

Calculating fair default charges in credit card contracts

A statement of the OFT's position

April 2006

© **Crown copyright 2006**

This publication (excluding the OFT logo) may be reproduced free of charge in any format or medium provided that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as crown copyright and the title of the publication specified.

CONTENTS

<i>Chapter</i>		<i>Page</i>
1	Executive summary	1
2	The OFT's role under the UTCCRs	8
3	Legal principles	10
4	Application of the principles to credit card default charges	18
5	A practical way forward	27

1 EXECUTIVE SUMMARY

Overview

- 1.1 This statement sets out the Office of Fair Trading's (OFT) view of the principles credit card¹ issuers should follow in setting default charges in their standard contracts with consumers in order to meet the test of fairness set out in the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs). The principles have wider implications for analogous standard default terms in other agreements including those for mortgages, current bank accounts and storecards.
- 1.2 The statement stems from an OFT investigation into the fairness of standard terms in credit card contracts imposing charges for defaults, including failure to pay on the due date, exceeding a credit limit and failure to honour a payment made. It has been prepared in the light of discussions with eight leading credit card issuers and their legal advisers of a set of proposals from us, and with the Association for Payments and Clearing Services (APACS). It takes account of empirical information the credit card issuers have provided. It also takes account of the arguments they put forward, but it is a statement of the OFT's position and should not be taken as representing a consensus view. It is intended to set out a consistent basis on which we believe it is possible to calculate fair default charges for the purposes of the UTCCRs.
- 1.3 The statement sets our view of the law, which is in essence that default charge provisions are open to challenge on grounds of unfairness if they have the object of raising more in revenue than is reasonably expected to be necessary to recover certain limited administrative costs incurred by the credit card issuer. It goes on to explain how we think the relevant legal principles apply in practice to credit card agreements. The statement is intended to provide guidance for financial institutions setting default charges.

¹ For this purpose references to 'credit cards' do not include 'store cards'.

- 1.4 Our view is based on an assessment of the relevant circumstances. We have particularly considered the legitimately recoverable costs incurred by eight leading credit card issuers, which we have assumed to be largely representative of the industry as a whole.
- 1.5 The statement is intended to be realistic, bearing in mind that credit card issuers have widely differing financial and administrative systems, and also different customer profiles. We have sought to leave room for the operation of incentives to efficiency and competition by allowing for competitive differences in underlying administrative costs and in structuring charges, rather than seeking to force charging structures into a single mould.
- 1.6 On the analysis we have undertaken we have concluded that generally credit card default fees have been set at a significantly higher level than is fair for the purposes of the UTCCRs. The level of a fair fee will, however, be dependant on the precise business circumstances. Some exceptional factors, for example whether a card issuer requires (not merely allows) customers to give it direct debit authority to ensure a minimum payment is made, may lead to a lower level of instances of default. A card issuer operating a policy of this kind may be able to justify a higher level of default fee than one that does not because its relevant business costs are being recovered from a proportionately smaller number of defaults. However, even in the circumstances of this kind the card issuer may only recover the relevant limited administrative costs arising out of those defaults.
- 1.7 In the circumstances we have considered the best way to achieve a swift reduction in fees that are unjustifiably high, while avoiding heavy-handed regulation. We are adopting a two-fold regulatory strategy. First, the statement is intended to provide practical and straightforward guidance enabling banks to compete vigorously and fairly while also protecting consumers from standard terms that could cause significant harm to their economic interests. Our expectation is that credit card

issuers will take the guidance in this statement and apply it to their business circumstances to arrive at a fair default fee.

- 1.8 Second, in order to encourage a swift change in market practice we have decided to include in the statement a simple monetary threshold for intervention by OFT on default charges. The threshold is £12.
- 1.9 Our presumption will be that credit card default charges set above this level are unfair unless there are exceptional factors. Conversely, in line with our current enforcement priorities, we do not propose at present to consider legal action where charges are set below £12. The statement discusses a number of exceptional factors that have been brought to our attention. These factors would be viewed restrictively, in order to avoid creating incentives to banks to invent artificial ways of trying to circumvent the practical consequences of the principles set out in this statement.
- 1.10 Where we conclude that a fee above the threshold is unfair we are likely to challenge the charge but will have regard to all the circumstances in deciding whether to do so or not. We will regard default charges set below the threshold as either not unfair or insufficiently detrimental to the economic interests of consumers in all the circumstances to warrant regulatory intervention at this time. This does not affect in any way the statutory rights of individual consumers, or groups of such consumers, to challenge the level of default charges, either above or below this threshold.
- 1.11 The setting of the threshold is a provisional practical measure to move the whole market towards compliance. We are not proposing 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. Our position is that default fees need to be recalibrated in line with the principles set out in this statement to achieve consistency with the UTCCRs. The indication of a monetary threshold does not affect this – it is a statement of our enforcement policy, reflecting in

particular our duty to target our resources on serious consumer detriment as a priority over cases involving less harm to consumers.

