Decision Ref:	2019-0428
Sector:	Banking
Product / Service:	Repayment Mortgage
Conduct(s) complained of:	Errors in calculations
Outcome:	Upheld

LEGALLY BINDING DECISION
OF THE FINANCIAL SERVICES AND PENSIONS OMBUDSMAN

Background

The Complainant holds two loan accounts with the Provider. The Complainant argues that the Provider has unfairly applied a surcharge interest rate to his loan accounts. The Complainant calculates that the overcharge on the accounts from December 2009 to June 2017 was more than €15,000.

The Complainant's Case

The Complainant argues that the application of the surcharge interest rate was not advised on a transparent basis. He argues that the surcharge rate was never discussed between the parties and was never negotiated. He further argues that its application was not transparent as there is no reference to surcharge interest in the main body of the facility letter. Rather it is contained in one small section within the general terms and conditions which runs into many sections covering multiple situations. The Complainant argues that the surcharge was neither negotiated nor a genuine pre-estimate of the loss that would have been incurred by the Provider. He further argues that it was inserted *in terrorem*, can be deemed a penalty, and is therefore unenforceable.

The Complainant argues that in the case of *ACC Bank plc v Friends First Managed Pension Fund is Limited* [2012] IEHC 435, the experts on both sides of the case agreed and concluded that the bank in applying the margin to the loan agreement would already have accounted

for a "*probability of default*". The Complainant argues that there are at least 15 court cases which have ruled that the surcharge clauses were unenforceable, as recently confirmed in the Court of Appeal ruling in the *Breccia* cases *(Sheehan v Breccia* [2018] IECA 286).

The Complainant argues that this case upheld the previous rulings in relation to surcharge interest clauses and confirmed that the clause being relied on by the Provider to charge surcharge interest is unenforceable as it should be construed as a deterrent against default and a penalty. In the circumstances, he argues that the Provider is not entitled to recover surcharge interest.

The Complainant points out that the Provider, in its submissions to this Office, is trying to retrospectively renegotiate a contract which it cannot do. He states that if there are any flaws in the contract, the fault lies with the writer of the contract that is, the Provider itself. He further argues that the Provider continued to apply a surcharge rate despite the ruling in the *Friends First* case and, therefore, after the Provider was aware that the clause in question was unenforceable as it was at a rate which was generic, so therefore not negotiated. The Complainant argues that the Provider had an opportunity to amend its general terms and conditions but chose not to do so. The Complainant's third party adviser has calculated that the Complainant is due a refund of €13,318.20 in relation to Account 1 (*****530) and €2,067.01 in relation to Account 2 (*****062), amounting to €15,585.21. The Complainant also argues that he has incurred additional costs of €600 plus VAT since July 2018.

In response to the Provider's suggestion that this Office would make a determination on whether or not the Provider can seek damages for breach of contract against the Complainant for failing to meet repayments on the loan accounts, the Complainant argues that this falls outside the scope of the complaint, which was a request for this Office to determine whether or not the surcharge interest rate clause being relied on is enforceable or not.

<u>The Provider's Case</u>

The Provider argues that the *Friends First* case being relied on by the Complainant is set around a completely different set of circumstances and is therefore not an appropriate comparison for the present complaint. The Provider states that it extended a facility to the Complainant in 2002 to finance the building of a residential investment property (RIP) in the Midlands and in 2003 to purchase two hotel suites and car spaces in Dublin. In 2008, the Provider claims that the Complainant took on a substantial loan with another financial Provider to restructure his existing RIP portfolio with another provider, and to provide an equity release to assist with the purchase of commercial property in Budapest. The Provider claims that he obtained a further substantial foreign loan for the purchase of this property. The Provider states that in September 2009, the Complainant advised that he had lost tenants in his [European] property and his income was impacted accordingly. Thereafter difficulties began to arise in relation to the repayment of his loans with the Provider in the form of unpaid direct debit payments. The Provider states that the repayment profile on his loans was very volatile during the period. It states the Complainant's requests for interest

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only payments were declined due to the increased risk associated with the Complainant in terms of the overall debt.

The Provider appears to have a concern that income from Irish properties was being converted to overseas debt rather than used to make payments on the Provider's loans.

The Provider has furnished detailed information in relation to the Complainant's overall debt position, and history of repayments. The Provider states that the Complainant indicated his intention to sell the Midlands RIP in 2011 but this does not appear to be progressed until 2017. The Provider indicates that the Complainant's volatile repayment profile continued over a number of years and a significant level of time was spent by the Provider in contacting the Complainant to obtain adherence to the agreed repayment schedule, to progress the sale of the Midlands RIP, and to extract meaningful information about the Complainant's financial position.

