HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

Number 03941, 17 November 2017

Retail banking: overdrafts and bank card charges

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Summary

This note sets out the background and chronology to legal challenges mounted by both the public and the Office for Fair Trading (OFT) against credit card companies and high street banks over their charging policies. Most of the note is of historical interest. The issues of charges are largely settled and not subject to such intense public concern. The 'baton' of the OFT Review of the domestic banking market has now been passed to successor organisations such as the Competition and Markets Authority (CMA) and the Financial Conduct Authority (FCA) both of which have broader economic interests in the personal current account market.

The main historical issue was on charges banks make when customers go overdrawn, perhaps by only a small amount or for a short period of time. Similar arguments applied to credit card companies when the customer exceeds their credit limit. The note explains the legal arguments involved.

Although the issue has been around for some years, it reached almost epidemic proportions between 2005 and 2007 with significant public and media pressure ranged against the banks and credit card companies. More formal opposition to charges emerged from consumer pressure groups which encouraged individuals to contest charges.

Put very simply, the issue is that if the charges are related to the provision of a service, and hence have some sense of proportionality in relation to that service, they are legal (though possibly excessive). If they are penalties, i.e. they are prohibitive charges that banks levy to punish people from going overdrawn or from borrowing too much, then they are illegal. There is a further consideration, which is whether or not the charges were subject to review by the competition authorities under the terms of the unfair consumer contracts legislation.

Whilst actions against credit card charges were resolved relatively quickly and practice changes agreed, a multitude of individual legal actions against current account charges were only brought to a stop by virtue of a waiver on action by the Financial Services Authority whilst a test case was heard. At each stage of the case, the verdict was appealed against resulting in it going to the Supreme Court. To the surprise of most commentators (previous verdicts had been against them), the Supreme Court found in favour of the banks. This result meant that both regulators and banks needed to find a non-legal resolution.

The note also takes a look at the more general reviews into competition in the current account market conducted by the OFT, and latterly the CMA and the FCA, which developed alongside the specific charges investigation and continue.

One solution to the competition and regulatory issues of concern has been the promotion of account 'switching'. The evidence suggests that this has had only modest impact so far and therefore interest in this market is unlikely to end soon.

Part 1 of this Paper deals with the historical issue of charges. Part 2 is more concerned with broader market issues.

1. The legal challenges

1.1 Historical context

Of all the charges levied by companies, bank charges are especially reviled by the media and consumers alike. Perhaps for historical reasons, public perception is often that banking should be free. The financial crisis, amongst other things, reinforced the view that banks were essential parts of society – almost on a par with the utilities – and not just any other company. For example, proposals exist currently to force banks to provide fee free basic bank accounts for all who need them. Banks themselves contribute to this perception by not explicitly charging for many of their services and where they do, often call the charge a 'subscription' or some other euphemism. Thus, when customers find that they have been charged there can be a good deal of resentment. This is particularly the case when what look like punitive charges are levied when an account goes overdrawn or a credit card limit is breached. The sense of injustice may be heightened by the fact that the breach may be for a very small amount or for a very short period of time, or both.

Although the issue has been around for some years, it reached almost epidemic proportions between 2005 and 2007 with significant public and media pressure ranged against the banks and credit card companies. More formal opposition to charges emerged from pressure groups like the Bank Action Group (BAG)[1] which encourages individuals to contest charges. BAG's contention is that the charges routinely levied by banks and the credit card companies for, often small, failures on the part of customers to manage their accounts are disproportionate and therefore illegal. It is the disproportionality, it was claimed, that made them illegal.

Put very simply, if the charges are related to the provision of a service, and hence have some sense of proportionality in relation to that service, they are legal (though possibly excessive). If they are penalties, i.e. they are prohibitive charges that banks levy to punish people from going overdrawn or from borrowing too much, then they are illegal. There is a further consideration, which is whether or not the charges were subject to review by the competition authorities under the terms of the unfair consumer contracts legislation. A section concentrating on the legal points of the case can be found in the Appendix of this note.

In all, the banks had to face three strands of criticism. Two concerned specific practices, the third was a more general investigation of the state of the retail banking market.

- First, an investigation by the Office of Fair Trading (OFT) into charges levied on credit cards.

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1 Bank Action Group website

- Second, a test case by the OFT against a selection of banks supplanting thousands of potential legal actions brought by bank customers against overdraft charges.
- Lastly, an enquiry by the OFT into the competitiveness of the retail bank current account market.

This note outlines these. The OFT ceased to operate from 1 April 2014. Its responsibilities passed largely to the new Competition & Markets Authority (CMA) and to the Financial Conduct Authority (FCA).

1.2 The 2003 OFT investigation into credit card charges

In 2003 The OFT began an enquiry into the 'default' charges levied by the credit card companies when, for example, a cardholder exceeded their credit limit, or where they forgot to make the minimum payment one month. The investigation was carried out in the light of the Unfair Terms in Consumer Contract Regulations (UTCCR). They reported in April 2006. The OFT report found:

> Credit card default charges have generally been set at a significantly higher level than is legally fair, said the OFT today. The OFT estimates that across the industry this has led to unlawful penalty charges currently in excess of £300 million a year.
>
> The OFT now expects all credit card issuers to recalculate their default charges in line with the principles set out in a statement published today and to take urgent action where needed to reduce the level of credit card default fees. The industry has until 31 May to respond to the statement. These principles also apply to default charges in other consumer contracts such as those for bank overdrafts, store cards and mortgages.
>
> **Where credit card default charges are set at more than £12, the OFT will presume that they are unfair, and is likely to challenge the charge unless there are limited, exceptional business factors in play.** A default charge is not fair simply because it is below £12. Setting a threshold for intervention is a pragmatic pro-consumer action that is designed to give the industry the opportunity to change its practice without litigation. It is supported by detailed guidance to the industry as to how to reduce the likelihood of public enforcement.
>
> […]
>
> John Fingleton, OFT Chief Executive, said:
>
> 'Our statement of principles provides practical guidance to banks which increases their incentives to compete vigorously while protecting consumers from being charged unfair amounts. Our threshold approach is a spur to changes in market practice. We expect credit card issuers to adjust their default fee levels quickly. We have not ruled out future legal action if the market does not respond positively.'[2]

[2] OFT 5 April 2006

The OFT did not insist that default fees should be equivalent to the threshold, and a court will certainly not consider that a default fee is fair just because it is below the threshold. Exceptional business factors may mean that a default charge over £12 is not unfair. This does not necessarily mean that the current level of the default charge is consistent with the OFT's interpretation of the requirements of unfair contract terms legislation. So, for example, where a card issuer has a policy of requiring customers to pay minimum monthly repayments by direct debits, or only offers credit cards to customers that satisfy a relatively high scoring requirement, it may be able to set a fair default fee at a level above the threshold. The OFT set out what it thought were fair charging principles in a document *Calculating fair default charges in credit card contracts: A statement of the OFT's position*, also published in April 2006.