- 1.12 We recognise that it is desirable that default fees possess some degree of certainty and that if they were to fluctuate with undue regularity this might add unnecessarily to administrative costs and detract from predictability and transparency for consumers. On the basis of our analysis we consider that the threshold is robust and that absent exceptional circumstances there are unlikely to be grounds to consider any higher threshold for our action over the short or medium term. We will, however, consider further action if trends in the market suggest that this threshold approach is insufficient to bring about appropriate and early change in the market.
- 1.13 We will in general be careful to ensure that the concerns we have raised are effectively addressed. We cannot be tolerant of strategies which seek to avoid the substance of these concerns, for example by merely changing nomenclature or re-characterising the charges. We deal with this again below.
- 1.14 It must be stressed that this is a statement of our position and reflects the exercise of our discretion as an enforcement agency. Only a court can decide finally whether a term is unfair, or at what level default charges should be set to meet the requirements of the UTCCRs. It should be kept in mind that other enforcers may apply for injunctions under the UTCCRs and that the UTCCRs may be relied upon by consumers in private claims.

Key principles

1.15 Default charges are not 'core terms'. They are subject to the general test of fairness set out in the UTCCRs.

1.16 In applying this test of fairness we have taken the view that a court would be likely to regard as unfair a default charge provision that enabled the issuer to recover more than the damages which would be awarded at common law in the event that a consumer was individually sued for breach of contract. Such a charge should therefore:

- reflect a reasonable pre-estimate of the net² limited additional administrative costs which occur as a result of the specific breaches of contract and which can be identified with reasonable precision
- reflect a fair attribution of those costs between defaulting customers
- be based on a genuine estimate of the total numbers of expected instances of default in the relevant period, and
- treat costs other than those net limited additional administrative costs as a general overhead of the credit card business and disregard them for their purpose of calculating a default fee.

That said,

- we are not insisting that credit card issuers have default charges that discriminate between the different types of default under consideration
- we accept a reasonable degree of rounding in the level of the default charge calculated in accordance with these principles

² This denotes that a default charge should take into account a credit card issuer's expected ability to mitigate the loss it suffers as a result of default.

- once recalculated in line with these principles, we would expect the charges to be reasonably stable over time, and not to fluctuate with short term variations in cost patterns, and
- we can accept, within reason, the use of graduated charges, lower for the first default and higher for subsequent defaults, where the amount and gradient of the ascending charges are consistent with the principles set out in this statement.

Implementation

- 1.17 We expect all credit card issuers to take on board the principles contained in this statement and to recalculate their default charges accordingly. Credit card issuers are being asked to confirm by 31 May their response to this statement and their willingness to make any necessary adjustments to their credit card default charges. We are mindful that changes to a default charge may require IT system and other business changes by the credit card issuers. Some of these changes may take some time to fully implement, for example updating documentation for consumers. Nevertheless, in view of the scale of consumer detriment involved in the imposition of unlawful default charges, we consider that steps to reduce charges should be taken as a matter of exceptional priority even if this means that consequential changes occur at a later date. We or our co-enforcers will investigate further and will take appropriate action if change does not occur within a reasonable timescale.
- 1.18 Where in particular business circumstances exceptional factors apply and a credit card issuer believes it is able to justify a default charge above the threshold, it will be expected to confirm the basis of this view and may be asked to provide accounting information to support the higher charge.

1.19 In our view the basic principles set out here also apply to other analogous default charges in consumer contracts, for example in agreements for bank overdrafts, mortgages and store card agreements. We invite the banks to reconsider such charges accordingly.

2 THE OFT'S ROLE UNDER THE UTCCRS

The OFT's role

- 2.1 The UTCCRs implement EU Council Directive 93/13/EEC on unfair terms in consumer contracts. They came into force on 1 July 1995 and were re-issued in 1999 (coming into force on 1 October 1999). The UTCCRs are explained in guidance we have published, in particular our briefing note on *Unfair standard terms* (OFT143, revised 2005), and the comprehensive *Unfair contract terms guidance* (OFT311), published 2001).
- 2.2 Only a Court can determine that a term is unfair but the OFT has a duty to consider any complaint it receives about unfair terms.³ Where we consider a term to be unfair, we have the power to take action on behalf of consumers in general to stop the continued use of the term; if necessary by seeking an order from the Court (or an interdict in Scotland). Since 1999 we have shared these powers with a range of other enforcers. These include all local Trading Standards Services, certain national regulatory bodies and Which?⁴
- 2.3 Part 8 of the Enterprise Act 2002, which came into force on 20 June 2003, gives the OFT and certain other bodies an alternative enforcement mechanism against traders that breach consumer legislation. Under Part 8, the OFT, Trading Standards Services and designated enforcers can seek enforcement orders against businesses that breach UK laws giving effect to specified EC Directives and harm the collective interests of consumers. These include the Directive on unfair terms in consumer contracts. The Enterprise Act also gives the OFT a formal coordinating

³ Regulation 10(1) requires the OFT to consider any complaint received unless a qualifying body notifies OFT that it will do so or if the complaint appears to be frivolous or vexatious.