The Provider contests the argument that it is not entitled to apply surcharge to the Complainant's loan accounts on a number of grounds. It states that the concept of surcharge was clearly explained in the letter of offer signed by the Complainant. It states that the required repayment schedules were made clear to the Complainant and the impact of failing to agree to these schedules was also highlighted to him on many occasions. The Provider argues that the Complainant was provided with numerous arrears letters during the relevant period detailing the level of arrears and also that the surcharge rate of 6% that was being applied to the arrears balance. The Provider argues, therefore, that the application of a surcharge interest rate was communicated in a wholly transparent manner on many occasions over a number of years. The Provider argues that the arrears which arose on its loans were due to the Complainant taking on significant external debt after the Provider's funds had been drawn down and diverting income to support both the operational and financial cost associated with the significant debt with another Provider. The Provider argues that the Complainant prioritised repayment of external debt and provision of operational funding for these properties ahead of repayment of the Provider's loans, which resulted in the emergence of arrears. The Provider argues that it made every effort to encourage the Complainant to address his arrears position to avoid the application of the surcharge. The Provider argues that the management of the Complainant's loans consumed an inordinate amount of time, and far exceeded the normal requirements for loan facilities of the size and complexity of the Complainant's.

The Provider has set out a history of payments made and missed in relation to both loans between 2009 and 2017, including the accrual of significant arrears balances from time to time. The Provider has stated that Account 1 is now closed and the Account 2 remains open with all repayments made on line.

The Provider states a loan is considered to be in arrears when repayment has not been made in line with the agreed repayment schedule. It explains that the provision of partial loan repayments result in the loan being in arrears for an amount equivalent to the shortfall in the repayment made by comparison with the contracted repayment. It states that where applicable, the surcharge is applied to loans on a quarterly basis in line with the charging of quarterly loan interest.

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It states that the entries are recorded separately with the narrative "*Interest Applied*" relating to ongoing accruing interest and the narrative "*Interest*" relating to surcharge interest applied. It states that surcharge is calculated at the rate of 6% on the balance considered to be in arrears for the amount of time it is in arrears. The Provider states that a surcharge was applied to both accounts for the first time on 15 December 2009 and continue to be applied to both loans where arrears arose.

The Provider has highlighted a large number of arrears letters sent to the Complainant in relation to both accounts which detail the amount and number of repayments that were in arrears, and the level of surcharge that would apply to the arrears, including the amount of surcharge which applied at the time of each letter, from December 2009 onwards.

The Provider argues that the circumstances of the present complaint illustrate the justification on the part of the Provider in charging surcharge interest and states its belief that the principles approved in the *Friends First* case support this. Alternatively, the Provider argues that the *Friends First* case was wrongly decided, and it is entitled to recover from the Complainant reasonable costs and losses arising as a result of breach of contract. It argues that the amount of these costs and losses are more than the amount of the surcharge interest charged and that the Complainant is not therefore entitled to any payment, refund or compensation from the Provider. The Provider states that from December 2009 to December 2017, total surcharge interest of €11,413.18 was levied in relation to Account 1 and surcharge interest of €1,936.41 was levied in relation to Account 2. As a result of delayed or non-payment of scheduled repayments on the loan accounts, the Provider argues that it was deprived of the income to which it was otherwise entitled. It further argues that it had to consider provision against the Complainant as a defaulting borrower which would have been based on all of the outstanding amount owing by the Complainant and not just the amount which the Complainant failed to pay. It states that the failure to make a payment is an indicator that the borrower is in financial difficulties and as a result the Provider has to consider whether or not it would receive any future payment after that failure. The Provider states that delayed or non-payment triggered reporting obligations within the group and to the Central Bank of Ireland. The Provider states that internal legal and management resources were engaged to consider the Provider's options and to deal with internal and external risk management and reporting. It further triggered engagement or attempted engagement with the Complainant to understand the reason for the default and its debt recovery process.

Significantly, the Provider states when a loan is in default, it attracts a capital weighting of 150% so the cost of capital to the Provider increased by 50%. The Provider has estimated that the additional management and capital costs incurred by it, due to default position on the loans, was €1,216.63 per quarter on average from December 2009 to December 2017. During the same period, the Provider charged total surcharge interest of €404.53 per quarter. It argues, therefore, that the costs incurred by the Provider as a result of the default by the Complainant exceeded the surcharge levied by a factor of 3.5 to 1.

The Provider highlights the case of *Lordsvale Finance plc vs Bank of Zambia* [1996] QB 752, cited with approval in the *Friends First* case, to support the proposition that money is more expensive for a less good credit risk than for a good credit risk, and that a small rateable

increase in interest charged is justifiable. The Provider states that under its terms and conditions, surcharge interest is calculated on the amount due for payment which has not been paid. It is not automatically chargeable on the full amount of the loan balance, unless the full amount of the loan is due for repayment but has not been paid.