In practice, the £12 charge has become near universal. However, most companies increased interest rate margins and other charges, such as for using a credit card abroad. Other innovations include charging customers for cards they do not use often enough and charges if a card account is in credit.

In a related development, in March 2010, the credit card issuers announced a code of conduct agreed by them, which offered improved conditions for users. This gave extended protection against interest rate rises on existing balances; an end to the practice of applying repayments to the balance with the cheapest interest rate; and restrictions on offers of unsolicited increases in credit balances. This agreement was in response to Government threats to refer the companies to a full OFT review. It is estimated that these measures will cost the industry £533 million in the first two years.

1.3 OFT court case regarding bank (overdraft) charges

Background

Following on from its investigation into credit cards the OFT turned its attention to 'default' charges levied by banks. This case ran concurrently with the general review of bank accounts mentioned above. The results of both these strands are considered in the section after this.

In September 2006 the OFT published a press notice which reviewed the impact of its findings into credit cards and announced that its intention to examine banks' current account charging structures:

> In response to the OFT's statement of principles on the calculation of credit card default charges, credit card issuers have agreed to reduce their default charges - the majority by almost half.
>
> [...]
>
> The April statement also indicated that the OFT considers that the broad principles in relation to default charges are likely to be relevant to other standard agreements with consumers such as those for bank current accounts. The responses received from the

> banking industry have generally challenged this belief but the OFT remains of the view that the broad principles do read across to the retail banking area and has decided to undertake further work on the application of these principles to bank current accounts. In the course of this work the OFT will liaise closely with the Financial Services Authority (FSA) and hold discussions with the British Bankers' Association (BBA) to ensure that distinctive features of retail banking and the circumstances in which default charges are applied are identified and taken into account.[3]

The announcement that the OFT was investigating other bank charges, even though it was only described as a 'review of the issues' rather than a formal investigation, gave enormous impetus to the virtual tidal wave of individual claims against banks for the recovery of 'illegal' charges.

Typically, an individual initiated an action against a bank; the bank resisted the claim; the individual took the bank to court where, just before the case was heard, the bank settled out of court. *The Independent*, which took up the issue as a front page campaign in summer 2007 commented that "The hysteria over bank charges has spiralled out of control over the past few weeks, as consumers have headed in their droves for the courts, desperate to avenge their "unfair treatment".[4]

This 'stampede' had become something of a one-way route to compensation, but because the banks routinely gave in pre-trial, a clear legal determination was no closer and the integrity and 'dignity' of the court process was being undermined. The situation became even less clear when Lloyds TSB actually allowed some cases to proceed and won in a case in Birmingham, suggesting that the banks may have been unnecessarily timid in the past.[5]

In March 2007 the OFT announced the findings of its preliminary investigation:

> 'The UK retail banking market performs well in many dimensions, especially relative to international norms. However, the issue of bank current account charges is a matter of real concern to the banks' customers, and raises wider questions about competition and transparency of pricing. The initial scoping work we have undertaken has demonstrated to us that this is not only an issue for those people who are being charged, but also for customers who are not defaulting on their bank accounts. A quick-fix solution is not the answer as this might be of limited long-term benefit and could have unintended and far-reaching consequences across the whole sector and on consumers as a whole.'

It proposed to set up a full enquiry into the broad workings of the retail banking market, to report sometime towards the end of 2008 [See section 4 below.].

However, neither the OFT or the banks could ignore the chaos surrounding individual claims which was engulfing them at the time. In July 2007 the OFT entered into an agreement with eight current

3 OFT 7 September 2006 Press release,
4 *The Independent* 23 June 2007
5 *Birmingham County Court Berwick & Haughton v Lloyds TSB Bank*

account providers (seven banks and one building society) to bring a test case in order to "ensure an orderly and timely resolution of the legal issues associated with its investigation".[6] These "legal issues" were:

- the applicability of the *Unfair Terms in Consumer Contracts Regulations 1999* and
- the applicability of the common law of penalties.

The test case

The case commenced on 17 January 2008 and the judgment was handed down on 24 April 2008.[7] The case considered whether the provisions of the *Unfair Terms in Consumer Contracts Regulations 1999* which sets out the meaning of unfair contract terms, apply to some bank charges. The case also considered whether the common law on penalty charges applied to these relevant charges. The charges being considered by the court were:

- **Unpaid Item Charge**: levied when the customer gives an instruction for payment or, in some cases at least, withdrawal that the bank declines to honour because the customer does not have sufficient funds in his account (or an arranged facility which covers it).
- **Paid Item Charge**: levied when the customer gives an instruction for payment or, in some cases a least, withdrawal, for which he has insufficient funds in his account and which the bank honours.
- **Overdraft Excess Charge**: levied if, during a specified period (typically a day or a month) … an account is and/or goes overdrawn (and there is no overdraft facility), or… the debit balance is and/or goes above the limit on an existing overdraft facility, and in both cases irrespective of the reason why the excess has occurred.
- **Guaranteed Paid Item Charge**: a charge distinct from a Paid Item Charge which some of the Banks levy when the honour "in accordance with the guarantee, a cheque issued in conjunction with a cheque guarantee card (or, in the case of some banks, a debit card payment made under a guaranteed debit payment system) for which the customer does not have sufficient funds.[8]

In the judgment made on 24 April 2008, Mr Justice Andrew Smith found that although there was no common law case against "relevant charges", the charges were subject to assessment under the *Unfair Terms in Consumer Contracts Regulations 1999.*[9] The charges **were potentially excessive or unfair, but not illegal**. The OFT website explained that:

6 OFT press notice, OFT welcomes High Court ruling on unarranged overdraft charges, 24 April 2008
7 Office of Fair Trading v Abbey National PLC and 7 others, [2008] EWHC 875 (Comm)
8 See para 3 of Office of Fair Trading v Abbey National PLC and 7 others, [2008] EWHC 875 (Comm)
9 Office of Fair Trading v Abbey National PLC and 7 others, [2008] EWHC 875 (Comm)

> The Judge found that unarranged overdraft charges in personal current accounts can be assessed for fairness under the UTCCRs [*Unfair Terms in Consumer Contracts Regulations 1999*]. The Judge rejected the banks' contentions that the relevant charges are exempt from an assessment as to fairness under Regulation 6(2) of the UTCCRs.
>
> The Judge also found that in respect of terms now generally used by the banks for personal current accounts (other than basic accounts), those of HSBC, Lloyds, Nationwide and RBSG are in plain and intelligible language and those of Abbey, Barclays, Clydesdale and HBOS are largely in plain intelligible language but not so in certain specific and relatively minor respects. The Judge also found that the relevant charges are not capable of amounting to penalties at common law.
>
> […]
>
> It is important to note that this Judgment only covers points of legal principle and does not determine whether the relevant charges are actually unfair. The OFT has not yet reached any conclusions about the fairness of the charges.[10]

The Times Law Report of the case sets out the factors considered by the Judge and his conclusions:

> MR JUSTICE ANDREW SMITH said that the terms in standard form contracts provided for four basic categories of relevant charges about which the claimant was concerned: unpaid item charges, paid item charges, overdraft excess charges, and guaranteed paid item charges.
>
> The terms generally used by the banks for personal current accounts, other than basic accounts, were in plain intelligible, or largely in, plain intelligible language.
>
> The banks' terms and charges did not amount to penalties and so were not unenforceable at common law against the customer. The banks had argued that the charges were not payable upon a breach of contract on the part of customers.
>
> None of the provisions that the claimant identified meant that the customer was under a contractual commitment such that relevant charges could have been a penalty for breach of the commitment, and so unenforceable at common law.
>
> If there was doubt about the meaning of these provisions, they would have been given the interpretation most favourable to the consumer and so as to avoid customers being under any contractual commitment.
>
> On the question of whether the fairness of the terms was excluded from assessment by the claimant, the banks submitted that the charges were the price or remuneration, or part of the price or remuneration, for services that they supplied and therefore regulation 6(2) applied to the terms.
>
> The banks made two principal submissions:
>
> The whole package argument They supplied a "bundle" or "package" of services to their current account customers which enabled the customers to manage their day-to-day finances, including services whereby customers could, without prior

[10] OFT website, Questions and answers for OFT personal current account work, http://www.oft.gov.uk/advice_and_resources/resource_base/market-studies/personal/personal-test-case/personal2

arrangements, request an overdraft by issuing a payment instruction which, if executed, would create or increase borrowing from the bank, and where the bank chose to grant such a request, customers could borrow from the bank on its standard terms.

The relevant charges, together with other revenue in particular form from interest paid by customers on borrowing and the use of credit balances in customers' accounts, were the price or remuneration for the package or services.

His Lordship held that the payments were not made in exchange for the whole package of services supplied by the bank when it was operating a current account.

Further, the payments were not the price or remuneration for those services in any natural meaning of the phrase or within the meaning of regulation 6(2).

The payments would not have been so recognised by the typical customer when he opened a current account with a bank, and they were not generally so presented by the banks in their terms or other documentation.

Moreover, the basis of the whole package argument was that the relevant charges were not the price or remuneration for services but part of the price or remuneration for services.

An assessment of the fairness of the relevant charges did not involve an assessment of the level or adequacy or appropriateness of the overall price or remuneration for the package of services supplied by the bank, and an assessment of the fairness of the relevant charges as against those services, apart from being entirely beside the point, would not have intruded upon the essential bargain between the parties that the United Kingdom intended under Council Directive 93/113 EEC (OJ 1993 L95/29) and the 1999 Regulations should be protected from assessment.

The specific services argument. If the charges were not to be regarded as part of the price or remuneration for the package of services supplied by the banks to customers with current accounts, then they were the price or remuneration for some part of those services; that was, for the services or a service supplied in connection with borrowing requests where no facility had been arranged in advance.

His Lordship held that each of the four categories of relevant charges needed to be considered separately but none of them was the price or remuneration in exchange for services by way of providing an unarranged overdraft. Therefore, the specific services argument was rejected.

Therefore the banks' arguments failed and it followed that the relevant terms were not exempt from assessment under the 1999 Regulations.

That was not surprising since regulation 6(2) exempted assessment of the fairness of the balance of the essential bargain between a seller or supplier and a consumer.

As the banks themselves explained, under a "free-if-in-credit" price structure, the economic balance in a contract between a bank and its current account customer was between the package of services supplied by the bank and the total benefits to the bank from operating the current account, not only by way of relevant

> charges but also in particular by way of the use of the funds if the account was in credit and interest if it was in debit.
>
> On no view did an assessment of the relevant charges, or relevant terms, impinge upon the adequacy of the totality of the benefits received by the bank in exchange for the package of services.
>
> The claimant's investigation might well have involved consideration of the fairness of the structure of a "free-if-in-credit" pricing regime but that was very different from an assessment of the overall adequacy of the benefits to a bank from operating it.[11]

As expected, at the next court hearing, which took place on 22 May 2008, the banks appealed against the initial ruling a case which began on 29 October 2008.

The First Appeal

The basis of the banks' appeal was that bank charges were not liable to be judged by the OFT on the grounds of unfairness. The banks lost this appeal which reported on 26 February 2009. In a statement the OFT said that:

> The OFT welcomes the Court of Appeal's very clear confirmation today that the unarranged overdraft charging terms for personal current accounts can be assessed for fairness.
>
> The Court found that these terms are not part of the core or essential bargain between a consumer and their bank, and therefore consumers do have protection under the Unfair Terms in Consumer Contract Regulations (UTCCRs) for these terms.
>
> […]
>
> We are now analysing the implications of the judgment for our ongoing investigation. The OFT has already written to the banks with its provisional view on the fairness of the terms, setting out its concerns that they may be unfair. We expect to reach a final decision on fairness later this year.[12]

The British Bankers Association (BBA) responded by saying that they would seek leave to appeal to the Supreme Court. The full judgement can be found here. The Supreme Court hearing after the Appeal Court's ruling began in June 2009.

Supreme Court Appeal

The Supreme Court gave its judgement on 25 November 2009. To the surprise of many, the Court found in favour of the banks. The appeal before the Supreme Court was on a narrow issue. It related to whether the OFT could challenge the charges as fair in relation to whether they were adequate as payment. A press summary of the case was published by the Court. It said:

> This appeal involved a relatively narrow issue. The Supreme Court had to decide not whether the banks' charges for unauthorised overdrafts were fair but whether the OFT could launch an investigation into whether they were fair.
>
> At present, banks provide retail banking services on the basis that customers whose accounts are kept in credit (in other words who

11 "Bank charges can be assessed for fairness", Law Report, *The Times,* 29 April 2008
12 OFT press release 26 February 2009

> lend money to the banks) will not be charged for the services provided; customers who have authorised overdrafts will be charged interest on the money that they borrow from the bank; and customers who incur unauthorised overdrafts will be charged, not only interest on the sums borrowed, but fixed fees for each particular service involved.
>
> The OFT has power to assess the fairness of terms in consumer contracts but this is subject to the limits laid down in the Unfair Contract Terms in Consumer Contracts Regulations 1999, which implemented European Council Directive 93/13/EEC. Regulation 6(2)(b) states that the assessment of the fairness of a term in a contract "shall not relate to the adequacy of the price or remuneration, as against the goods or services supplied in exchange". In other words, the "value for money" equation is excluded.
>
> The Court of Appeal held that this exclusion applied only to the "core terms" of the contract and not to ancillary terms such as the charges for unauthorised overdrafts. The Supreme Court unanimously held that the charges for unauthorised overdrafts fell within this exclusion. They were part of the price paid by the customer for the banking services provided. However, the charges might still be open to assessment by the OFT on other grounds under Regulation 5.[13]

A Supreme Court press notice explaining the implications of the decision said:

> Lord Walker made clear that the scope of the appeal was limited – the court did not have the task of deciding whether or not the system of charging current account customers was fair, but whether the OFT could challenge the charges as being excessive in relation to the services supplied in exchange.[14]