⁴ Formerly known as the Consumers' Association.

role to ensure that action is taken by the most appropriate enforcement body in each case. More information on the Enterprise Act can be found on our website: www.offt.gov.uk

3 LEGAL PRINCIPLES

The test of fairness

3.1 An unfair standard term is not binding on the consumer.⁵ A term is considered unfair under the UTCCRs⁶ 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.'

3.2 The requirement of 'good faith' reflects the principle of fair and open dealing with consumers. It does not simply mean that terms must not be used deceitfully; it means that terms should be drafted in a way that respects consumers' legitimate interests. In assessing fairness we take note of not only how a term is used, but how it could be used. The test of fairness also takes account of the circumstances surrounding the conclusion of the contract and the effect of the other terms in the contract.⁷

3.3 Schedule 2 to the UTCCRs illustrates possible respects in which a term may be unfair to the consumer by means of a 'grey list' of possible kinds of unfairness. Of particular relevance to default charges is paragraph 1(e) of Schedule 2, specifying terms that have the object or effect of requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation.

⁵ Regulation 8(1).

⁶ Regulation 5(1).

⁷ Regulation 6(1).

Default charges are not 'core terms'

3.4 'Core terms' relate to the definition of the main subject matter of the contract or to the adequacy of the price or remuneration as against the services supplied in exchange. They are subject to the UTCCRs, but are outside the scope of the test of fairness by virtue of Regulation 6(2). We do not consider that terms providing for default charges are core terms. (In this context the breaches of contract which may lead to a default charge typically arise where a customer exceeds a credit limit, fails to pay or fails to honour a payment.) Consumers do not generally enter into such contracts expecting to incur these charges. We consider that the charges are not the substance of the bargain but are simply an incidental charge that is applied if some of the main obligations are not complied with.

Relevance of the common law principles on damages

3.5 Recent ECJ jurisprudence has underlined the need for consideration to be given to the consequences of a term under national law in assessing contractual unfairness for the purposes of Directive 93/13.⁸ The decision of the House of Lords in *Director General of Fair Trading v First National Bank*⁹ also underscored that it is a helpful exercise to compare the duty of the consumer under the term, on the one hand, and the obligations of the consumer under national law, in the absence of the term, on the other. In assessing the fairness of the charges and in particular whether they amount to a disproportionately high sum under paragraph 1(e) of Schedule 2, the amount of money stated as being payable on breach must be compared with the damages which would be awarded at

⁸ *Freiburger Kommunalbauten GmbH Baugesellschaft & Co KG v Hofstetter* C-237/02 [2004] 2 CMLR 13.

⁹ 2002] 1 AC 481.

common law in the event that a consumer was individually sued for breach of contract. As such it is therefore necessary to have regard both to the principles of causation of loss and remoteness in considering default charge terms.

- 3.6 Under common law the innocent party to a contract is not provided with a complete indemnity for all loss that in fact results from a particular breach however improbable, however unpredictable.
- 3.7 In terms of remoteness, damages for breach of contract are traditionally divided into 'general damages' and 'special damages'. 'General damages' are those damages foreseeable as flowing naturally and probably from the breach of contract in the ordinary course of events. 'Special damages' are damages foreseeable in the particular circumstances of the case because of special matters known to both parties at the time of making the contract. These are the two types of damages referred to in *Hadley v Baxendale* (1854) 9 Exch. 341.
- 3.8 We have great difficulty in seeing any general damages that could flow naturally from exceeding a credit limit of a credit card agreement. We deal with possible special damages in paragraph 3.13 below.
- 3.9 So far as a failure to pay or a failure to honour payment are concerned, in general a party to a contract who fails to pay an amount of money due to the other side is not usually liable to pay any damages to the creditor except such interest as may be payable by statute or agreement. The presumption is that in the ordinary course of things a person does not suffer any other loss by reason of the late payment of money.
- 3.10 Under credit card contracts with consumers, interest is payable at the agreed rate in respect of any outstanding amounts, where the balance detailed in the consumer's statement is not paid in full by the due date, including any amounts not paid by the due date.

- 3.11 Some credit card companies charge a month's interest on the whole of any money overdue even if it or part of it is paid by the consumer before the next month's due date.
- 3.12 In so far as it is claimed that any other losses are suffered, the ordinary rules of damages would apply, but against the background that interest is payable by the consumer to compensate the credit card company for the detention of their money. We do not see that a company might have any claim for 'general damages'.
- 3.13 Whether a company might be able to claim 'special damages' for a default would depend on the company being able to prove that:
- the consumer was aware at the time of contracting that, if he committed a breach of this nature, the company would suffer losses by incurring such costs
 - such specific costs could constitute 'damages' claimable by the company in the event of breach, and
 - the consumer understood and contracted on the basis that he would be liable for such costs as damages.
- 3.14 On this basis we see some scope for a company to argue that a consumer might be aware that if he defaults, the credit card company will incur certain additional administrative costs of notifying him of his breach and of advising him as to why and how to remedy the breach ('limited additional administrative costs'), particularly if the matter had been explained in the contract and previously drawn to the consumer's attention in clear and unambiguous terms.
- 3.15 We consider that notification to the consumer of his default, and, possibly, subsequent communication between the consumer and the company on the topic, can serve the interests of the consumer as well as the card issuer. On that basis, it might be possible to argue that it would not be unfair for the consumer who has defaulted to bear some part of the common costs of those communications. It might also be

arguable that it is reasonable that those who default rather than consumers generally should be responsible for these limited additional administrative costs.