It states that from a credit risk perspective, the failure to pay quarterly instalments means that not only is the relevant loan in default but it cross-defaults other loans by the same Provider to the same borrower. It argues that its 6% surcharge interest represents a small rateable increase in interest charged and that it is commercially justified. It argues that the Complainant cannot credibly argue that its dominant purpose in formulating surcharge interest was to deter him from breach. The Provider also relies on the interest rate of 8% set out in the European Communities (Late Payments in Commercial Transactions) Regulations 2012. The Provider argues that it was accepted in the *Friends First* case that generic pre-estimates of the additional cost of funding or loss to a credit institution would not be possible as it would depend on the nature of the default which would not be known or knowable at the contract stage. It states its belief that it cannot be the case that default interest by reference to a pre-set percentage is not possible under Irish law. The Provider again highlights that the surcharge clause does not apply automatically to the principal amount outstanding and so does not lead to the doubling or tripling in the overall rate of interest.

The Provider highlights that the Complainant has not disputed its submission that he failed to make payments which he was contracted to make and that this continued over eight years. The Provider states that it is due compensation for breach of contract and is entitled to be put in the same position as if the loan agreement had been performed.

The Provider disagrees with what it perceives as the suggestion by the Complainant that the decision in *Friends First* was to the effect that default or surcharge interest could not be charged as the general margin already compensated a bank in the event that the borrower failed to pay. The Provider states that this does not reflect how it or any other financial institution set its margin rates. In setting the margin to apply to a particular product or borrower, the Provider states that it takes a number of factors into consideration. It accepts that the margin charged factors in the creditworthiness of the borrower and the likelihood that the borrower will or will not pay, but is not designed to compensate the Provider for the losses occasioned as a result of non-payment by the borrower.

The Provider states that if this Office was to determine that the Provider could not charge surcharge interest under the provision in its general terms and conditions in this case, it requests that this Office determine that, as a matter of contract, it is entitled to recover its costs, losses and expenses which flow from the breach by the Complainant of the facility agreement with the Provider over a period of eight years. It claims that these costs exceeded the surcharge interest charged and so the Complainant is not entitled to repayment.

In relation to the reliance by the Complainant on the *Breccia* case, the Provider states that case involved a non-bank purchaser of debt at a discount so its losses would not be comparable to this complaint. The Provider states that as a regulated credit institution, it was subject to regulatory capital costs in relation to the Complainant’s loans. It argues that

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it is difficult to determine in advance the probable loss or damages in the event of a breach by a borrower of the loan agreement and that in those circumstances a certain latitude should be allowed. It states that it is demonstrated that its actual losses, costs and expenses are higher than the surcharge interest and it accordingly does not consider the surcharge interest charged to have been extravagant or unconscionable.

It argues that the circumstances surrounding the Complainant's complaint support the charging of the surcharge interest by it and that to hold otherwise would unjustly enrich the Complainant at the expense of the Provider where the Complainant's breach of contract has caused the Provider to suffer costs, expenses and losses.

The Complaint for Adjudication

The complaint for adjudication is that the Provider has wrongfully applied a surcharge interest rate on the Complainant's loan accounts in reliance on a surcharge interest clause which, it is alleged, constitutes a penalty clause and is therefore unenforceable.

Decision

During the investigation of this complaint by this Office, the Provider was requested to supply its written response to the complaint and to supply all relevant documents and information. The Provider responded in writing to the complaint and supplied a number of items in evidence. The Complainant was given the opportunity to see the Provider's response and the evidence supplied by the Provider. A full exchange of documentation and evidence took place between the parties.

In arriving at my Legally Binding Decision I have carefully considered the evidence and submissions put forward by the parties to the complaint.

Having reviewed and considered the submissions made by the parties to this complaint, I am satisfied that the submissions and evidence furnished did not disclose a conflict of fact such as would require the holding of an Oral Hearing to resolve any such conflict. I am also satisfied that the submissions and evidence furnished were sufficient to enable a Legally Binding Decision to be made in this complaint without the necessity for holding an Oral Hearing.

A Preliminary Decision was issued to the parties 15 August 2019, outlining the preliminary determination of this office in relation to the complaint. The parties were advised on that date, that certain limited submissions could then be made within a period of 15 working days, and in the absence of such submissions from either or both of the parties, within that period, a Legally Binding Decision would be issued to the parties, on the same terms as the Preliminary Decision, in order to conclude the matter.

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Following the issue of my Preliminary Decision, the Provider made a further submission under cover of its letter to this Office dated 3 September 2019. A copy of that submission was transmitted to the Complainant for his consideration.

The Complainant's representative, in his letter to this Office dated 16 September 2019, advised that the Complainant had no further submissions to make.

