role of consumers in competition and competition policy', above n 149 at 136.
[230] Productivity Commission, *Review of National Competition Policy Reforms*, Discussion Draft, October 2004.

- It is likely that Australian banks are generating substantial profits from penalty fees.
- Profits derived from penalty fees most likely represent supra-competitive profits to Australian banks.
- Australian banks must release, or be forced to release, data enabling the public to determine how much revenue and profits Australian banks generate from penalty fees each year.

3.5 Who pays penalty fees?

Given that Australian banks are likely to be generating substantial, and likely supra-competitive, profits from penalty fees, it is important to consider whether all consumers are contributing to this revenue stream, or whether some consumers are unfairly bearing the burden of excessive penalty fees.

3.5.1 Banking fees in a "user-pays" system

In its submission to the inquiry by the Parliamentary Joint Statutory Committee on Corporations and Securities into fees on electronic and telephone banking (the **ABA Submission**),[231] the ABA pointed out that the introduction of explicit banking fees was an inevitable result of deregulation of the Australian banking market.[232] The ABA stated, 'gone are the "bad old days" when, generally speaking, borrowers paid high rates and savers received low rates to subsidise transactors.'[233] Instead, the ABA submitted, cross-subsidies have disappeared as competition has put a squeeze on the interest margins earned by banks on loans. As a result, banks have moved to a user-pays system in which consumers pay for the transactions they make.[234]

We agree with the ABA Submission's general assessment regarding the introduction of transaction banking fees. It is clear that consumers, as a whole, have benefited from reforms that have seen interest margins decrease. The RBA 2003 Fees Bulletin confirmed this, stating that 'the increase in banks' fee income has offset only a small part of the reduction in banks' interest rate margins over the past decade.'[235] PricewaterhouseCoopers also demonstrated this.[236] As Stephen Bartholomeusz has written:

> '[t]raditionally…the high margins and super-profitability of home lending enabled banks to cross-subsidise other retail banking services and treat customers uniformly.
>
> The margins, and the cross-subsidies, came under pressure from two directions…
>
> To both recover a portion of lost margin, banks started to introduce fees and, because they no longer had the capacity to cross-subsidise, they structured them on a user-pays basis.'[237]

However, the ABA Submission also stated that 30-75% of customers do not pay fees.[238] This means implicitly that, in fact, banking fees are not imposed on a strictly user-pays basis at all but rather that some consumers are paying fees whereas others are not.

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[231] ABA, 'Electronic Banking and Financial Services: Providing Convenience and Value', *Submission to the Inquiry by the Parliamentary Joint Statutory Committee on Corporations and Securities into Fees on Electronic and Telephone Banking*, July 2000.
[232] As above at 7.
[233] As above.
[234] As above at 7-8.
[235] RBA 2003 Fees Bulletin, above n 211 at 1.
[236] PricewaterhouseCoopers, above n 80 at 2.
[237] Stephen Bartholomeusz, 'Face the fact: bank fees are better for you', *The Sydney Morning Herald*, 18 April 2003.
[238] ABA, 'Electronic Banking and Financial Services: Providing Convenience and Value', above n 231 at 4, 9, 11.

Two general categories of consumers tend to receive transaction and account-servicing fee waivers or reductions – high-value customers and low-income consumers. The RBA 2003 Fees Bulletin stated:

> '[m]ost 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.'[239]

Likewise, the ABA Submission stated that:

> '[t]ypically, a customer will be eligible for a fee waiver or discount, if they provide their bank a certain level of business either through borrowing for a home or a business or purchasing a wider range of services, such as funds management, superannuation or insurance. This approach is normal commercial behaviour; for example, packaging of telephone and Internet services.
>
> Banks also provide fee-discounted services to the financially disadvantaged.'[240]

However, while both high-value customers and low-income consumers have access to fee waivers, the fee waivers typically granted by banks do not cover the range of penalty fees. One important difference between high-value customers and low-income consumers is that high-value customers are likely to be able to avoid penalty fees. On the other hand, it is low-income consumers who are most likely to incur penalty fees on their accounts. This is because penalty fees are levied for defaults that usually relate to a lack of funds or lack of ability to pay, a situation inherent to the nature of being a low-income consumer. Given that penalty fees are considerably higher than other banking fees, this is a significant burden for low-income consumers to bear. Given that a large proportion of other consumers are not paying fees, low-income consumers who pay penalty fees must, in a sense, be cross-subsidising the transactions of other consumers.

Further, low-income consumers who are not eligible for accounts with fee waivers will pay account-servicing and transaction fees in addition to penalty fees. Most banks require there to be a minimum balance of a significant amount in an account before a fee waiver applies.

The RBA 2003 Fees Bulletin makes it clear that there have been winners and losers from the process of deregulation and introduction of bank fees described above and that low-income consumers are more likely to be "losers":

> '[o]verall, 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 [our emphasis].'[241]
>
> and
>
> '…those who have benefited most are those with a loan secured by a residential mortgage, who use electronic payment channels and *who avoid late payment and other similar charges*...In contrast, those customers *without a loan, who have low balances and have a high volume of transactions* would not have benefited from the fall in interest margins and would be paying higher fees [our emphasis].'[242]

The RBA 2004 Fees Bulletin repeated this assessment:

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[239] RBA 2003 Fees Bulletin, above n 211 at 4.
[240] ABA, 'Electronic Banking and Financial Services: Providing Convenience and Value', above n 231 at 10.
[241] RBA 2003 Fees Bulletin, above n 211 at 4.
[242] As above at 6.

> ‘As noted in the past, this does not mean that all customers have been made better off by the changes. Customers with only deposit accounts, for example, have faced a significant rise in fees without any offsetting benefits in the form of lower interest margins.’[243]

Bartholomeusz also makes this point:

> ‘not all customers are better off…Saying that the growth in bank fees has tapered off, and indeed that the fees only partly compensate the banks for their lost margin, doesn’t, of course, indicate that the fees are set at an equitable level.’[244]

The ACCC underscored this issue in 2002 when it issued its draft determination in relation to an application for authorisation made to the ACCC by the ABA, on behalf of ten major Australian retail banks, in respect of an arrangement proposed by the ten banks to offer a Basic Bank Account (**BBA**) with an agreed set of minimum standards (the **ACCC Draft Determination**).[245] The BBA was an initiative to offer a low cost banking product to low-income consumers. The ACCC Draft Determination proposed to deny authorisation to the BBA proposal, on the basis that it would not have a net public benefit given the features of the account that were being proposed.