Lord Phillips suggested that because the scope of appeal was limited, it might still be open for the OFT to assess the fairness of the charges according to other criteria – criteria that do not relate to the charges' "adequacy as payment":

> This agreement between the parties reflects acceptance by the Banks in the Court of Appeal of a finding by Andrew Smith J that was contrary to one of their submissions. The Banks had submitted that a term of a contract that provided the "price or remuneration" for "goods or services supplied" was absolutely exempt from assessment for fairness by reason of Regulation 6(2) [Unfair Contract Terms in Consumer Contracts Regulations 1999]. This was described as the "excluded term" construction of the Regulation. Andrew Smith J held that this was not correct. Regulation 6(2) precluded assessing a price term for fairness by reference to its adequacy as payment for the goods or services provided in exchange. It did not, however, preclude assessing a price term for fairness according to other criteria. This has been described as the "excluded assessment" construction of the Regulation.
>
> Mr Sumption [QC for Barclays Bank plc] submitted that the difference between the "excluded term" and the "excluded

13 Supreme Court website at: http://www.supremecourt.gov.uk/docs/uksc_2009_0070_ps.pdf

14 Supreme Court press summary, Office of Fair Trading (Respondents) v Abbey National plc & others (Appellants) [2009] UKSC 6, 25 November 2009

> assessment" constructions was "a distraction from the real issues". It is certainly a distraction from the narrow issue that the parties are now agreed is before the court. But it is only because the "excluded assessment" construction has prevailed that the issue has been narrowed from that in the Agreed Statement of Facts and Issue. Had the "excluded term" construction prevailed, a finding in favour of the Banks that the Relevant Terms were included within the meaning of the word "price" in Regulation 6(2) would have precluded any challenge to those terms on the ground of fairness. As it is, if the Banks succeed on the narrow issue, this will not close the door on the OFT's investigations and may well not resolve the myriad cases that are currently stayed in which customers have challenged Relevant Charges.[15]

Put simply, the point on which the Supreme Court had differed from the Appeal court was over whether the charges were related to a bundle of services or to 'ancillary' services – overdraft borrowing etc. The banks had argued that they provided a package for each account and the charges that were triggered on certain events were integral to the entire package. Since regulation 6(2) means that the price of something (the charges), cannot be assessed as fair or unfair in relation to its *adequacy* as payment for the goods or services provided in exchange, if the account was a package, then they could not be judged to be fair or otherwise by the OFT.

But, the Supreme Court suggested that the OFT could judge the fairness of the charges in relation to different criteria because, they said, the Court of Appeal was wrong to make a distinction between a core package and ancillary services. They found that Regulation 6 (2) (b) "contained no indication that only the 'essential' price or remuneration was relevant. In fact, any monetary price or remuneration payable under the contract would naturally fall within the language of Regulation 6 (2) (b)".[16]

The Financial Services Consumer Panel described the judgement as a 'technical' point and urged banks to "get round the table with the OFT, the FSA and consumer groups to agree a fair solution going forward".[17]

The Independent newspaper, which advertised itself as the leading campaigner on this issue, was 'surprised and disappointed' about the ruling:[18]

> Having campaigned against the swingeing sums levied by banks on account holders who inadvertently went into the red or transgressed their overdraft limit, we had hoped that the judges would uphold the rulings of lower courts, and allow the Office of Fair Trading to investigate the charges. This did not happen.
>
> The ruling means that this particular avenue for those seeking redress is now closed. Permission to appeal to the European Court was also denied. So far as the judicial process is concerned, therefore, all options have been exhausted. This is a setback; but it need not, and should not, be the end of the quest.

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15 *Office of Fair Trading (Respondents) v Abbey National plc & others (Appellants) [2009] UKSC 6*, paras 60-61
16 Supreme Court Summary Response
17 FSCP press release 30/11/09
18 Independent editorial 26 November 2009

A more detailed description of the legal arguments surrounding the case can be found in the appendix to this note.

2. The economic and market challenges

2.1 OFT investigation into competition amongst personal current account [PCA] providers

As stated above, the OFT concluded in March 2007 that it could not promote a 'quick fix' for account charges in the way that it had proposed one for credit cards. So, in April 2007 it announced that it was extending its investigation into competition amongst current account providers. In a press release it stated that it would look at the impact of the free in credit current account model and its impact on competition within the banking sector and the fairness (aside from the legal points) and impact of unauthorised overdraft charges and returned item fees.[19]

The report was published on 16 July 2008.[20] Its main message was to dispel the view that current accounts were 'free'. It estimated that current accounts earned £8.3 billion for the banks and yet explicit charges were only £2.6 billion. Hence there was a considerable degree of hidden charging. Having said that, it acknowledged that the free in credit model was popular with millions of account holders who paid nothing for a range of banking services which were routinely charged for in other countries. The executive summary included the following:

> The OFT has found evidence of competition in the PCA market. Banks can also demonstrate high consumer satisfaction and low fees on many of the more visible elements of current accounts – such as withdrawals from ATMs. Internet and telephone banking have also made it easier for consumers to manage their account. However, the OFT believes that the PCA market as a whole is not working well for consumers.
>
> A combination of complexity and a lack of transparency means that consumers and competition are focused almost exclusively on more visible fees, and not on the less visible elements such as insufficient funds charges and forgone interest – despite the fact that these make up the vast bulk of banks' revenues. For insufficient funds charges, this effect is exacerbated by a lack of simple mechanisms for consumers to control, or opt out of, an unarranged overdraft. Furthermore, a significant proportion of consumers believe that it is complex and risky to switch accounts, with the result that switching rates are very low.
>
> As a result, we believe the ability for the market to function well has become distorted in three ways:
>
> - first, there seems to be a substantial cross subsidisation from those consumers who incur insufficient funds charges to those who do not; and to a significant extent from 'vulnerable', low income and low saving consumers, to higher income, higher saving ones

[19] OFT 26 April 2007 Press release,
[20] OFT; Personal current accounts in the UK; July 2008

- second, the extent of this cross subsidisation means there is a substantial misalignment between the banks' revenues and their costs on many of their products and services. This may lead to inefficiency through under or over consumption of services by consumers, and
- third, the lack of consumer awareness and switching on the less visible elements provides banks with little incentive to compete on them. This may also have an impact on longer term productivity within the banking sector. Without competition in these areas, banks have lower incentives to create new and innovative services.

> Furthermore, given the constraints on competition, and in particular the low switching rates, we are not persuaded that any additional profits made from less visible elements are fully competed away in terms of lower fees in other areas. This raises the possibility that a significant proportion of the profits made on less visible elements are kept by banks rather than passed back to consumers through more intensive competition.
>
> In essence, the OFT believes that the market may be stuck in an equilibrium that does not work well for many consumers. A significant number of consumers do not know how much they will effectively pay in bank fees or how individual elements in the charging structure will be implemented, either before or after they are incurred. This limited understanding of key account elements, combined with low confidence in switching, means that the banks have less incentive to provide better offers on insufficient funds charges and interest. Without better offers from banks, however, consumers have little incentive to switch.[21]

Under 'next steps' the report sets out a plan for future action:

> There are three areas of the market where we believe improvements may deliver significant benefits to consumers and the wider economy. The first is increased transparency, with banks informing consumers in a way that greatly reduces the need for high levels of regulatory intervention. The second is an increase in the number of active and informed consumers so as to enhance the current competition between banks, delivering efficiency in supply and value for consumers. The third is to improve the switching process, by minimising barriers to switching and improving consumers' perception of the process.