Having considered the Provider's additional submission, and all of the submissions and evidence furnished to this Office, I set out below my final determination.

At issue in the present complaint is whether the Provide was entitled to levy more than €15,000 in surcharge interest on the Complainant's loan accounts between 2009 and 2017. The complainant does not deny that the facilities were in default during the relevant period, nor does he deny that the contractual documentation provides for a surcharge interest rate in such circumstances.

Instead, the argument made is that the clauses in question constitute penalty clauses as a matter of Irish law and are therefore unenforceable. The surcharge interest charged on both account appears to have been paid by the Complainant who is now seeking a refund of that interest. No delay or waiver-type of argument has been made by the Provider in this regard. Rather the Provider argues that it was justified in charging the surcharge interest to compensate it for the additional costs associated with the default of the Complainant, in circumstances where the actual costs incurred by it were approximately 3.5 times greater than the surcharge interest levied.

The Surcharge Interest Clauses

In respect of Account 1, a letter of sanction issued on 25 May 2002, incorporating the Provider's then general terms and conditions. These were accepted by the Complainant on 25 May 2002. A variation of the facility dated 28 July 2005, incorporating the same general terms and conditions, was accepted by the Complainant on 3 August 2005. These general terms and conditions for commercial loans provide for the application of a surcharge interest rate in respect of Account 1 as follows:

> "*5. In the event of any payment of Interest or principal not being made on the Due Date (as defined in the Sanction Letter) then the amount due shall itself carry Interest at the rate appropriate to the Loan Facility.*
>
> *In addition to the Interest payable, as specified above, further Interest at the rate of 0.5% per month shall, by way of liquidated damages, be payable on all amounts which are not paid on the Due Date or on the date of demand. The Bank shall capitalise all such Interest in the manner specified in Condition 4 above. Until repayment sums demanded on foot of Condition 11 shall carry Interest (including interest on Interest computed on a day-to-day basis) at the rate payable in the Loan Facility on the Due Date or at the date of such demand.*"

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In respect of Account 2, the Complainant accepted the offer set out in a letter of sanction dated 10 December 2003 which incorporated the Provider's updated general terms and conditions. These updated general terms and conditions for commercial loans provide for a surcharge interest in respect of Account 2 as follows:

> "*4.4.6 Any sum payable by the Borrower under a facility which is not paid on the due date shall bear interest at 0.5% per month above the rate otherwise applicable to the Facility from the due date to the date of actual payment*."

I note from statements provided to the Complainant during the relevant period (or at least until September 2016) that when surcharge interest was applied to the accounts, it was not labelled as 'surcharge' or '*default*' interest in the statements. Rather the surcharge interest was labelled as "*Interest*", as distinct from the normal margin labelled as "*Interest Applied*". The Provider has argued that this represents transparency. I do not agree and I do not see how this can be described as transparent. The addition of surcharge was made clear, however, in standardised arrears letters sent to the Complainant during the relevant period.

Each of these letters noted the total arrears outstanding, the number of payments in arrears, the amount of arrears-related surcharge interest or arrears interest since last capitalisation, and the surcharge and standard rates of interest that applied. The surcharge interest rate was identified at 6%. The letters also noted that "*interest, including surcharge interest on the overdue amount, continues to accrue on a daily basis*". As a result of these letters, I accept that the Provider was transparent in its application of surcharge interest to the Complainant's account during the relevant period, though this ought to have been clearer on his account statements.

Case Law

According to Breslin and Corcoran "*A clause in a loan agreement to the effect that the amount of interest payable upon a default by the borrower is automatically increased, may be unenforceable if, properly construed, it is a penalty*". [Breslin and Corcoran, *Banking Law* (4th ed, 2019, Round Hall), paragraph 8–037].

The leading Irish authority is the Supreme Court decision in *Pat O'Donnell & Co Ltd v Truck and Machinery Sales Ltd* [1998] 4 IR 191, which focused on the distinction between a permissible genuine pre-estimate of damage and an impermissible sum in excess of any actual damages that would possibly or probably arise from breach.

In ACC Bank Plc v Friends First Management Pension Funds Ltd [2012] IEHC 435, the question of whether default interest in a loan contract was a penalty was considered by Finlay Geoghegan J. On the evidence, each side's expert agreed that where a facility goes into default, it would be re-categorised as impaired. This classification has cost implications for the lending bank because it will need to set aside an increased level of capital for the anticipated loss. It appears also to have been agreed that the actual cost to the bank would vary according to the nature of the default. Finlay Geoghegan J. concluded that the interest surcharge of 6% per annum could not be considered to be a reasonable pre-estimate of loss. Application of the surcharge trebled the margin on the facility, and almost doubled the

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applicable interest rate, and the entire surcharge was triggered even if one interest payment fell into arrears. This was not, therefore, akin to the minimal 1% additional interest found to be acceptable and enforceable in the UK decision of *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752. At paragraph 79, Finlay Geoghegan J. expressed the basic rule, as endorsed in *Pat O'Donnell*, as requiring the court to determine whether or not the additional sum payable is a genuine pre-estimate of the probable loss by reason of the breach. The court should determine whether the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach, by comparing the amount that would be payable on breach with the loss that might be sustained if a breach occurred.