Features that particularly concerned the ACCC were:[246]

- the relatively low number of fee free transactions being proposed (six) – this number was not sufficient and would likely mean that the majority of low-income consumers incurred transaction fees and/or carried large amounts of cash around, raising security concerns;[247]
- the fact that balance inquiries would be counted as part of the fee free transactions – it would greatly assist low-income consumers to be able to find out how much money they have in their account, in particular to assist them in avoiding penalty fees;[248] and
- the level of dishonour and account overdrawn fees that would be applied to BBAs – in relation to penalty fees, the ACCC stated:

  > ‘[t]he Commission is not opposed to the imposition of account overdrawn or dishonour fees. However, the Commission is concerned with the high level of these fees and the impact such fees will have on the financial situation of low income consumers. The imposition of account overdrawn or dishonour fees at the level they are currently applied to basic banking accounts may undermine the public benefit resulting from providing the BBA initiative. These fees have the potential to impose costs on low income consumers far greater then [sic] the savings which consumers would experience with the provision of six fee free transactions per month. Furthermore, the Commission considers that it is not appropriate to promote the proposed BBA in its current form as a zero cost account when such fees are charged.’[249]

In other words, it was recognised that penalty fees are too high and impact heavily on low-income consumers, even if low-income consumers were to pay nothing for account-servicing or transactions on their bank account (the effect of penalty fees on low-income consumers is discussed below). Interestingly, the ACCC welcomed a revised BBA proposal by the ABA which addressed the above concerns. The ABA instead withdrew the entire BBA proposal.

We note here that the deregulation of the Australian banking industry was an important plank of the wide-ranging micro-economic reform agenda implemented by Australian governments over the last two decades. The Productivity Commission, in its recent review of NCP reforms (NCP being one of

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243 RBA 2004 Fees Bulletin, above n 210.
244 Bartholomeusz, ‘Face the fact: bank fees are better for you’, above n 237.
245 ACCC, *Draft Determination – Application for Authorisation lodged by The Australian Bankers’ Association (ABA) on behalf of 10 ABA member retail banks – In respect of proposed arrangement in which the 10 member banks will agree to offer a Basic Bank Account with an agreed set of minimum standards*, 16 December 2002.
246 As above at ii.
247 As above at 30.
248 As above.
249 As above at 31.

the key micro-economic reform processes implemented[250]), acknowledged that the benefits of NCP 'will not have been evenly spread across different income groups' and that 'reforms designed to remove sources of inefficiency in the economy will create some 'losers' as well as 'winners''.[251]

The Productivity Commission did not consider that this was sufficient reason to forego reforms that are of substantial net benefit to the community as a whole. It also pointed out that many households affected by direct price increases will have benefited from lower prices for other goods and services as a result of the reforms and that changes in income distribution over the 1990s may not necessarily be caused by NCP and related reforms.[252]

Nevertheless, the Productivity Commission recognised that the implementation of NCP reforms must take account of distributional (and adjustment) impacts and recommended that distributional and adjustment issues be assessed up-front as part of the framework for future reforms.[253] Further, the Productivity Commission acknowledged that, in some cases, distributional and adjustment issues will not be able to be addressed through the social security and taxation systems but may require additional measures to promote equitable outcomes.[254]

As stated above, we agree that Australian consumers as a whole have benefited from reforms to the Australian banking industry and would not dispute that the negative impacts of the reforms on some consumers would not have been a reason to have foregone the reforms. However, as set out above, it is clear that the reforms have resulted in negative distributional impacts on low-income consumers, particularly the charging of excessive penalty fees.

Further, we consider that the negative impact of penalty fees on low-income consumers is not an issue that can be addressed adequately through the general social security and taxation systems. Rather, penalty fees are a creature of the Australian banking market; for example, penalty fees have continued to increase despite the introduction of new technologies that have reduced payment processing costs for Australian banks (discussed in section 2.4 of this Report). In addition, their impact, discussed in detail in the following section, amounts to more than the imposition of higher prices on low-income consumers; they also create various flow-on effects, including trapping low-income consumers in financial hardship, which must be specifically addressed.

3.5.2 The impact of penalty fees on low-income consumers

The practical effect of penalty fees

In July 2002, the Consumer Credit Legal Centre (NSW) released a report setting out the results of a national survey it conducted of the experiences of financial services caseworkers.[255] The consultation with consumer caseworkers revealed that caseworkers were highly critical of penalty fees. Some caseworkers also felt that financial institutions used penalty fees to generate revenue.[256]

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[250] NCP is a package of reforms aimed at encouraging competition to improve the wellbeing of all Australians, arising out of the recommendations of the Hilmer Report, which was commissioned by the Council of Australian Governments in 1992. NCP is underpinned by three intergovernmental agreements signed in April 1995 by the Commonwealth, State and Territory Governments: the Competition Principles Agreement; the Conduct Code Agreement; and the Agreement to Implement the National Competition Policy and Related Reforms. These agreements are available at http://www.ncc.gov.au/publication.asp?publicationID=99&activityID=39.
[251] Productivity Commission, *Review of National Competition Policy Reforms*, above n 230 at 79.
[252] As above at XIX-XX, 79-84.
[253] As above at XLIII, 299.
[254] As above at 137.
[255] Consumer Credit Legal Centre (NSW) Inc., *Financial Services Caseworker Consultation*, July 2000.
[256] As above at 21.