- 3.16 On the other hand, we do not consider that a consumer entering into a credit card contract would be aware or even understand the nature of costs such as the increased credit risk represented by defaulting consumers and capital costs. Furthermore, we consider that they are not caused by the defaults in any legally relevant way and are too remote. The raising of provisions and the charge-off of bad debts are not losses which could form the basis of a claim for damages for breach of contract by failure to pay a sum of money due.
- 3.17 In considering costs arising from default, a credit card company should also be careful to avoid double recovery. In particular, it would need to take into account the fact that it may derive certain benefits from the actual or anticipated default of a consumer. For example, a proportion of the multilateral interchange fee (MIF) is assigned to default. (We are investigating MasterCard's and Visa's MIF arrangements under the Competition Act 1998 and Article 81 of the EC Treaty.)
- 3.18 These benefits may also include those arising out of operating a risk-based pricing policy, that is, offering a higher APR (or a separate product with a higher interest rate) to a particular class of consumers based on an evaluation of their poorer credit risk. Moreover, consumers who default are generally required to pay the full amount of interest due on the outstanding balance. A credit card company should ensure that there is no duplication between such benefits and the money recovered by way of a default charge.

- 3.19 We deal in detail with which costs may and may not be legitimately recovered through a default charge in Chapter 4.

Pre-estimate of costs

- 3.20 In practice it might be difficult to make a pre-estimate of the limited administrative recoverable costs attributable to an individual defaulter on each occasion of default, and that doing so would actually increase the costs. For this reason, we consider it would not be unreasonable for a company to pre-estimate the costs and provide for the payment of a reasonable, fair and proportionate amount representing a potential defaulter's fair share of the limited additional administrative costs.
- 3.21 Indeed, for the purposes of the common law, any post-contract rationalisation of default charges is by definition not a genuine pre-estimate and would therefore not save the term to which it relates from being considered to constitute a penalty, even if by happy co-incidence the amount did not exceed what would have been set if a genuine pre-estimate had been conducted. To be certain of being fair and enforceable, it would further need to be based on a genuine allocation of such costs fairly amongst the number of expected defaults, so that any individual defaulter would not be treated unfairly by being made to bear a disproportionate share of the estimated costs fairly ascribable to others.
- 3.22 In order to be fair in these circumstances under the UTCCRs, and not to constitute a penalty under common law, such pre-estimate of costs would also have to be limited to the type of costs which would be legitimately claimable as damages against the individual consumer if the credit card company were to sue him individually for breach of contract. It must not include costs which could never normally be recovered either because they would not qualify as damages or because they would not be regarded as having been caused by the default in a legally relevant sense.

- 3.23 We consider that in a consumer contract, where the parties are not of equal bargaining power, **any** estimate that included costs which could not legitimately be claimed as damages from an individual consumer in a case brought at common law, and which made a material difference to the overall charge, is likely to constitute a penalty in law.
- 3.24 Any provision in the contract which constituted a penalty would be very unlikely to satisfy the test of fairness under the UTCCRs since it is very likely that it would be considered to be a term which has the object or effect of requiring a consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation.¹⁰
- 3.25 In any event, putting the rules on penalties to one side, if a standard default charge term in a consumer contract allows the supplier to recover a sum greater than it could recover in damages were the term not included, it is liable to be considered unfair for the purposes of the UTCCRs since it would have the effect of requiring the consumer to pay a disproportionately high sum in compensation. Where the parties to a contract have a supplier/consumer relationship, the principle of freedom of contract has been qualified by the enactment of the UTCCRs. The restraints of remoteness and causation cannot be ignored in considering whether an agreed amount of damages is a penalty, and whether it meets the requirements of fairness under the UTCCRs.
- 3.26 In the light of the above discussion we take the view that certain predictable administrative costs, as set out at paragraphs 4.1 to 4.3, might potentially be recovered in a default charge without being inconsistent with the UTCCRs. We consider that it would only be legitimate for a default charge to take account of kinds of administrative cost that could be objectively and consistently identified so that a

¹⁰ Paragraph 1(e) of Schedule 2 of the UTCCRs.

consumer could have been aware that a cost of that sort would arise from his default. The example of such a cost we have in mind is the cost of informing the consumer of his breach and advising him on what to do about it.

A fair default fee

3.27 In our view a fair default charge should:

- be calculated on the basis of a reasonable pre-estimate of the net limited additional administrative costs which occur as a result of the specific breaches of contract and can be identified with reasonable precision
- reflect a fair attribution of those cost between defaulting consumers¹¹
- be based on genuine estimate of the total numbers of expected instances of default in the relevant period, and
- treat costs other than those net limited additional administrative costs as a general overhead of the credit card business and disregard them for their purpose of calculating a default fee.