In *AIB plc v Fahy* [2014] IEHC 244, O'Malley J accepted that "*a bank is entitled in principle to charge surcharge interest where a borrower is in default*" but held the surcharge interest rate of 12% to be a penalty where the bank offered no evidence as to the basis for its calculation so it could not be seen as a genuine pre-estimate of loss.

Most recently in *Sheehan v Breccia* [2018] IECA 286, the clause under scrutiny provided for a 4% per annum uplift in interest payments. Expert banking evidence was heard in the High Court to show that while it was not possible to accurately predict the level of loss that would be incurred on default, banks are likely to incur additional risk and administrative costs when a loan goes into default. The default or surcharge rate was almost double that of the normal interest rate applying under the loan. The creditor, a co-shareholder in the underlying business, argued that where a precise pre-estimate of damage was impossible and the provision was commercially justifiable, the bargain made between the parties should be respected provided the surcharge was not extravagant or unconscionable.

This approach was rejected by the Court of Appeal which indicated that only the Supreme Court could reconsider the principles as to whether a surcharge interest clause is or is not a penalty.

Speaking for the Court of Appeal (at paragraph 22), Finlay Geoghegan J. noted that:

a) the onus of establishing that a clause is a penalty rests on the party alleging same;

   and

b) the question of whether a clause is penal must be assessed at the time the agreement was entered and not at the date of breach.

Finlay Geoghegan J. held (at paragraph 40) that the question for the court to determine was "*whether or not the additional sum payable is a genuine agreement for the payment of liquidated damages*". This question then turns on whether or not the additional sum payable represents a genuine pre-estimate of the probable loss to the innocent party by reason of the potential breaches of contract to which the clause applies. The learned judge accepted that latitude ought to be applied where there is a difficulty in establishing a pre-estimate of the damage suffered where there is probable variation in what loss and damage that will in fact be suffered. As a result, Finlay Geoghegan J. held (at paragraph 44) that the question

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could be phrased as a determination of whether "*the clause is a genuine attempt by the parties to estimate in advance the loss which will result from the breach*" (emphasis added).

In *Sheehan v Breccia*, Finlay Geoghegan J. concluded that the 4% surcharge interest clause in question was not a genuine attempt to agree upon liquidated damages or estimate the loss which the original lender might suffer by reason of a relevant default. In reaching this conclusion, the learned judge noted that the clause was contained in the bank's general terms and conditions. Accordingly, it could not have been a genuine advance estimate of the bank's loss arising on a breach of the specific loan agreement between the bank and the borrowers. She further noted that expert evidence established that the probable loss depends on an interplay between the amount outstanding at the time of default, the value of the security ultimately realised, and the cost in time or effort in achieving these outcomes. The judge further accepted that the experts were in agreement that the pre-estimate of probable loss in the event of default formed part of the analysis which the bank did prior to determining the general interest rate to be applied to the facility.

Analysis

Applying the *Friends First* and *Breccia* principles to the present complaint, I note the following:

1. In assessing the clauses applicable in the present complaint, I accept that the Complainant bears the onus of establishing that the clause is a penalty. To this end, the Complainant has relied on case law in which various surcharge interest rates of 4%, 6% and 12% were held as unenforceable. The Complainant also argues that the clauses were not negotiated between him and the Provider and that there was no discussion in relation to them.

   I note that in the cases considered by the Courts, expert banking evidence was led by both sides to assist the courts in establishing whether the clauses in question were penalties. While no expert evidence is available to me in the context of the present complaint, I believe that I am entitled to note the expert evidence as cited in those cases to assist me in determining the question.

2. The question of whether the clause is penal must be assessed at the time the agreement was entered into, and not at the date of breach. The Provider has not made any submissions or proffered any evidence whatever to assist this Office with assessing its rationale for including the annual 6% surcharge interest rate at the time the loan agreements were entered into in 2002 and 2003. Rather, the entire focus of its submissions has been to demonstrate the history of the lending relationship and the additional resources deployed by it after default that is, after arrears appeared on the accounts from December 2009 onwards. On the basis of the *Breccia* judgment, I do not believe I am entitled to look to the costs actually incurred by the Provider from 2009 to 2017 as a post-breach justification for the application of a particular rate of surcharge interest in 2002 and 2003.