Case studies included:

The client had a keycard that she used to access her account. As far as she knew it was only a debit account with no overdraft facility. One month she made a series of withdrawals using EFTPOS, which did not give her any information on the balance left in the account. Inadvertently she had overdrawn her account and made several withdrawals after that. The total amount overdrawn was a few hundred dollars. However she was charged a $25.00 overdraft fee every time she overdrew the account. This totalled $250.00 by the end of the month. Even though an amount equivalent to the amount overdrawn was deposited into the account during the month, the account remained overdrawn due to the overdraw fees.[257]

Client has a $15 transaction fee deducted by bank at the end of the month which overdraws account by $15, client deposits $15 but subsequent overdraw fee of $20 overdraws account again, causing second overdraw fee.[258]

Customer was sick one week, and so unable to deposit her pay cheque. During that week two direct debits of $18 and $10 proceeded, and as there were insufficient funds in the account a default fee of $35 was charged in respect of each.[259]

Customer had a direct debit facility with [major bank]. An incorrect amount was debited by the bank, leaving her account overdrawn. A $20 fee was debited to her account. As the account remained overdrawn further transactions resulted in additional fees being charged, all as a result of the bank's initial mistake. The customer's financial counsellor contacted the branch manager, detailing what had taken place and pointing out this had caused the customer substantial hardship. The manager refused to refund any of the fees on the basis that many customers faced the same problems.[260]

One case worker also commented that:

> '[a] lot of problems with overdrawn fees arise because [the Financial Institution] has direct debited the client's account too early; in other words, before the client's income has been deposited. This is a particular issue for Centalink [sic] recipients and other low income people who use all their income each pay period.'[261]

Indeed, the charging of penalty fees often means that a customer's account remains overdrawn when the customer might otherwise have been able to clear the arrears on their bank account. Some of the case studies above demonstrate this. In addition, CLCV staff opened accounts with cheque facilities with several major banks and wrote cheques on the accounts to see what would happen when the cheques were dishonoured. Although the amount of a dishonoured cheque was returned to the account, the dishonour fee ensured that the account remained overdrawn, meaning that further transactions would also incur penalty fees and attract interest for the bank.

It is clear that penalty fees impact harshly on low-income consumers and can operate to make it difficult for low-income consumers to run their bank account and manage their income and expenses.

Penalty fees as a contributor to financial exclusion

As discussed earlier, consumers in Australia must have access to a bank account if they are to participate fully in today's society. Clearly, given the necessity of a bank account, the inability to access or maintain one is critical to an individual's capacity to remain engaged with our society. The ACCC stated in its second submission to the Financial System Inquiry:

[257] As above at 22.
[258] As above.
[259] As above.
[260] As above at 47.
[261] As above.

'[b]arriers to accessing [financial] services can significantly detract from the quality of life and social standing of individuals and families.[262]

For example, in their paper entitled *Financial Services and Social Exclusion* (**Financial Exclusion Paper**),[263] Connelly and Hajaj pointed out that non-mainstream financial services are limited, more expensive and less likely to be regulated.[264] Without a bank account, a consumer is also forced to deal only with cash, which excludes them from using less expensive and/or more convenient payment means.[265]

The Financial Exclusion Paper was concerned with the phenomenon of financial exclusion as a major contributor to the problem of social exclusion, and examined ways to address and prevent the occurrence of financial exclusion. The Financial Exclusion Paper defined financial exclusion as:

'the lack of access to financial services by individuals or communities due to their geographic location, economic situation or any other "anomalous" social condition which prevents people from fully participating in the economic and social structures of mainstream communities.'[266]

Issues of affordability and of access were identified by the Financial Exclusion Paper as the main causes of financial exclusion. In terms of affordability, the Financial Exclusion Paper noted the same trends discussed earlier, namely that following deregulation of the Australian banking market, some consumers have benefited whereas low-income consumers have been hard hit by changes to the way fees are levied on financial products.

The ACCC, in its second submission to the Financial System Inquiry, discussed how financial exclusion occurs in the competitive Australian banking environment:

'[t]he impact of changes to the type of financial services being provided and their associated fee structures can also impact adversely on less well off members of society…Deposit taking institutions operating in a competitive environment are likely to adopt a cost reflective mix of charges and fees for [basic and low cost deposit] accounts rather than relying on earnings from interest spreads.

If, however, the bank fees and charges associated with basic-type accounts are disproportionate to the underlying costs, and the government fees and charges, associated with providing such accounts, then particular groups of customer may not be able to access the services of certain types of deposit taking institutions. They will be marginalised (disenfranchised) from participating in the mainstream financial system.

From society's standpoint it is important that the right balance is struck between facilitating the access requirements of particular groups of customers (especially those from less well off backgrounds), the revenue needs of government, and the recovery of fixed, variable and opportunity costs imposed on financial institutions in providing those products. 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.'[267]

The Financial Exclusion Paper illustrates the way in which the above trends create a "bank fee poverty trap" that captures low-income consumers and prevents them from moving into more affordable banking accounts.[268] The trap operates in the following manner:[269]

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[262] ACCC, *Second Submission to the Financial Services Inquiry*, above n 174, at 78.
[263] Financial Exclusion Paper, above n 116.
[264] As above at 8.
[265] As above at 10.
[266] As above at 8.
[267] ACCC, *Second Submission to the Financial Services Inquiry*, above n 174, at 79-81.
[268] Financial Exclusion Paper, above n 116 at 12-13.
[269] As above at 13.

- Banks charge fees on most accounts if a minimum balance is not maintained. Not only is this minimum balance out of the reach of low-income consumers, banks regularly increase both the fees and the minimum balance required to avoid fees.
- Low-income consumers are usually not eligible for fee waivers granted due to conducting other business with the bank, such as a home loan, or due to membership of a professional association.
- Fees are lower for electronic payment channels such as the Internet, however there are other costs associated with the use of these channels that make it difficult for low-income consumers to access them.[270] For example, low-income consumers are far less likely to have access to a computer or the Internet.[271]
- Bank accounts for low-income consumers have limited features, for example they do not pay interest and limit the number of fee free transactions, rather than granting a full fee waiver.
- Very heavy fees are imposed for any form of default. In some penalty fee situations, interest and penalty interest may also be charged.