¹¹ Authority for the proposition that averaging is the appropriate approach may be taken from *English Hop Growers v Dering* [1928] 2 KB 174, CA.

4 APPLICATION OF THE PRINCIPLES TO CREDIT CARD DEFAULT CHARGES

Costs that the OFT considers may be legitimate to include in a pre-estimate of damages

- 4.1 We have referred above to the limited additional administrative costs arising from the consumer's breach of his contract. We consider that the consumer might be aware or understand when contracting that the company will incur an administrative cost in sending a letter to him notifying him of his breach and attempting to encourage the consumer to rectify the situation and meet his obligations generally. The estimated cost of sending the letter might therefore fall within a fair agreed sum of damages.
- 4.2 Other similar costs could also be included if they are foreseeable (as discussed above), if they can be specifically identified and defined, and can be reasonably attributed to particular default of the consumer. If they cannot be defined or reasonably attributed, then that only underlines the unfairness of trying to make the consumer in default liable for costs of the company which are potentially unlimited and subject to manipulation.
- 4.3 We accept that a credit card issuer will incur costs that are directly attributable to dealing administratively with defaults. We also accept that, as well as direct costs, there will be overheads, shared with other functions of the business, associated with carrying out these administrative activities. It would not have had to incur these costs if there were no default. However, if any of these costs are to be apportioned to defaulters, it can only be fair to do so if they are calculated on objectively justifiable principles, have a substantial causal connection with the administration of defaults and satisfy the test of remoteness. We have not sought to provide an exhaustive definition of the recoverable direct or common costs, but these may include staff costs, premises, telephone, letters and postage, IT systems, depreciation

of assets related to running collection systems pre default notice, IT support and other central services such as human resources. A starting point for the allocation of shared overheads might be the ratio of full-time equivalent staff engaged in administration of default charges to the total of staff with whom those overheads were associated.

Costs that the OFT does not consider legitimate to include

- 4.4 As explained above, in considering which costs could be included in the calculation of a genuine pre-estimate of the costs that occur on default, we consider that certain costs should not be included.

Increased credit risk costs and charge off costs

- 4.5 We accept that the occurrence of default during a financial year might well result in additional provision having to be made in a company's accounts in respect of those defaulting consumers. It is also accepted that the fact that a consumer defaults in a payment, or exceeds his credit limit, might evidence that the account is impaired and that the credit risk of that consumer is not the same as when he first signed up or at the moment before the default itself. As such, the account's value might be less than the amount lent to the consumer or, indeed, the amount which the account was previously considered to be worth.
- 4.6 However, we note that market research from APACS (Plastic Card Review 2004) indicates that 73 per cent of card payers who missed one payment in 2003 did not go on to miss two payments in 2003. This is significant. This research appears to indicate that in the majority of cases any perceived increase in the risk of total default does not materialise, at least not in that year.
- 4.7 We also note that according to the Plastic Card Review 2004, 54 per cent of all personal credit card holders paid off their bills in full every month and that these regular full payers accounted for 77 per cent of all credit card spending. If any of those regular full payers made a (possibly inadvertent) default in one month they would have to pay an amount of

interest for one month which they would not otherwise have paid even if they had rectified the fault immediately. In addition they would of course also have to pay the default charge. Effectively therefore those who rectify their financial position may be required to meet the costs (legitimate or otherwise) of those who ultimately do not.

- 4.8 The important point is that even if specific provision is raised in every account where there has been a late payment, these specific provisions should be reversed (or more precisely, adjusted) when the consumer rectifies the breach, as appears to happen in a large number, if not the majority, of cases. On that basis the provisions do not crystallise unless and until the consumer's debt is written off.
- 4.9 Thus in so far as all consumers who default are made to bear a share of this increased credit risk cost, many if not most of them are not responsible for the increased cost, since the (large) majority will have rectified their default promptly and will not go on to default again. This rectification should lead to a cancellation of the previous incremental expense in relation to that account.
- 4.10 However, whatever the true and proper accounting treatment of provisions in respect of such defaults, under the common law these expenses could not be the subject of a damages claim against a consumer who had defaulted in a payment of money or by exceeding his credit limit. The expense is not caused by such breach in any legally relevant sense, it is too remote and too imprecise to allocate to this particular body of consumers. The nature, extent and occurrence of the provision, and hence the expense, depends on the accounting and other policies followed by the company. These are not a proper subject for damages for breach of contract particularly in a contract of this sort with a consumer.
- 4.11 As to charge-off, we do not think a company is entitled to include a cost representing the charge-off of the debts when consumers default, as a percentage of the total amount written off in the relevant period. It could be argued that at the time the late fee is levied a credit card company

cannot predict whether the individual consumer will flow to charge-off but that the defaulter is part of a population that is riskier and therefore it is fair to make defaulters pay a share of the charge-off costs.