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3. The question of whether the agreement provides for the payment of liquidated damages normally falls to be decided by determining whether the clause is to be construed as a genuine pre-estimate of loss. I note that the clause under scrutiny in respect of Account 1 is expressed in terms of liquidated damages ("*further Interest at the rate of 0.5% per month shall, by way of liquidated damages, be payable on all amounts which are not paid on the Due Date* . . .") but I am not satisfied that this wording in and of itself has a bearing on the classification of the clause as a liquidated damages or penalty clause. The real question is whether the clause can be construed as a genuine pre-estimate of loss. The Provider has made no submission or provided any evidence in relation to an advance estimate of the costs or losses that might accrue on the default of the Complainant, instead focusing on the actual costs incurred by it after the breach.

4. Latitude ought to be applied where there is a difficulty in a pre-estimate of the damage suffered where there is probable variation in what loss and damage will in fact be suffered. I accept the Provider's argument that there is a difficulty in this complaint – and likely all lending cases – in estimating the likely damage that will be suffered by it should the borrower default on the loan facilities. This is because probable loss depends on an interplay between regulatory capital requirements, the amount outstanding at the time of default, the level and duration of the breach, the value of the security ultimately realised, and the cost in time or effort in remedying the default position. I further accept that that "[*a*] *default interest rate addresses the borrower's impaired credit, the true cost of which is normally impossible to quantify precisely*"; Breslin and Corcoran, paragraph 8–044. While latitude should be applied, however, I would expect some explanation from the Provider who set the rate in question for its rationale in imposing a 6% surcharge interest rate to the Complainant's loan facilities.

   As the matter is phrased in *Breccia*, there is no evidence before me of "*a genuine attempt by the parties to estimate in advance the loss which will result from the breach*".

5. The fact that a surcharge interest clause is contained in a bank's general terms and conditions tends to show that it could not have been a genuine advance estimate of the bank's loss arising on a breach of the specific loan agreement between the bank and the borrowers in question. In the present complaint, the clauses in question are both contained in the Provider's general terms and conditions, and there is no reference to the surcharge rate in either of the facility letters. In these circumstances, the 6% rate that was applied cannot have been a genuine advance estimate of the Provider's losses arising on a breach of the either or both of the loan agreements under scrutiny.

The Provider has placed considerable emphasis on the fact that its surcharge interest rate applies only in relation to the arrears balance and not on the overall amount outstanding on the loan (unless repayment of the loan has been demanded). It attempts to distinguish this from the situation pertaining in the *Friends First* case where Finlay Geoghegan J. referred to a doubling of the interest rate or a tripling of the margin applicable to the facility. I do not

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believe that this distinction can properly be drawn, however, as it appears that surcharge rates are typically only charged on the amounts under the facility that are unpaid or due. According to Breslin and Corcoran:

> *"A typical default interest clause will provide that if the borrower defaults on a scheduled payment of interest or repayment of capital then interest on the unpaid sum will accrue at a rate higher than the contractual rate. Thus if the contractual rate is 2% per annum, the default rate might be set at 5% above that rate – making an effective rate of 7% per annum whilst the payment is in default.*
>
> *The doctrine of penalties is enlivened because the loan agreement thereby provides for payment of a sum of money on a breach of contract and the question is whether the uplift in interest is a valid liquidated damages claim, or whether it is a penalty*."

(*Banking Law* (4th ed, 2019, Round Hall), paragraph 8–038.)

Further, the Provider is factually incorrect in the distinction it attempts to draw. In *Friends First*, the clause in question provided that "*if the Borrower defaults in the payment on the due date of any sum . . . payable under a Facility, the Borrower shall pay on demand interest thereon from and including the date of such default to the date of actual payment*" at the 6% annual rate. That surcharge rate (which Finlay Geoghegan J. noted was double the interest rate and triple the facility margin) applied only to the arrears amounts on the loan account, and not to the balance on the loan facility. Similarly, in the *Breccia* decision, the relevant clause provided that the surcharge interest rate was payable on "*any monies due by the borrower to the bank and for the time being unpaid . . . calculated on a daily basis from the due date to the date of actual payment …*" That surcharge rate also applied, therefore, only to unpaid or arrears balances and not the overall loan balance.

It is therefore the case that the surcharge interest clauses under scrutiny in the present complaint, applying only in relation to unpaid amounts and not to the entire balance of the facility, are typical of the kind considered and held unenforceable by the Irish courts in recent case law.

The Provider has argued in the alternative that the *Friends First* case is wrongfully decided. This Office must respect the law as interpreted by the Courts, including the case law analysed above. Indeed, these cases have been of considerable assistance to this Office in clarifying the issues surrounding the application of surcharge interest. If the Provider wishes to overturn a series of Court cases that it disagrees with, this Office is not the appropriate forum in which to attempt to do so.