All of these factors create the trap, making it extremely hard for a low-income person to save money:

> '…it is so difficult for a poorer person to move into a more affordable account. They are unlikely to earn interest and continual fees mean that they are unlikely to meet minimum balance requirements - especially on fixed incomes, like social security benefits. *Any temporary defaults will set them back substantially and often lead to a cycle of other fees.* Even if low income consumers do gradually progress to the stage where they may avoid paying some fees, the fee structure at most banks changes every one to two years and may price them out again. [our emphasis]'[272]

The Financial Exclusion Paper also terms this situation 'the "double whammy" of being poor and paying higher fees for financial services', as it has been called in the United Kingdom.[273] Meanwhile, Australian banks' fee income continues to increase with, as stated earlier, household fee income in 2003 increasing by a large 15% from 2002, in comparison with fee income overall which increased by only 12% from 2002,[274] and "other" household fee income increasing by over 50% in the six years to 2002.[275]

In other words, low-income consumers are forced to bear a disproportionate burden in relation to fees, particularly penalty fees, and in effect *cross-subsidise high value customers* that the banks are competing to attract. Not only is this unfair in and of itself, but the charging of penalty fees is also a major factor in preventing low-income consumers from escaping a cycle of financial difficulty.

The ACCC stated that the 'centrality of financial services products indicates that there is a clear need for these issues to be addressed.'[276] It is imperative that the issue of penalty fees be addressed to help dismantle the "bank fee poverty trap" and prevent reverse cross-subsidisation by redistributing the burden of fees more equitably across all consumers.

The difficulty of avoiding penalty fees

Australian banks may argue that penalty fees are imposed, not as reverse cross-subsidisation, but in order to discourage bad practices on the part of consumers. For example, the Financial Exclusion Report noted that the ANZ introduced a new fee for cash advances on a credit card in 2001 in order

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[270] See, for example, as above at 16-17.
[271] See, also, Jennifer McLaren and Gianni Zappalà, 'The new economy revisited: an initial analysis of the digital divide among financially disadvantaged families', *Background Paper No.5*, The Smith Family, Research & Social Policy Team, September 2002.
[272] Financial Exclusion Paper, above n 116 at 13.
[273] As above.
[274] RBA 2004 Fees Bulletin, above n 210 at 2.
[275] See Appendix B.
[276] ACCC, *Second Submission to the Financial Services Inquiry*, above n 174 at 81.

to discourage cash advances, because ANZ's data showed that consumers who utilised cash advances were more likely to default on repayments.[277] Apart from the dubious legality of such a motive (as discussed in Chapter 2, this may contribute to an assessment of penalty fees as unenforceable penalties at law), there is no evidence that high fees do actually discourage consumers from defaulting in some way. This is because low-income consumers are often unlikely to have control over whether they default, given that low-income consumers use all their income in a pay period and do not usually have the ability to create a "safety cushion" of funds.

The US Check Fees Report also noted that '[b]ankers claim that they assess high fees to discourage customers from bouncing cheques. Yet, 95 percent of bankers report no drop in the number of bounced checks after fees are increased.'[278] In addition, the US Check Fees Report noted that banks use "tricks" to cause even careful consumers to bounce checks.[279]

While not necessarily deliberate "tricks", in Australia several factors make it harder for consumers to avoid penalty fees:

- Banks include the amount of uncleared funds in the total amount available on an account – this can cause a consumer to overdraw their account unwittingly.[280]
- Banks may refuse to cancel a direct debit when requested by the customer – although a consumer should also cancel a direct debit authorisation directly with the merchant in writing, a bank is supposed to accept a customer's direction to cancel a direct debit, at least on a transaction or savings account.[281]
- A consumer must pay a fee to request that their bank stop a cheque they have written.[282]
- Overdraft protection can be obtained to prevent dishonour or honour fees, however an overdraft facility is expensive and the charge for it will be levied regardless of whether the account is actually overdrawn at any stage during the period of protection. It is therefore not often an affordable option for low-income consumers.[283] Further, some banks may not offer an overdraft facility on all accounts (particularly accounts for low-income consumers).
- There is a lack of adequate disclosure of penalty fees – this was discussed in Chapter 2. This includes inadequate disclosure of the fact that an account can be overdrawn – many consumers erroneously believe that they cannot overdraw their account from an ATM or spend above their credit card account limit.[284]

With regard to this last point, ASIC also stated, in its 2002 guide to good transaction fee disclosure,[285] that consumers need to be aware that a transaction may attract an overdraw fee *before* they make the transaction, so that they can make an informed choice at the time as to whether or not to proceed with the transaction, particularly given the significant size of these fees.[286] ASIC noted that there were no requirements for real-time disclosure of overdraw fees.[287]

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[277] Financial Exclusion Paper, above n 116 at 12.
[278] US Check Fees Report, above n 119 at 2.
[279] As above.
[280] See, for example, Consumer Credit Legal Centre (NSW) Inc., *Financial Services Caseworker Consultation*, above n 255 at 43-44.
[281] ABA, *Code of Banking Practice*, 2003 at clause 19; see, also, Consumer Credit Legal Centre (NSW) Inc., *Financial Services Caseworker Consultation*, above n 255 at 46-48; Australian Banking Industry Ombudsman, *Bulletin 29*, June 2001; Viney, *Review of the Code of Banking Practice Issues Paper*, above n 75 at 72-73.
[282] See, for example, Appendix A.
[283] See, for example, Appendix A.
[284] See, for example, Consumer Credit Legal Centre (NSW) Inc., *Financial Services Caseworker Consultation*, above n 255, at 21-22.
[285] ASIC, *ASIC's guide to good transaction fee disclosure for bank, building society and credit union deposit and payments products (transaction accounts)*, June 2002.
[286] As above at 23.
[287] As above at 24.

Further, www.bankrate.com has reported on a growing phenomenon in the United States whereby banks automatically apply "bounce protection" to customer accounts, meaning that payments made without sufficient funds are honoured but the customer is charged both a penalty fee and very high penalty interest – effectively a form of undisclosed short-term high-cost credit.[288] Bounce protection is considered particularly insidious because it allows consumers to overdraw their bank account, incurring a high fee and interest charges, when withdrawing money from an ATM or when making a purchase using their debit card – transactions for which, traditionally, any overdrawing of the account would have been declined without the charging of a fee.[289] This practice may creep into the Australian banking scene via an extension of the circumstances in which honour fees are applied. As discussed earlier, CLCV staff opened several accounts with Australian banks to test what occurs when cheques are dishonoured. One bank consistently honoured cheques presented when there were insufficient funds in the account, overdrawing the account and charging an honour fee instead (together with interest on the overdrawn amount).