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[21] OFT; Personal Current Accounts in the UK – *Executive Summary* July 2008

The basic structure of the market at the time showed a few banks dominating the market:

Market shares by number of customers, 2007

		Market share %
Established banks	Lloyds TSB	19
	Royal Bank of Scotland	17
	Barclays	15
	HSBC Group	14
Challenger banks	HBOS	14
	Abbey	6
	Nationwide	5
	Others	10

Source: Current Accounts, Finance Intelligence, June 2007, Mintel

In the OFT's follow up report in January 2013 it found that

> Aside from the impact of the HBOS merger with Lloyds TSB, the collective and individual shares of the four large providers in the market have been relatively static and have not changed significantly since 2007. It is only outside the four large providers that more significant change can be seen.[22]

Although the names had changed after the financial crash, the real ending of the dominance of a few banks remains a distant hope. The absence of Bradford & Bingley and Northern Rock has reduced 'Others'. HBOS joined Lloyds, but Lloyds lost the TSB in return. Abbey is now part of an expansionist Santander so may have moved up the table. A Financial Times article puts the Big Four – HSBC, RBS, Barclays and Lloyds as still having 75% of the market. New challenger banks in the form of Metro, the new TSB, and in time Tesco and Virgin Money, it said, will provide the new competition.[23]

Having carried out its review, but shorn of legal firepower by the Court's decision over charges, the OFT saw its role as one of coordinating the next round of consultations based on the Report with the banks. At this stage the main parties involved, the banks, the OFT and to a lesser extent customers all had something to think about. Both the banks and the OFT found themselves in a position where they had to reconcile conflicting interests.

The banks

On the one hand, the banks were keen to defend their charging structure and the service they provide. In April 2006, the BBA issued the following press notice:

> Unlike in other countries where customers pay both to have a bank account and for the services they use, in the UK banks provide free banking, including access to free debit cards, free

[22] OFT; Review of the personal current account market; January 2013
[23] Financial Times; *Banks jostle for current accounts*; 2 June 2014

> access to ATMS, free use of cheques, free use of direct debits, free internet banking, free telephone banking and the provision of free paper statements.
>
> The UK market is one of the most competitive retail banking markets in the world, and international research shows that UK banks provide extremely good value for customers.[24]

Furthermore they had won the overdraft fee court case and had managed to avoid paying £millions in back charges. But the banks have reasons for wanting to respond to their critics.

First, they were in a weak reputational position, both with the public and with government. The review, and the further consultations about reform, was held against the backdrop of the financial bail-out of the UK banking sector.

Secondly, even some banks thought that the existing system of current account charges is not one that is sustainable or desirable. For example, the limit on credit card charges and overdraft charges (see below) has reduced those income streams. The PPI[25] mis-selling scandal has done the same, with some banks pulling out of what was a very profitable line of business altogether. Taken together there is real pressure on the banks to find other income streams.

Moving from the old system of individual charges to the 'free' model was not easy, with each bank watching what the other was doing and either matching or outdoing them, leaving customers with no clarity about which was the cheaper bank to be with, as one offer was counterbalanced by an advantage with another institution.

Moving from free to charging could have the same consequences, but, if done collectively as part of an agreement with the OFT it could be less painful for the banks. Hence, there is a real incentive for the banks to engage with the OFT and others to establish a new system.

The Treasury Select Committee summarised evidence from banking witnesses about the future of free banking:

> There has been a growing debate around the future of so-called free banking. For example, former Barclays Chief Executive, John Varley, has publicly stated that "it is possible that free-in-credit banking is a structure that has outlived its time", adding that the concept was "idiosyncratic by the standards of the world" and "worth re-examining".
>
> When John Fingleton was asked about the future of so-called free banking, he said that he "wouldn't favour saying that you should regulate to have fixed fees for banking" adding that "seem to be heavy-handed". Mr Fingleton believed that greater transparency—discussed earlier in this chapter—and "paring away at hidden charges, so that you are forcing the banks to put more and more of it up front" could lead to the emergence of "more products with up-front fees". In such a scenario, "you might still have some free-if-in-credit banking, but cross-subsidised in a more transparent way that enables better switching between consumers". He argued "that type of diversity in the consumer

24 British Bankers Association 5 April 2006 (ret'd 20 November 2007)
25 Payment protection insurance

> offering might be better than trying to impose a standardised approach".
>
> Ms Ana Botin argued the key issue was "choice" and spoke of packaged products which Santander was introducing in the UK as evidence that the market was evolving to provide greater choice for consumers:
>
> We have brought out a number of products of packaged accounts. I believe it's a very interesting product. We did a lot of that in Banesto in Spain, so we would have a flat fee account and you would pay anything from €5 a month to €15 and would get a different value for that. This is not a very big market right now in the UK, but some customers like it and we have brought out different models of it. What's important is choice.
>
> Joe Garner spoke of how HSBC was trying to increase choice for its customers. He explained that HSBC had introduced "a £15 a month current account with no charges whatsoever" which it was "impossible to incur charges on." He said the account had "not taken off to a great degree".
>
> RBS argued that "there is a widespread perception amongst the UK public that core banking services such as current accounts and credit cards should be provided for free". The consequence of this, they argued, was "that it would be commercially difficult for a bank, as a first mover, to start charging for fees."
>
> Ms Ana Botin concurred saying that the free banking seemed "an ingrained model for the UK banking consumer" and it was something "people value and it seems to work".
>
> This viewpoint was echoed by Which? whose research showed "that consumers would be very price sensitive if faced with an explicit charge, such as monthly or annual charges for operation of their current account, and would switch to a non-fee account."[26]

The most apparent development has been the rise of subscription bank account packages, where the customer pays so much a month for a package of banking, insurance, retail discounts and car breakdown, or some combination.

An article in the Financial Times 30 April 2011 reported findings of a research report into the rise of the fee based account (FBA). By 2010, there were more FBAs than the free-in-credit (FIC) accounts. It is estimated that 14 million people had FBAs. The cost of such packages has risen from £10 a month in 2006 to £15 a month in 2010, but the number of benefits has risen from between six and 10 to well over 20. One account offered 27 benefits.

It remains to be seen if the plethora of packages on offer makes it easier to choose between accounts and achieve what the Treasury Committee and the OFT see as being the mark of a more competitive market - an increase in the rate at which individuals change their bank accounts.