The 6% surcharge interest rate applicable in the present case is of the same order that was stuck down as unenforceable in *Friends First*, and 2% higher than the surcharge interest rate held as a penalty in *Breccia*. The general interest rate applicable to the Complainant's loan facilities fluctuated between 2.8% and 0.91% during the period December 2009 to December 2017, thought it was at 4.8% in October 2002 and 3.6% in August 2003. Account 1 was subject to a margin of 1.25 % above Euribor and the margin on Account 2 was 1.5% above Euribor. The 6% surcharge rate can therefore be seen as four times the margin on

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Account 2 and almost five times the margin on Account 1. I accept that the likelihood of default by the Complainant would have been one factor taken into account by the Provider in setting the relevant facility margin. There is no evidence before me as to what factors, if any, were considered by the Provider in determining that a 6% surcharge interest rate was appropriate to the Complainant as an individual borrower to compensate the Provider for the (seemingly) inevitable cost to it if the Complainant defaulted in the repayment of his loan facilities.

Crucially, and as with the *Breccia* clause, the surcharge interest clauses in question are contained within the Provider's general terms and conditions, so could not have been a genuine advance estimate of the Provider's loss arising on a breach of the specific loan agreements between the Provider and the Complainant. While I accept that that some latitude should be applied due to the difficulties in pre-estimating damages that may be suffered on a default in loan repayments where there are a number of variables at play, there does not appear to have been any attempt, let alone a genuine attempt, to estimate in advance the loss that would result from breach in the present complaint.

On the basis of the relevant legal principles and the foregoing analysis, I do not think that the surcharge interest clauses in question can be properly described as providing for the payment of liquidated damages on default. Rather, the clauses are designed to deter a breach of contract and hence can be properly described as penalty clauses, since there is no evidence of an attempt by the Provider to estimate in advance the losses that would result from the Complainant's failure to meet scheduled repayments under the loan facilities.

Compensation for the Costs Incurred by the Provider

The Provider has set out in detail the history of arrears in relation to the two loans from 2009 onwards and its attempts to engage with the Complainant to clear the arrears balances. I accept, on the basis of the documentation before me, that significant time and resources were utilised by the Provider in dealing with the Complainant's loans. I note that the Provider has estimated that the additional management and capital costs incurred due to the default position on the Complainant's loans were €1,216.63 per quarter on average from December 2009 to December 2017, compared with average surcharge interest charged of €404.53 per quarter during the same period.

The Provider has expressed a wish for this Office to confirm that it is entitled to a remedy in breach of contract against the Complainants in light of his failure to meet agreed contractual repayments on the accounts. Without expressing any view on the merits of such a cause of action, this Office is not in a position to make any finding as to whether the Provider can or cannot seek to recoup its alleged losses from the Complainant. The role of this Office is to investigate and adjudicate upon complaints from consumers regarding the conduct of regulated financial service Providers. It does not have a role in investigating, or determining the scope of, potential causes of action against consumers, customers or Complainants. If the Provider wishes to pursue an action in contract against the Complainant arising from his (now remedied) default in meeting scheduled repayments on his loan facilities, this is not the appropriate forum in which to do so. The role which this Office has in respect of the

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present complaint is in determining whether or not the surcharge interest rate that was applied by the Provider to the Complainant's accounts was applied lawfully or not.

In this context, however, I note that the Court of Appeal in *Sheehan v Breccia* [2018] IECA 286 (at paragraph 33) explained that its analysis of the surcharge interest clause in question was premised:

> "*on an assumption (but without any decision to that effect) that Anglo in 2006 (or 2008) would have had a claim recognisable in law for damages for loss and damage which it might suffer by reason of the failure of [the borrower] to make a payment due under the agreements on a due date which went beyond the sum in question and interest thereon at a commercial rate*."

The Court of Appeal therefore analysed whether the surcharge clause represented liquidated damages or a penalty clause expressly on the basis that the additional costs associated with default would (theoretically) be compensable in contract, and hence, capable of being converted into a liquidated damages clause. These issues however are matters to be dealt with by way of legal proceedings before the Courts.

On the basis of the case law that I have set out and analysed above, I am satisfied that the clause in question, relating to this complaint, is unenforceable and therefore the entirety of the surcharge interest applied to the Complainant's loan accounts from 2009 to 2017 was wrongfully applied.

The Provider, in its post Preliminary Decision submission of 3 September 2019 stated that in my Preliminary Decision I had not fully or adequately analysed the surcharge interest clause and had *"…incorrectly applied the Breccia decision…"* to the complaint at hand.

I do not accept the Provider's contention. I have fully considered the clause in question.

I believe I have correctly applied the decision reached in *Sheehan –V- Breccia* [2018] IECA 286.