It is also interesting to note another development in the United States - banks have been increasing credit card late payment and over the limit fees and shortening the time period in which to pay credit card balances, making it harder for customers to pay on time and avoid penalty fees.[290] In addition, new fees have been introduced and more credit card issuers are now charging penalty interest on top of normal interest rates if a consumer pays late.[291] Such measures introduced into the Australian environment would hurt low-income consumers further by making it harder to avoid credit card penalty fees.

All of these factors only exacerbate the "bank fee poverty trap" that low-income consumers find themselves in.

- Penalty fees are unacceptably high.
- Penalty fees are disproportionately borne by those who can least afford to pay them, namely low-income consumers.
- It is difficult for low-income consumers to avoid penalty fees.
- Penalty fees contribute to preventing low-income consumers escaping their state of financial hardship.

3.6 Options for reform

The situation with regard to penalty fees in Australia must be addressed. However, the difficulties posed by the lack of information regarding penalty fees makes it difficult to tackle the problem. For this reason, it is clear that the first steps that must be taken involve obtaining accurate and comprehensive data regarding penalty fees.

It is our opinion that the RBA must undertake this task, as it is the only body in Australia that has the power to force disclosure of relevant information from Australian banks, under the *Payments System (Regulation) Act 1998* (Cth) (as discussed in Chapter 2). Both the costs to Australian banks in processing customer defaults and the income and profits earned by Australian banks from penalty

[288] Laura Bruce, 'Some rubber checks cost you more than others', *www.bankrate.com/nsc/news/chk/20030212a1.asp*, February 2003.
[289] National Consumer Law Center, Consumer Federation of America, Consumers Union, National Association of Consumer Advocates and Woodstock Institute, *Comments to the Federal Reserve System: Proposed Amendments to Regulation DD and Proposed Overdraft Protection Guidance*, August 2004 at 4, available from http://www.consumerlaw.org/initiatives/test_and_comm/content/BounceLoanComments8_6_04.pdf.
[290] Lucy Lazarony, 'Credit card penalties get more severe', *www.bankrate.com/nsc/news/cc/20010514a.asp*, March 2002.
[291] As above.

fees must be examined in detail before further recommendations can be made or action taken. The RBA is able to undertake a study jointly with the ACCC and/or ASIC, as set by the precedent of the Interchange Fees Report.

Australian banks have certainly begun to take steps to address the problems facing low-income and disadvantaged consumers of financial services.[292] The banks are slowly accepting that they have social obligations to the Australian community[293] and most now offer lower fee transaction accounts to certain disadvantaged groups, including concession holders, pensioners and young people. In this regard, it is disappointing that the ABA and its member banks did not make further efforts in relation to the BBA proposal after the ACCC made its draft determination.

The importance of a BBA account with effective features was recognised by PIRG several years ago.[294] A better Australian BBA proposal would be an important step in addressing the "bank fee poverty trap" and the disproportionate burden imposed by penalty fees on low-income consumers. It is imperative that any BBA proposal include measures to reduce the level and extent of penalty fees. Otherwise, as recognised by the ACCC, low-income consumers will not, in effect, have access to a low cost banking account.

However, regardless of the fact that a detailed study into penalty fees is required, current penalty fees charged by Australian banks are plainly excessive. This includes penalty fees levied on credit card accounts, which would most likely not be subject to a BBA proposal. The excessive nature of penalty fees is, of itself, an indication of market failure in the Australian retail banking market, delivering supra-competitive and economically inefficient benefits to Australian banks. In other words, current competition policy has failed to address the problem of penalty fees and is unlikely to do so in the future, as was found in the case of interchange fees (see Chapter 2).[295]

Therefore, it seems clear that, whatever the results of an RBA inquiry into penalty fees might be, some form of regulation of penalty fees may be required. Various options exist to effect such regulation, for example the imposition of a social charter for banks, further licensing requirements or specific legislation. Consumer-directed measures will also be important in addressing penalty fees, for example measures designed to reduce the difficulties faced by consumers in finding and comparing information about penalty fees and in switching bank accounts more generally.

In addition, any measures will require the commitment of an active regulator. For example, in 2001 Louise Sylvan, then head of the ACA, set out the following key areas as a focus for ASIC's consumer protection function in relation to financial services:

- 'adequate disclosure: clear, transparent and (where possible) comparable information on products across financial services;
- adequate protection: conduct and licensing rules, appropriate liability for industry and sound redress and protection for consumers; and
- good advice: reliable, independent, accurate advice - untainted by hidden commissions or inadequate training.'[296]

Strong enforcement by ASIC would compliment the agency's other roles, including education, licensing and the monitoring of self-compliance programs. However, ultimately ASIC may not be

[292] See, for example, Louise Petschler, 'Banks show they care?', *Choice Online*, May 2001, www.choice.com.au; Adele Horin, 'Credit where credit's due as bank dives into shark-infested waters', *The Sydney Morning Herald*, 25 November 2004 at 6.
[293] ABA, *Supplementary Submission to Inquiry into Fees on Electronic and Telephone Banking*, 12 September 2000; Financial Exclusion Paper, above n 116 at 36.
[294] PIRG, *Big Banks, Bigger Fees: The 1999 PIRG Bank Fee Survey*, above n 167.
[295] See, also, Financial Exclusion Paper, above n 116 at 34-35.
[296] Louise Sylvan, *Focussing on the Consumer in Financial Services Regulation: Address to the 2001 ASIC Summer School'*, above n 168 at 8.

the appropriate regulator to deal alone with the problem of excessive penalty fees. As the Financial Exclusion Paper pointed out:

> '[p]erhaps the greatest gap in financial services regulation is that in the post Wallis environment, no regulator has responsibility for ensuring affordable access to financial services.'[297]