The OFT

The OFT was pulled in different ways. Its historic role is to improve competition in the UK. The OFT gave itself about six months of

[26] *Competition and choice in retail banking*, Treasury Select Committee, Ninth Report HC 612 2010-12

'intensive' talks with the banks and consumer groups to see what could be rescued from the confusion that ensued following its loss in the courts over overdraft charges. The OFT had behind it public and political support but had had its legal legs largely swept from beneath it by the judgement. In talks with the banks, it tried to find some common formula for banks to voluntarily agree charging structures. This was a peculiar position for the chief enforcer of competition to find itself in.[27]

The OFT published the results of its consultation in March 2011.[28] The result was not an upfront attack on the level of charges or how they would be levied, instead the agreement focused on how banks could enable their customers to opt-out of the possibility of unauthorised overdraft lending. Poorer account holders were found to be significantly affected by unauthorised fees which they perceived to be outside of their control and unaffordable.

In March 2011 the OFT also produced a progress report into its work into current accounts.[29] The executive summary includes the following:

> Since the OFT's last progress update in September 2010, there has been further progress in the PCA market, specifically around improving consumer control over the use of unarranged overdrafts. In particular, the Lending Standards Board (LSB), which has been leading two industry working groups on these issues, has finalised:
>
> - minimum standards for PCA providers covering how they offer customers the ability to opt out of unarranged overdraft facilities,
>
>   and
>
> - best practice guidance for PCA providers in dealing with customers in (or at significant risk of being in) financial difficulty who incur unarranged overdraft charges (UOCs).
>
> 1.4 With the finalisation of these new minimum standards, which will be included in the revised Lending Code which is published on 31 March 2011, the OFT expects more individual PCA providers to begin to offer their customers the ability to opt out of unarranged overdrafts.
>
> Furthermore, most PCA providers in the UK have now published their existing responsibility policies on their websites and will be revising these policies in light of the changes to the Lending Code in due course.
>
> 1.5 Taken together these developments, alongside the initiatives around switching and transparency already agreed, should help consumers drive competition and incentivise PCA providers to improve product offerings and give better value for money. There are some encouraging signs in this regard. For example, the average unpaid item charge level levied by major PCA providers in Great Britain has fallen from £17 in March 2010 to £14 in March 2011 (this is down from approximately £34 in 2007).

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27 Imagine the OFT calling in Tesco's and Sainsbury's to decide egg pricing!
28 Personal current accounts in the UK, OFT1319, March 2011
29 Personal current accounts in the UK : progress update

> The Treasury Select Committee conducted its own enquiry into the retail bank market. It too criticised the free bank account model in its March 2011 Report *Competition and choice in retail banking*.[30]

In January 2013 the OFT published the results of its follow up investigation into the impact of the 2008 market study.[31]

Personal bank account revenue

	2006	2011
Total	£8.3bn	£8.8bn
Per active account	£152	£139
% of which dertived from:		
unarranged overdrafts	31%	21%
net credit interest	50%	43%

Source: OFT

The Competition and Markets Authority (CMA), in its 2016 Report (see below) estimated that "the total average revenue per PCA to the bank in 2014 was approximately £177 per year".[32]

Box 1: Account Switching

The OFT has invested the automatic switching service with great importance as a catalyst for change – possibly because there are so few other options. It came into force in September 2013 and the first signs are that more people are switching than before.

Personal and small business bank account switching

	Number of accounts
2013 Sept - Dec	318,990
2014	1,156,838
2015	1,033,939
2016	1,010,423
2017 (Jan - Oct)	756,731

Source: Bacs

The January 2013 Oft Report recommended that the FCA or the CMA carry out a review of the effectiveness of the new switching service once it had been in place for at least 15 months. In September 2014 the FCA carried out a wide ranging review into how switching was working. It found that the system "is working well for consumers who have chosen to use the service" but that there was "a lack of consumer awareness and confidence in CASS [the process]. If consumers are unaware or not confident using the service then it is likely to have a more limited impact."

30 Treasury Committee, Ninth Report, HC 612, March 2011
31 OFT; Evaluating the impact of the 2008 OFT Market Study and UTCCR test case into personal current accounts; January 2013
32 CMA *Retail Banking Market Investigation*

2.2 Reviews post 2013: the Financial Conduct Authority (FCA) and the Competition and Markets Authority (CMA)

Competition and Markets Authority

The *Retail Banking Market Investigation* final Report was published in 2016.

It confirmed that the PCA market in the UK remained highly concentrated despite the efforts and encouragement given to the 'challenger banks':

> The PCA markets in both GB and NI are concentrated, whether concentration is measured by volume of main PCAs or, for the UK, by net revenue. Concentration levels have increased since the financial crisis following Santander's acquisitions of Bradford & Bingley and Alliance & Leicester building societies and LBG's acquisition of HBOS (notwithstanding its subsequent divestment of TSB). Although new entrants and smaller banks are gaining market share this has been slow and, excluding the impact of mergers x and acquisitions, the four largest banks in GB account for over 70% of main PCAs and collectively have lost less than 5% market share since 2005.[33]

It assessed that there were significant differences in costs of accounts between banks and that a large number of customers would benefit from switching,

> Our estimate of the gains from switching found that many PCA customers could make substantial financial gains from switching. In GB for customers on standard or reward accounts we found that around 90% would gain financially from switching to a cheaper product.
>
> The average gain from switching for these customers to one of the five cheapest products is around £92 per year. For customers on packaged accounts, 50% of customers could gain by switching and the average gain tends to be higher at just under £170 per year.

However, they found it difficult to assess the degree which customers valued things like the packaged accounts or the service they got from their bank:

> However, our analysis of gains from switching for customers on packaged accounts is more caveated, as our assumptions on the value of the benefits offered by packaged accounts may not reflect the true value to all customers of such benefits and not all customers will regard the different benefits available as interchangeable.
>
> For GB customers on standard or reward accounts, the average gains are highest for those customers who use overdrafts and increase with the number of days in overdraft. Overdraft users have potentially the most to gain from switching, with GB customers in overdraft for 8 to 14 days a month gaining approximately £180 per year. GB customers who use unarranged overdrafts for eight or more days a month and do not use any

33 CMA *Retail Banking Market Investigation*

> arranged overdrafts could gain by switching between £540 and 564 per year[34]

With respect to overdraft charges the main reform suggested was that there should be a maximum monthly charge (MMC) for all overdrafts – though in practice this is likely to affect unauthorised overdrafts more. The Report said:

> To address concerns about the cumulative costs of overdraft charges for heavier unarranged overdraft users, we are requiring all PCA providers to set an MMC for use of an unarranged overdraft facility. The MMC, which will be set by each PCA provider, will specify the maximum amount that the provider will charge a customer during any given month due to unarranged overdraft and will include all unarranged overdraft charges including debit interest and unpaid item fees.
>
> The MMC remedy will benefit overdraft customers in two main ways.
>
>> First, it will improve transparency. The introduction of a common measure of this aspect of overdraft pricing will provide a point of comparison for customers wishing to choose a PCA. While other aspects of overdraft pricing will also be relevant, this intervention will help cut through some of the complexity of overdraft fees and charges, in particular for heavier unarranged overdraft users.
>>
>> Second, it will provide some protection for the heavier unarranged overdraft users – a group that incurs the highest charges for using their PCA, but are least likely to switch to another provider. While the MMC will be set by individual banks themselves rather than centrally regulated, the increased visibility of this aspect of pricing and the associated need to have a competitive offering will constrain the level at which this is set by individual banks. Heavier overdraft users would therefore have some comfort as to their maximum monthly exposure to fees and charges, as opposed to the current situation where this exposure can be open-ended.[35]