The Provider states:

> *"The fact that the surcharge interest clause was part of the general conditions was not considered to be the sole or even the most important feature (see paragraph 50 of her Judgement) and it seems to have been the least important of the five features identified above. We submit that the Emphasis in the Preliminary Decision on the fact that the surcharge interest clauses in question were part of the general conditions was incorrect"*

I do not accept the Provider's assertion. While the Provider has put forward the argument that it is *"the least important of the five features identified"* it is still an important feature which I believe I gave fair and proper consideration to.

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At paragraph 51 of Finlay Geoghegan J decision in *Sheehan –V- Breccia* [2018] IECA 286, she states:

> *"51. The first important contractual features is that it forms part of the general conditions and therefore is not a clause which is specific to the borrowing of Mr Sheehan".*

The Provider, in its post Preliminary Decision submission of 3 September 2019 has also submitted that I have:

> "*Adequate powers under the Financial Services and Pensions Ombudsman Act 20017 (the "2017 Act") to consider* [the Providers] *counterclaim*.

Further the Provider states that:

> *"in order to properly discharge his functions, and in the interest of fairness, fair procedures, adjudicative efficiency and effective determination of a complaint (and any justifications or defence) on its merits, the Ombudsman should have done so or declined to adjudicate on the complaint".*

The Provider appears to be of the view that if I am not be in a position to confirm that the Provider is entitled to a remedy in breach of contract against the Complainant, then I should have declined to adjudicate on the Complainant's complaint.

I do not accept the Provider's position. I am entitled to accept jurisdiction of a complaint as per section 50(2) of the Financial Services and Pension Ombudsman Act 2017.

If the Provider is seeking a remedy of breach of contract it has the option of pursing matters through the courts.

I would also direct the Provider's attention to section 60(4) of the FSPO Act:

> *"Where a complaint is found to be upheld, substantially upheld or partially upheld, the Ombudsman may direct* ***the financial service provider*** *to do one or more of the following:…"* (Emphasis added)

This shows that the ***Act*** only empowers me to direct "*the financial service provider"* and not a consumer or a complainant. I have no legal or other basis on which to make a direction against a complainant.

Finally, for the avoidance of any doubt to the question of Jurisdiction when there is a question on this, section 50 (2) of the ***Financial Services and Pensions Ombudsman Act 2017*** states how such a question is settled:

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> *"50(2) where a question arises as to whether the Ombudsman has jurisdiction, under this Act, to investigate a complaint, the question shall be determined by the Ombudsman whose decision shall be final".*

Based on the case law and the circumstances of this complaint, I am not satisfied that the Complainant is entitled to a refund of all surcharge interest charged on his two loan accounts, accounting for any compounding or capitalising of that surcharge interest.

For the reasons set out above, I uphold this complaint and direct that the Provider refund all surcharge interest charged on the Complainant's loan accounts, accounting for any compound or capitalising of that surcharge interest. Furthermore, I direct the Provider to pay a sum of €1,000 for the inconvenience caused to the Complainant as a result of its conduct.

Conclusion

My Decision pursuant to ***Section 60(1)*** of the ***Financial Services and Pensions Ombudsman Act 2017***, is that this complaint is upheld, on the grounds prescribed in ***Section 60(2) (a).***

Pursuant to ***Section 60(4) and Section 60 (6)*** of the ***Financial Services and Pensions Ombudsman Act 2017,*** I direct the Respondent Provider to rectify the conduct complained of by refunding all surcharge interest charged on the Complainant's loan accounts, accounting for any compound or capitalising of that surcharge interest.

I also direct that the Provider make a compensatory payment to the Complainant in the sum of €1,000, to an account of the Complainant's choosing, within a period of 35 days of the nomination of account details by the Complainant to the Provider.

I also direct that interest is to be paid by the Provider on the said compensatory payment, at the rate referred to in ***Section 22*** of the ***Courts Act 1981***, if the amount is not paid to the said account, within that period.

The Provider is also required to comply with ***Section 60(8)(b)*** of the ***Financial Services and Pensions Ombudsman Act 2017.***

The above Decision is legally binding on the parties, subject only to an appeal to the High Court not later than 35 days after the date of notification of this Decision.

GER DEERING
FINANCIAL SERVICES AND PENSIONS OMBUDSMAN

6 December 2019

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Pursuant to *Section 62* of the *Financial Services and Pensions Ombudsman Act 2017*, the Financial Services and Pensions Ombudsman will publish legally binding decisions in relation to complaints concerning financial service providers in such a manner that—

(a) ensures that—

(i) a complainant shall not be identified by name, address or otherwise,

(ii) a provider shall not be identified by name or address,
and

(b) ensures compliance with the Data Protection Regulation and the Data Protection Act 2018.