As with interchange fees, tackling penalty fees will require a coordinated approach by the RBA, the ACCC and ASIC. Indeed, the Financial Exclusion Paper called for the government to provide one regulator with 'the regulatory power and resources to coordinate the investigation of financial exclusion in Australia and to take steps to address financial exclusion',[298] as is the case in the United Kingdom with its Financial Services Authority.[299]

While unable to pre-empt the findings of a detailed analysis of penalty fees, it is clear that any regulation must include measures that address the problems of:

- Inadequate disclosure of penalty fees – this may include clarification of existing disclosure obligations as they relate to penalty fees and the use of standardised, plain English disclosure documents;
- Lack of availability of a truly low cost bank account to low-income and disadvantaged consumers which limits the level and extent of penalty fees – this may mean the imposition on banks of a requirement to offer such a bank account; and
- Excessive penalty fees – this may involve the imposition of caps on the fees banks may charge consumers or the regular review and adjustment of bank fees.

[297] Financial Exclusion Paper, above n 116 at 40.
[298] As above at 49.
[299] As above at 41-42.

RECOMMENDATIONS

Recommendation 1

Australian banks should release sufficient data to enable the Australian public to make an accurate assessment of the costs incurred by banks in processing customer defaults.

Recommendation 2

Australian banks should release disaggregated data which identifies the amount of fee income earned from penalty fees, from penalty fees on household and on business accounts, and from penalty fees in relation to household deposits and loans (including a disaggregation into the different types of loans - housing, personal and credit card).

Recommendation 3

The RBA should undertake a comprehensive study of penalty fees charged by Australian financial institutions, using its powers under the *Payments System (Regulation) Act 1998* (Cth) to obtain information if necessary, and should report its findings in detail to the Australian public.

Recommendation 4

Australian banks should offer a truly low-cost Basic Bank Account to low-income consumers that addresses the concerns expressed by the ACCC in its previous draft determination and, in particular, does not levy excessive penalty fees on customers.

APPENDIX A

Table comparing certain fees and charges charged by the ANZ, Bendigo Bank, Westpac, the CBA, the NAB and St George on personal transaction accounts as at November 2004[300]

Fee	*ANZ*	*Bendigo Bank*	*Westpac*	*CBA*	*NAB*	*St George*
Cheques						
Cheque dishonour	$45.00	$40.00	$40.00	$35.00[301]	$50.00	$45.00
Deposited cheque dishonour	No fee (Business account - $9.00)	No fee (Business account - $10.00)	No fee (Business account - $9.50)	No fee (Business account - $10.00)	No fee (If deposited into credit card account - $12.00) (Business account - $13.00)	$10.50 (Business account - $10.50)
Stop cheque	$15.00 (Stolen cheque – no fee if provide copy of police report)	$5.00 (Lost or stolen cheque - no fee)	$5.40 (Lost or stolen cheque book where cheques not signed – no fee)	$15.00 (Lost or stolen cheque - no fee)	$5.00 $8.00 if cheque number not provided (Lost, stolen or unsigned cheque - no fee or $5.00 if cheque number not provided)	Staff assisted: $9.00 (single) $10.50 (multiple in sequence) Phone/Internet banking: $6.00 (single) $8.00 (multiple in sequence)

300 All fees are on a per item/transaction basis unless otherwise specified.

301 CBA charges an additional $4.00 for notification by telephone of the dishonour (per call) and an additional $10.00 for notification of the dishonour to a third party – it is unclear whether CBA is able to use its discretion in making a notification or whether it is able to do so only on the customer's instructions.

Fee	*ANZ*	*Bendigo Bank*	*Westpac*	*CBA*	*NAB*	*St George*
Transaction accounts						
Periodic payment dishonour	$45.00	$15.00 (after 4 unsuccessful attempts on consecutive days)	$40.00	$35.00[301]	$35.00	$45.00
Direct debit dishonour	$45.00	$40.00	$40.00	$35.00[301]	$50.00	$45.00
Honour (overdrawn account)	$29.50	$27.50[302]	$30.00[303]	$30.00[304]	$30.00[305]	$38.00
Overdraft protection (All banks charge interest on overdrawn amounts)	$17.00 per quarter up to $500 or $1000 limit	$50.00 or 0.5% of the approved limit (whichever is greater) up to maximum $500 limit. Temporary overdraft – no extra fee Permanent overdraft - $250 fee	Temporary: $12.00 for $250-$499 limit $25.00 for $500-$999 limit Permanent: $250.00 and $8.00 per month for $1,000 to $25,000 limit	No fee up to $100 limit $9 per quarter from $100 to $499 limit $15 per quarter from $500 to $999 limit No cost if not used	$35.00 per half year up to $1,000 limit $50.00 per half year from $1001 to $2000 limit	$6.00 per month on approved facility

[302] Charged each day on which the customer performs a transaction on their account and the account remains overdrawn at the end of the day.
[303] No fee is charged if the account is returned to a positive balance (or to a balance within the agreed overdraft limit, if applicable) by 6pm Sydney time on the day the transaction is conducted.
[304] Charged on the day one or more transactions are honoured. A maximum of one charge per day applies. The fee is not charged on any day on which a transaction on the account is dishonoured.
[305] Charged each day where debits are paid and the account overdraws or remains overdrawn.

Fee	*ANZ*	*Bendigo Bank*	*Westpac*	*CBA*	*NAB*	*St George*
Credit cards						
Credit card late payment	$35.00	$15.00 (if minimum repayment amount exceeds $25)	$25.00	$25.00	$30.00 (where account balance is $50 or greater at the time fee is debited)	$25.00
Credit card over limit	$35.00	$27.50	$25.00	$25.00	$25.00 (if limit exceeded by more than 2%)	$15.00

Sources: ANZ, *ANZ Personal Banking Account Fees and Charges*, November 2004.

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APPENDIX B

Nicole Rich

From: "BARNES, Matthew" <barnesm@rba.gov.au>
To: <nicole@clcv.net.au>
Cc: "DIXON, Liz" <dixone@rba.gov.au>
Sent: Friday, May 16, 2003 5:00 PM
Attach: Book2.xls
Subject: Fee income from household deposits and

<<Book2.xls>>

Nicole,

Please find attached data on fee income from household deposit and loan accounts.