- 4.12 Whether or not this is an acceptable accounting requirement, we do not accept that defaulters can fairly be held liable in law for such expenses. In the first place, we fail to see how these costs can legitimately be said to have been caused in any legally relevant sense by a particular default of the consumer given that, according to the APACS figures referred to above, most defaulters do not default again in any given year, let alone are their accounts written off at a later stage. It would be unfair to the majority of defaulters whose accounts never go into charge-off, to require them to pay a share of the charge-off costs of those accounts which do go into default.
- 4.13 However, even if there were an exact correlation between first time defaulters and accounts written off, a bank would still not be able to claim from the individual defaulter the amount written off or an expense representing that amount or part of that amount in its accounts because the bank's only claim against such person is for what he owes, which is the amount written off. Effectively, any attempt to make the defaulters as a group pay the amounts charged off by the company in respect of defaulters would be unfair in at least two ways. It would be effectively claiming the same amount twice from the particular defaulter whose account is charged off (once as the amount owed, and once as the expense of writing it off). Secondly, it would have the effect of making the large number of defaulters whose accounts do not go into charge-off share the cost to the company of those whose accounts are eventually charged off.
- 4.14 In our view, these costs cannot be claimed as damages from defaulting consumers for breach of contract. They cannot be said for legal purposes to be caused by the individual default of the consumer, or, if they can, they are too remote. The extent and incidence of these costs depends on the particular accounting and other policies followed by the

company. These have nothing to do with questions of damages for breach of contract.

- 4.15 Any losses borne by a company as a result of increased credit risks do not fall under either head of *Hadley v Baxendale*. In our view they cannot be included in any fair pre-estimate of damages suffered by a credit card company in respect of a default of payment or exceeding the credit limit.

Debt collection agency costs

- 4.16 Banks will seek to recover sums due from persistent defaulters, whether by using debt collection agencies or in-house staff. In some cases these efforts will be successful, in others not. Debt collection occurs once a customer defaults to a degree which leads the credit card company to give instructions for the legal recovery of what is outstanding. It is not something which is applicable to the casual defaulter, or even a repeat casual defaulter. As already pointed out, only a small proportion of the defaulters, even repeat defaulters become the subject of debt collection procedures. In general, for similar reasons as explained above in relation to charge-off, we take the view that it is unfair to make the large number of defaulters whose behaviour does not give rise to the need to commence debt-collection procedures share the cost to the bank of those who do. Such cost is a general expense of credit business that the bank must seek to recover from interest charges and other revenues.

Fraud costs

- 4.17 Some card providers have argued they should be entitled recover as part of the default charge costs which might arise from the charge-off as a result of fraud. We do not agree with this. These costs cannot be said to have been caused by a failure to make payment on due date, or by exceeding a credit limit. They are caused by fraud.

Capital Costs

- 4.18 These could be described as the additional cost of funds, both of debt and equity financing, which could be alleged to be incurred as a consequence of default. It could be argued that accounts in default require a relatively high level of capital because of the higher probability that these accounts will result in charge off.
- 4.19 We take the view that these costs are not caused by the default in any legally relevant sense. Moreover, even if additional costs were incurred, they would not constitute damages under either head of *Hadley v Baxendale*, as they are too remote. Such costs are highly unlikely to constitute damages recoverable for breach of contract. Accordingly, they could not in most situations, and certainly not in contracts between parties of unequal bargaining power involving ordinary consumers, legitimately be taken into account in pre-estimating the damages which would be suffered by the credit card company in the event of default.

Inflated administrative costs

- 4.20 It has been put to us that to require charges not to exceed recoverable costs might encourage a tendency for banks to 'gold plate' their operations for handling defaults, in order to increase costs and thus justify higher charges in order to deter defaults. We believe that charges set so as to match recoverable costs that are higher than they need to be would be open to challenge for unfairness, and we would expect to take action accordingly. Taking what a court would order under the common law as a comparable yardstick, it is normal in the assessment of damages for the injured party to be expected to mitigate his loss, and thus to be awarded compensation only for such costs as he could not reasonably avoid incurring.

Disguised penalties

- 4.21 The analysis in this statement is in terms of explicit, transparent default fees. Attempts to restructure accounts in order to present events of default spuriously as additional services for which a charge may be made should be viewed as disguised penalties and equally open to challenge where grounds of unfairness exist.¹² (For example, a charge for 'agreeing to' or 'allowing' a customer to exceed his credit limit is no different from a charge for the customer's 'default' in exceeding his credit limit.) The UTCCRs are concerned with the intention and effects of terms, not just their mechanism.

Supposed consequences

- 4.22 It has been contended that if credit card issuers are not allowed to charge defaulters for all the costs they incur in connection with default they will simply have to spread such costs more widely amongst all customers, resulting in an increase in overall interest charges payable by customers for using their cards. It has been argued that this is more unfair to the general body of customers, who would all have to pay towards the default of only some of them, than is the present regime. It is said to be fairer that only those who default should have to contribute towards these costs in this way and our proposals will actually result in unfairness.
- 4.23 We believe that this is a superficial and false argument. The Regulations specifically exempt terms relating 'to the adequacy of the price or remuneration' payable for services from the test of fairness, provided they are in plain and intelligible language. They are 'core terms' for the

¹² See *Unfair contract terms guidance* (OFT311), paragraph 5.8.

purposes of Regulation 6(2) and incapable of being unfair on the ground that they are higher than might otherwise be the case.