The CMA rejected the idea that the regulator should set the limit:

> We considered setting a regulated upper limit on the MMC but have decided not to do so. MMCs set by the banks rather than a regulator will mean the banks themselves remain accountable for their overdraft charges, in what we expect to be a significantly more competitive environment. A regulated upper limit might validate a particular level of cap, incentivising some banks to set MMCs at the upper limit as opposed to competing down the level of MMC. It might also lead banks to become significantly more restrictive in allowing unarranged overdrafts, with the associated risk that some customers could lose access to this form of credit.[36]

The CMA also recommended that banks should establish systems of 'overdraft alerts' to avoid the situation where customers accidentally become overdrawn. The CMA noted that

> There had been a reduction in the relative use of unarranged versus arranged overdraft charges since 2011. They thought this

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[34] CMA *Retail Banking Market Investigation*
[35] CMA *Retail Banking Market Investigation*
[36] CMA *Retail Banking Market Investigation*

> was because customers have increased information about their accounts through text messages from banks and increased usage of internet and mobile banking, which helps them either avoid going overdrawn or to limit the period they were overdrawn However, the number of customers receiving these types of alerts is limited because only a few PCA providers automatically enrol customers into these alerts.[37]

According to FCA research "text alerts alongside mobile banking reduced unarranged charges by 24%."[38] Based on this evidence the CMA decided to require PCA providers to enrol automatically all their customers, where feasible, to receive unarranged overdraft alerts.

Box 2: Account Switching

The OFT had placed great faith in the power of switching to provide the remedies it could not. The CMA found disappointing evidence of its efficacy:

> (a) Over a third of respondents to our survey had been with their main PCA provider for more than 20 years. (b) Over a half of respondents had been with their main PCA provider for more than ten years. (c) Only 3% of PCA customers had switched PCAs to a different bank in the last year. Over the past three years only 8% had switched. (d) Over three-quarters of PCA customers had neither searched nor switched in the last year.[39]

The Report describes many barriers to switching but ultimately an obvious barrier is that most people never pay them or not regularly:

> over a half of customers did not incur any direct charges in the last quarter of 2014 for using their PCA and the most common source of charges were overdraft charges. Around three quarters of customers who incurred charges paid less than £10 in the three-month period we analysed.[40]

Theoretical gains from lower costs don't seem to provide much of an incentive to switch if one thinks the chance of paying them is fairly low.

Financial Conduct Authority

The FCA's immediate response to the CMA report was to promise action on several fronts:

- Prompting increased customer engagement
- Improved transparency for overdraft users
- Promoting innovation
- Improving service.[41]

The full Response can be found here.

With respect to the cost of overdrafts and the proposed MMA the FCA said:

37 CMA *Retail Banking Market Investigation*
38 CMA *Retail Banking Market Investigation*; FCA (2015), Occasional Paper No. 10: Message received? The impact of annual summaries, text alerts and mobile apps on consumer banking behaviour.
39 CMA *Retail Banking Market Investigation*
40 CMA *Retail Banking Market Investigation*
41 FCA Press Release 3 November 2016

> The CMA will require firms to set and publicise the monthly maximum charge (MMC) consumers could incur from use of an unarranged overdraft. We will review the effectiveness of this measure once it has been in place long enough to measure its impact – expected to be late 2018 at the earliest. In order to help us do this, we will begin collecting baseline data in 2017.[42]

Maximum monthly charge

As well as collating data on the impact of the MMA order – due end 2017, the FCA is also going to include overdraft charges within its ongoing work into high cost credit (HCC). One argument made by the pay day loan companies when they were under extreme scrutiny was that the cost of unauthorised overdrafts could be even higher in APR terms than their loans were. It would appear that the FCA is investigating, given the price cap now in force on other forms of HCC.

The other recommendation made by the CMA was with regard to compulsory unarranged overdraft alerts

Overdraft alerts

The FCA states that it will look at how alerts work best. The research will consider the timing, types, variations, combinations, channels and formats of overdraft alerts that are most effective. For alerts specifically, disclosure of grace periods and available funds will also be considered.

The CMA, under its powers will itself require firms to enrol all their personal banking customers automatically into an unarranged overdraft alert. They will also require firms to alert these customers to the opportunity to benefit from grace periods, during which they can take action to avoid or reduce all charges resulting from unarranged overdraft use. The FCA is conscious that it should not duplicate regulatory requirements on firms, and will liaise with the CMA to ensure that the most appropriate regulation is applied.

2.3 Commercial reaction

Whether as a result of the FCA/CMA activity, at least two main banks have made significant changes to their overdraft charging regimes.

Lloyds Banking Group previously had interest rate charges, daily and monthly charges and charges for returned items for unauthorised overdrafts. These have been abolished – though the accounts may no longer permit the payments to go through instead. For authorised overdrafts the same range of charges has been replaced by a single daily charge.

Barclays too has cancelled unauthorised overdrafts and instead makes charges for each returned unpaid item. There is a monthly charges limit of £32 for a standard bank account.

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42 FCA; *Response to CMA final Report into the Personal Account Market*, November 2016

Appendix

The unfair charges case: the legal arguments

The legal arguments revolve around two issues. Have charges been 'penalties' and hence would be illegal. If they are charges and not penalties are they liable to be reviewed under the statute law which exists to regulate them?

Penalty?

The main thrust of the thousands of individual cases taken against the banks has been that the charges are in fact penalties. The BAG campaign quote the 'well established rule of common law…going back 100 years' on the question of penalty charges. Asbury's Laws of England explains the background to this claim:

The parties to a contract may agree at the time of contracting that, in the event of a breach, the party in default shall pay a stipulated sum of money to the other. If this sum is a genuine pre-estimate of the loss which is likely to flow from the breach, then it represents the agreed damages, called 'liquidated damages', and it is recoverable without the necessity of proving the actual loss suffered. If, however, the stipulated sum is not a genuine pre-estimate of the loss but is in the nature of a penalty intended to secure performance of the contract, then it is not recoverable, and the plaintiff must prove what damages he can. The operation of the rule against penalties does not depend on the discretion of the court, or on improper conduct, or on circumstances of disadvantage or ascendancy, or on the general character or relationship of the parties. The rule is one of public policy and appears to be sui generis. Its absolute nature inclines the courts to invoke the jurisdiction sparingly. The burden of proving that a payment obligation is penal rests on the party who is sued on the obligation.[43]

The case that appears most often in the literature is Alfred McAlpine Capital Projects Limited v Tilebox Ltd. A report on the principles raised by this case is shown below:

The recent case of ***Alfred Mcalpine Capital Projects Limited v Tilebox Limited*** [2005] EWHC 281 (TCC): 25th February 2005, revisited the question of penalty clauses in contracts.