Kind regards,

Matthew Barnes
Market Analyst
Domestic Markets
Reserve Bank of Australia
PH (02) 9551 8352

Total of All Banks

		1997	1998	1999	2000	2001	2002
HOUSEHOLDS							
Deposits							
	Account-Servicing	180	156	170	201	212	224
	Transaction	154	286	373	469	533	602
	Other	12	75	96	116	123	117
	Total	**346**	**517**	**639**	**786**	**868**	**943**
Loans							
Total Household Loans							
	Account-Servicing	435	534	572	710	733	911
	Transaction	41	80	96	104	147	173
	Other	110	176	175	222	229	314
	Total	**587**	**789**	**844**	**1035**	**1109**	**1397**

APPENDIX C

CONSUMER LAW CENTRE VIC LTD

AN INDEPENDENT NON-PROFIT PUBLIC INTEREST LEGAL CENTRE

Level 7/20 Queen Street, Melbourne 3000

Telephone (613) 9629 6300 Facsimile (613) 9629 6898

info@clcv.net.au www.clcv.net.au

ACN: 056 362 059

ABN: 13 056 362 059

24 July 2003

Mr Ian Macfarlane
Governor
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear Mr Macfarlane

Disaggregated data regarding the amount of banks' household fee income

We refer to the Reserve Bank of Australia's April 2003 Bulletin - Banking Fees In Australia (the **Bulletin**).

In the Bulletin, the Reserve Bank of Australia (**RBA**) states that banks' household fee income for 2002 was $2,699 million. This fee income amount is disaggregated into the categories of "Deposits", "Loans" and "Other Fees". The "Loans" category is further disaggregated into the categories of "Housing", "Personal" and "Credit Card". The RBA also disaggregates the "Deposits" category into "Transaction deposit accounts" and "Other deposit accounts" in the RBA's "F6 – Domestic Banking Fee Income" statistics table.

We have previously spoken to RBA staff to request a further disaggregation of the data regarding the amount of banks' household fee income. In particular, we requested disaggregated data on the amount of banks' household fee income which relates specifically to "penalty fees" charged by banks, for example fees for cheque dishonours and direct entry debit dishonours.

After speaking with RBA staff, we were sent further disaggregated data on the amount of banks' household fee income under the "Deposit" and "Loan" categories, both disaggregated into "Account-Servicing", "Transaction" and "Other" fee income. We understand that penalty fee income would be included in the "Deposits – Other", "Loans – Other" or general "Other" categories of fee income.

We now request that the RBA provide us with disaggregated data on the amount of banks' household fee income that is derived specifically from cheque dishonour fees and direct entry debit dishonour fees charged by banks.

If the RBA is unable to provide us with this data, we request that the RBA provide an explanation as to why it is unable to meet our request.

Please contact Nicole Rich on (03) 9629 6300 if you have any questions.

Yours sincerely
CONSUMER LAW CENTRE VICTORIA LTD

Chris Field
Executive Director

Nicole Rich
Public Interest Lawyer

RECEIVED 1.8.03

RESERVE BANK OF AUSTRALIA

65 Martin Place
GPO Box 3947
SYDNEY NSW 2001

Domestic Markets Department

Telephone (02) 9551 8300

Facsimile (02) 9551 8305
Email ryanc@rba.gov.au

In reply please quote DM
Filename g:\fmshare\letter to consumer law centre victoria ltd.doc

29 July 2003

Ms Nicole Rich
Public Interest Lawyer
Consumer Law Centre Victoria Ltd
Level 7
20 Queen Street
MELBOURNE VIC 3000

Dear Ms Rich

DISAGGREGATED DATA REGARDING THE AMOUNT OF BANKS' HOUSEHOLD FEE INCOME

The Governor has passed your letter on to me.

The RBA does not collect data on banks' fee income in the detail you require. I regret therefore that we cannot help you in your search for data on "penalty" fees. The data already sent to you contain all the detail that is available.

Yours sincerely

CJ Ryan
Head of Domestic Markets Department

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HOW TO AVOID PENALTY FEES: TIPS FOR CONSUMERS

1. Cheques, direct debits and periodic payments

If a payment (whether cheque, periodic payment or direct debit) comes out of your bank account and you do not have enough money in your account to cover the payment, your bank will either dishonour the payment or pay it and overdraw your account. Either way, your bank will charge you a high fee for doing so.

Tips to avoid paying dishonour fees and account overdrawn fees:

- Always make sure that you **know the balance of your bank account**. It is a good idea to write down every deposit that goes into your account and every withdrawal that comes out of it – that way, you can keep track of the balance. Don't forget EFTPOS transactions or direct debits that have taken money out of your account.
- **Check your account balance *before* writing a cheque**. If you cannot cover the amount of the cheque, consider whether you have to write the cheque at that time, or whether you have other options to make a payment.
- **Keep a record of when periodic payments or direct debits come out of your bank account** (perhaps in your diary). Make sure that you have enough money in your account to cover the payment at the right time.
- **Try to keep at least a small amount of money in your bank account** to cover unexpected debits and avoid your bank account becoming overdrawn. For example, your bank will debit your account for taxes and account keeping fees.
- If you are **relying on someone to make a payment** into your account, **check your account** to make sure that it has been made and that the correct amount has been deposited.
- **Report a lost or stolen chequebook** as soon as possible to avoid unauthorised use of your cheques.
- If you know that you are likely to overdraw your account, consider applying for **overdraft protection**, if it is available on your account and affordable. Ask your bank for details.
- Make sure you **know how to cancel a direct debit arrangement** if you need to. Ask your bank about its policy so that you know what to do. You should also cancel the direct debit authority in writing with the merchant.
- Check your account statements to make sure that any periodic payment or direct debit arrangement you have cancelled or that has finished **does not continue by mistake**.
- If you **change bank accounts**, make sure that you **cancel any direct debit arrangements** from your old account. They will not automatically be cancelled when you close your old account.