- 4.24 This is not only a matter of law. As a matter of practical economics, it is preferable for credit card providers' costs to be covered, if they so wish, by the overall interest rate charged for using the card. That rate is most likely to be in the forefront of the minds of consumers when entering contracts, and the figure is one which readily enables the consumer to compare the advantages (or otherwise) of signing up to one credit card rather than another. The transparency of core terms such as the interest rate payable on the card enhances the ability of consumers to compare and contrast the various credit cards on offer in the market and is therefore likely to bring about competitive downward pressure on the rates, and hence costs involved. It is therefore preferable, from the point of view of making markets work well that if credit card companies want to recover the remoter costs associated with default from their customers, they should do so by virtue of the overall interest rate payable for credit on the card.

Incidence of charges

Grace periods

- 4.25 As noted at paragraph 3.27 above, fair default charges should be produced by dividing a pre-estimate of numbers of chargeable defaults (the denominator) into a pre-estimate of the amount of limited additional administrative costs (the numerator).
- 4.26 A credit card issuer may exercise a discretion to waive its contractual entitlement to a default charge, either in accordance with a general policy to offer a limited grace period for late payments, or in response to a particular customer's circumstances. This may be part of good practice in customer care. However, it would not be fair as between defaulters if the number of fees that a credit card issuer expected to forgo, on an *ex gratia* basis, was deducted from the denominator used to reach the figure for the default charge. If this lower number of defaults were taken

into account, reducing the denominator, it would obviously inflate the resulting charge. Its effect would be that defaulters whose charges are not waived would bear a disproportionate share of the costs expected to arise because of all defaults.

4.27 It is of course a matter for each credit card company as to whether it chooses to waive a consumer's obligation to pay the default charge, but the fact that this might be predicted to occur should not result in a reduction of the denominator.

4.28 The giving of ex gratia waivers can be distinguished from a decision to impose contractual liability on consumers to pay charges only in certain circumstances. For example, a credit card company may in its terms and conditions provide for a standard grace period with regard to late payments, such that if the defaulter was not less than some specified number of days late, no charge would be due. However, this would not make it less objectionable for there to be unfair cross-subsidisation of the card issuer's costs, caused by defaulters who make good their default during an (albeit contractual) grace period, by other defaulters who are required to actually pay the default fee.

5 A PRACTICAL WAY FORWARD

- 5.1 It is clear to us from our inquiries that in many cases credit card default charges currently in force are unfairly high. In considering how best to deal with this finding we have kept in mind the OFT's commitment to making markets work well for consumers. Although early litigation by the OFT is an option we believe that there are other practical approaches that can be taken forward which, with the voluntary co-operation of the industry should bring about a swifter change in market practice. We are therefore adopting a two-fold practical regulatory strategy based on the publication of:
- a detailed statement in which we give guidance on our view of the law and its application in this area, and
 - a simple monetary threshold for intervention by us on credit card default charges.
- 5.2 The guidance on the limited administrative costs set out in this statement provides the basis for credit card issuers to set default charges in a way which we believe is consistent with the law, fair to consumers and enables them to compete vigorously. We expect credit card issuers, as responsible businesses, to review their charging structure on publication of this statement and adjust their default charges accordingly to arrive at a fair default fee.
- 5.3 As a practical measure, to help encourage a swift change in market practice, we are setting a simple monetary threshold for intervention by us on default charges. The threshold is £12.
- 5.4 Our presumption will be that credit card default charges set above this level are unfair unless there are exceptional factors that legally justify the higher charge. Where we see a fee above the threshold, we are likely to challenge the charge but will have regard to all the business circumstances and any exceptional factors in deciding whether to do so or not. We will regard charges set below the threshold as either not unfair, or insufficiently detrimental to the economic interests of

consumers in all the circumstances to warrant regulatory intervention at this time.¹³

5.5 We regard the setting of the threshold as a provisional practical measure to move the market towards compliance. We should make it quite clear that we are not inviting the banks to align their charges at such a threshold figure. We are not proposing 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. While our conclusion that default charges are not a primary focus of consumer choice implies that competition does not work well in this area, we are nonetheless determined that regulatory intervention should do nothing to impair such competition as exists to increase the efficiency of bank operations and overall value to consumers from banks' services. This approach leaves scope for different models of charging, provided they are cost-related.

5.6 The threshold is not intended to be a permanent feature of our intervention in this market. We will consider further action if trends in the market suggest that this threshold approach is insufficient to bring about appropriate and early change in the market.

5.7 It is also important to note that the threshold for action is a statement of our regulatory intent. We have no power to constrain private civil actions or to determine what a court should decide and other enforcers may apply for injunctions under the UTCCRs.