Penalty Clauses

In the case of ***Dunlop Pneumatic Tyre Co. Ltd. v New Garage & Motor Co. Ltd.*** [1915] A.C. 79 at 86. it was noted that a clause is penal if it provides for "a payment of money stipulated as *in terrorem* of the offending party", (i.e. a payment of a sum of money intended to frighten or intimidate the offending party).

[43] *Halsbury's Laws of England* Damages 5 (4) 1065

A clause that is found to be penal (i.e. a penalty clause) is generally invalid, and it is an unusual feature of the law of contract that the court will strike down penalty clauses, whilst (usually) permitting other clauses which have been freely agreed between the parties even if those clause are unduly harsh.

The Law Relating to Penalty Clauses

In the case of ***Commissioner of Public Works v Hills*** [1906] AC 368, Lord Dunedin formulated the test for Penalty clauses as follows;-

"The general principle to be deduced …is …that the criterion of whether a sum -- be it called penalty or damages -- is truly liquidated damages, and as such not to be interfered with by the Court, or is truly a penalty which covers the damage if proved, but does not assess it, is to be found in whether the sum stipulated for can or cannot be regarded as a 'genuine pre-estimate' of the creditor's probable or possible interest in the due performance of the principal obligation"

In the above noted case of ***Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited***, Lord Dunedin set out a series of propositions in respect of Penalty clauses, which have often been cited and relied upon for the last 90 years. These propositions being:-

1. Even though the parties may use the word 'penalty' or 'liquidated damages' in respect of a clause, it is for the Court to find out whether the payment stipulated is in truth penalty or liquidated damages.

2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party.

3. The essence of liquidated damages is a genuine covenanted pre-estimate of damage.

4. The question 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 as at the time of making the contract, not as at the time of the breach.

5. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration, may prove helpful, or even inclusive. Such tests being:-

(a) It will be held to be a penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.

(b) There is a presumption (but no more) that it is a penalty when, 'A single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.'

(c) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimate damage was the true bargain between the parties.

[…]

The background to the recent case of ***Alfred McAlpine Capital Projects Limited v Tilebox Limited***, was that on 27 April 2001, ***Tilebox*** and ***McAlpine*** entered into a written building contract. Clause 24 of the contract conditions provided that ***McAlpine*** should pay liquidated and ascertained damages for delay at the rate at the rate of £45,000 per week or part thereof. The Contract Completion Date was 14 August 2002, but building works were not completed by that date, and the works were not expected to be complete until June 2005 (i.e. some 2½ years late).

Against this background, ***McAlpine*** became concerned about its potential liability (of something approaching £6 Million) to liquidated and ascertained damages under clause 24 of the contract conditions. ***McAlpine*** took legal advice and, having done so, formed the view that the rate of liquidated and ascertained damages specified in the building contract was excessive, and was a penalty clause and was therefore invalid. ***Tilebox*** denied that clause 24.2 was a penalty clause.

The parties referred this matter to court, and in the court case Mr Justice Jackson, considered the authorities and made the following general observation:-

1. There seem to be two strands in the authorities. In some cases judges consider whether there is an unconscionable or extravagant disproportion between the damages stipulated in the contract and the true amount of damages likely to be suffered. In other cases the courts consider whether the level of damages stipulated was reasonable. Mr Justice Jackson came to the view that a pre-estimate of damages does not have to be right in order to be reasonable. There must be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages which is likely to be suffered before it can be said that the agreed pre-estimate is unreasonable.

2. Although many authorities use or echo the phrase "genuine pre-estimate", the test does not turn upon the genuineness or honesty of the party or parties who made the pre-estimate. The test is primarily an objective one, even though the court has some regard to the thought processes of the parties at the time of contracting.

3. Because the rule about penalties is an anomaly within the law of contract, the courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power.

4. Looking at the bundle of authorities provided in this case, Mr Justice Jackson noted only four cases where the relevant clause has been struck down as a penalty.

Based upon the above, and the circumstances of this case, Mr Justice Jackson formed the view that the liquidated damages clause in question was not a penalty clause, and therefore would be enforced.[44]

Unfair?

The key statutory provision which it is claimed makes the charges illegal are the *Unfair Terms in Consumer Contracts Regulations* 1999 (SI 2083/1999). Regulation five sets out the meaning of unfair terms:

5. (1) A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

(2) A term shall always be regarded as not having been individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term.

Schedule 2 of the regulations includes a (non-exhaustive) list of unfair contract terms. This includes "e) requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation". Regulation 8 sets out the effect of a contract term being deemed to be unfair. It says:

(1) An unfair term in a contract concluded with a consumer by a seller or supplier shall not be binding on the consumer.

(2) The contract shall continue to bind the parties if it is capable of continuing in existence without the unfair term.

Responsibility for the regulation of contract terms lies with the OFT. Regulation 12 gives the Director General of the OFT the power to issue injunctions on companies:

12. - (1) The Director or, subject to paragraph (2), any qualifying body may apply for an injunction (including an interim injunction) against any person appearing to the Director or that body to be using, or recommending use of, an unfair term drawn up for general use in contracts concluded with consumers.

(2) A qualifying body may apply for an injunction only where-

(a) it has notified the Director of its intention to apply at least fourteen days before the date on which the application is made, beginning with the date on which the notification was given; or

[44] Article taken from Always Associates *Legal update and cases* http://www.alway-associates.co.uk/legal-update/article.asp?id=82

(b) the Director consents to the application being made within a shorter period.

(3) The court on an application under this regulation may grant an injunction on such terms as it thinks fit.

(4) An injunction may relate not only to use of a particular contract term drawn up for general use but to any similar term, or a term having like effect, used or recommended for use by any person.

The charges considered during the 2008 case (the "relevant charges") were defined by the OFT as follows:

Unpaid Item Charge: levied when the customer gives an instruction for payment or, in some cases at least, withdrawal that the bank declines to honour because the customer does not have sufficient funds in his account (or an arranged facility which covers it).

Paid Item Charge: levied when the customer gives an instruction for payment or, in some cases a least, withdrawal, for which he has insufficient funds in his account and which the bank honours.

Overdraft Excess Charge: levied if, during a specified period (typically a day or a month) … an account is and/or goes overdrawn (and there is no overdraft facility), or… the debit balance is and/or goes above the limit on an existing overdraft facility, and in both cases irrespective of the reason why the excess has occurred.

Guaranteed Paid Item Charge: a charge distinct from a Paid Item Charge which some of the Banks levy when the honour "in accordance with the guarantee, a cheque issued in conjunction with a cheque guarantee card (or, in the case of some banks, a debit card payment made under a guaranteed debit payment system) for which the customer does not have sufficient funds.[45]

[45] See para 3 of Office of Fair Trading v Abbey National PLC and 7 others, [2008] EWHC 875 (Comm)