Note: Cheque accounts incur government debits tax, which is charged on every withdrawal, whether it is made by a cheque or by other means. This can add up to a significant amount and is not charged on other, non-cheque accounts. Consider whether you really need a cheque facility – you may be able to save money by making your payments some other way.

However, if you think that you will have trouble covering direct debit payments, consider whether you should enter into a direct debit arrangement *before* doing so.

2. Credit Cards

Tips to avoid paying credit card over-limit fees and late payment fees:

- **Beware:** Many people think that they will not be allowed to spend above the credit limit on their credit card. **Do not count on your bank to stop you spending over the limit** on your credit card. You may be allowed to make purchases when you have gone over the limit and be charged a fee without realising it.
- **Keep track of how much of your available credit you have already used**. Record details of the payments you make by credit card. This will also help you to notice any unauthorised transactions.
- If you have authorised a direct debit to come out of your credit card account, **know how to cancel the direct debit arrangement** if you need to. Ask your bank about its policy so that you know what to do. You may need to cancel the direct debit authority in writing with the merchant, not your bank.
- Generally speaking, **consider using only one credit card**, particularly if you think you may overspend.
- **Keep track of due date for payment** – if you do not pay the minimum balance due on time, your bank may charge you a **late payment fee**.
- If you can, **pay a few days in advance**, especially if you are sending your payment by mail.
- **Follow the guide to payment on your account statement** so that your payment is correctly registered on time.
- **Shop around for the best credit card for your needs**. For example, if you do not pay off the entire balance of the account every month, consider a credit card with no interest free period but a lower interest rate.
- **Report a lost or stolen credit card** as soon as possible to avoid unauthorised transactions.

3. General tips

Shop around

- Choose your bank accounts and credit cards carefully. Ask your bank about their penalty fees as well as other fees, and consider changing banks if you can get a better deal.

Request a refund

- You are entitled to a refund if a penalty fee is wrongly deducted from your account.

Complaints or problems

- Call the Banking and Financial Services Ombudsman on 1300 78 08 08. Their services are free of charge for consumers.
- If you need help with your debts, contact the Financial and Consumer Rights Council for a referral to a financial counsellor on 9663 2000 or 1800 134 139. Their services are free of charge.

PENALTY FEES: RESOURCE GUIDE FOR CONSUMER SUPPORT WORKERS

GENERAL TIPS

Shop around

- Tell your clients to shop around for the best account and/or credit card for them. Help your client determine whether they may be eligible for an account with a credit union.

Refunds

- Request a refund for a client if a penalty fee is wrongly deducted from their account.

Cancelling a direct debit arrangement

- Credit card accounts: Your client may need to cancel the direct debit directly with the merchant in writing. If this does not work, contact the bank or the Banking and Financial Services Ombudsman (see below). You may be able to assist your client to ask their bank to claim a chargeback.
- Transaction or savings accounts: The bank must act on your client's instructions to cancel the direct debit. If the bank refuses, contact the Banking and Financial Services Ombudsman (see below). Your client should also cancel the direct debit directly with the merchant in writing

Complaints or problems

- Contact the Banking and Financial Services Ombudsman:

  GPO Box 3A
  Melbourne Vic 3001
  Tel: 1300 78 08 08
  Fax: (03) 9613 7345
  www.bfso.org.au

The services of the Banking and Financial Services Ombudsman are free of charge for consumers.

TIPS FOR CONSUMERS

1. Cheques, direct debits and periodic payments

Give your client the following tips to avoid paying dishonour fees and account overdrawn fees:

- Always make sure that you **know the balance of your bank account**. It is a good idea to write down every deposit that goes into your account and every withdrawal that comes out of it – that way, you can keep track of the balance. Don't forget EFTPOS transactions or direct debits that have taken money out of your account.
- **Check your account balance *before* writing a cheque**. If you cannot cover the amount of the cheque, consider whether you have to write the cheque at that time, or whether you have other options to make a payment.
- **Keep a record of when periodic payments or direct debits come out of your bank account** (perhaps in your diary). Make sure that you have enough money in your account to cover the payment at the right time.

- **Try to keep at least a small amount of money in your bank account** to cover unexpected debits and avoid your bank account becoming overdrawn. For example, your bank will debit your account for taxes and account keeping fees.
- If you are **relying on someone to make a payment** into your account, **check your account** to make sure that it has been made and that the correct amount has been deposited.
- **Report a lost or stolen chequebook** as soon as possible to avoid unauthorised use of your cheques.
- If you know that you are likely to overdraw your account, consider applying for **overdraft protection**, if it is available on your account and affordable. Ask your bank for details.
- Make sure you **know how to cancel a direct debit arrangement** if you need to. Ask your bank about its policy so that you know what to do. You should also cancel the direct debit authority in writing with the merchant.
- Check your account statements to make sure that any periodic payment or direct debit arrangement you have cancelled or that has finished **does not continue by mistake**.
- If you **change bank accounts**, make sure that you **cancel any direct debit arrangements** from your old account. They will not automatically be cancelled when you close your old account.

Note: You should also inform your client that cheque accounts incur government debits tax, which is charged on every withdrawal, whether it is made by a cheque or by other means. This can add up to a significant amount and is not charged on other, non-cheque accounts. Have them consider whether they really need a cheque facility – they may be able to save money by making payments by other means, for example by credit card, direct debit or even by the occasional money order.

2. Credit Cards

Give your client the following tips to avoid paying credit card over-limit fees and late payment fees:

- **Beware:** Many people think that they will not be allowed to spend above the credit limit on their credit card. **Do not count on your bank to stop you spending over the limit** on your credit card. You may be allowed to make purchases when you have gone over the limit and be charged a fee without realising it.
- **Keep track of how much of your available credit you have already used**. Record details of the payments you make by credit card. This will also help you to notice any unauthorised transactions.
- If you have authorised a direct debit to come out of your credit card account, **know how to cancel the direct debit arrangement** if you need to. Ask your bank about its policy so that you know what to do. You may need to cancel the direct debit authority in writing with the merchant, not your bank.
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- **Report a lost or stolen credit card** as soon as possible to avoid unauthorised transactions.