¹³ The OFT, like other enforcers of the UTCCRs, has a discretion as to how best to allocate its resources to discharge its general duties. For us to take action against charges that are set at a low level (solely on the basis that the costs incurred by the bank in collecting them appear to be even lower than would justify the charge) would be to misuse resources better directed at cases involving more serious economic detriment.

Setting the threshold

5.8 The following points should be noted in relation to the threshold for action set by us:

- The information we have taken into account on the banks' recoverable costs includes not only direct costs but also indirect costs that have to be allocated on the basis of judgment. Accounting conventions and standard methodologies of cost accounting are of assistance in making such judgments but we have taken account of an inevitable margin of uncertainty associated with them.
- The different types of default we have considered may have different implications for the credit card issuers' costs. Thus an excess spend over a credit limit does not necessarily mean the customer will ever be at all late in payment. However, as a practical matter we are not convinced that it would be worthwhile for a regulator to attempt to fine-tune default charges to take account of the differences in costs. We do not wish to increase banks' costs by requiring them to undertake such fine-tuning, nor do we consider it a good use of enforcement resources to enter into arguments over such issues of detail. We have therefore set the threshold for default charges on the basis of total recoverable costs spread over instances of all three types of default, without attempting to differentiate between the different types.
- We accept that it could be unnecessarily burdensome if credit card issuers were obliged by law to reconsider and amend their charges in response to short-term fluctuations in expected levels of recoverable costs or events of default. A more broad-brush approach seems to us sufficient to deliver fairness to consumers. However, the benefits of stability of charges must be balanced against the need to make a pre-estimate of costs and defaults on an objective and reasonably precise basis. We take the view that a pre-estimate should not extend so far into the future as to necessitate unduly speculative forecasts. The length and amplitude of any economic cycle

applicable to the credit card market may be difficult to predict and there are other uncertain variables that could have significant effects. In the light of this, we have allowed some margin for changes in costs and incidence of default as can reasonably be expected over the short to medium term in the calculation of our threshold. On the basis of our analysis we consider that the threshold is robust and there are unlikely to be grounds to consider any higher threshold for our action over the short or medium term although it may be reviewed if there are exceptional changes in economic circumstances or business practice.

Exceptional factors

- 5.9 As mentioned at paragraph 1.6 above, certain exceptional factors have been brought to our attention as grounds on which current default charges might be considered fair. This section of the statement discusses certain such factors in the light of which we might decide not to challenge default charges set at a higher figure than the threshold. These circumstances would be viewed restrictively; in order to avoid creating incentives to credit card issuers to invent artificial ways of trying to circumvent the practical consequences of the principles set out in this statement.

Exceptional credit policies

- 5.10 A bank may set its credit policies in such a way that it may reasonably expect that, in comparison with its competitors, only a relatively small proportion of its customers will fail to make a minimum payment. The example that we have in mind is a bank that offers credit cards only to customers that satisfy a relatively high scoring requirement and has a policy of requiring those customers to pay minimum monthly repayments by direct debits. A bank in such exceptional circumstances is likely to find fewer incidents of default over which to spread recovery of its fixed costs. The denominator it uses to calculate default fees may therefore be lower. It would however still be necessary, in assessing the level of a

fair charge, to review whether only recoverable costs were being taken into account in the numerator.

Assistance to customers

- 5.11 A bank might introduce additional measures to alert customers to the approach of a deadline for payment, or to the fact that they were close to a credit limit. Principled and transparent policies that reduce the number of chargeable events of default are likely to be in consumers' interests. It would be reasonable for the denominator to reflect the likely reduction in instances of default in these circumstances, although the extent of the reduction should not be overplayed.

Implementation

- 5.12 We expect all credit card issuers to take on board the principles contained in this statement and to recalculate their default charges accordingly. Credit card issuers are being asked to confirm by 31 May their response to this statement and their willingness to make any necessary adjustments to their credit card default charges. We are mindful that changes to a default charge may require IT system and other business changes by the credit card issuers. Some of these changes may take some time to fully implement, for example updating documentation for consumers. Nevertheless, in view of the scale of consumer detriment involved in the imposition of unlawful default charges, we consider that steps to reduce charges should be taken as a matter of exceptional priority even if this means that consequential changes occur at a later date. We or our co-enforcers will investigate further and will take appropriate action if change does not occur within a reasonable timescale.
- 5.13 Where exceptional factors apply and a credit card issuer believes it is able to justify a default charge above the threshold, it will be expected to confirm the basis of this view and may be asked to provide accounting information to support the higher charge.

Implications for other standard default charges to consumers

- 5.14 The broad principles set out in this statement are likely to be relevant to other default charges in standard agreements with consumers, such as those for mortgages, store cards and bank accounts. We expect the banks and other finance businesses to consider the wider implications of these principles, and to bring any similar charges they impose for breach of contract into line with them, where and as appropriate bearing in mind the different legal and practical contexts in which they operate. If appropriate steps are not taken within a reasonable timescale, further regulatory investigation of the position can be expected.