



March 2006

BRIEFING

Fairness in the UK financial services sector

Summary

The following commentary looks at the impact of the concept of fairness in the UK financial services sector and considers a way of bringing greater certainty to this area. It is based on an article that originally appeared in *The Times*.

What is fairness? The question is frequently heard around the City these days. Most recently, it has been addressed in a speech by Sir Callum McCarthy, chairman of the Financial Services Authority (FSA), considering how the principle of consumers being responsible for their decisions fits in. The FSA's 'Treating Customers Fairly' initiative (TCF) has encouraged regulated firms to review each aspect of their business to ensure that it is fair to customers, with the risk of sanctions if not. Meanwhile, the new Consumer Credit Bill, in its current form, would allow judges to cancel credit agreements if they are 'unfair to the debtor'. Unusually, the power would be retrospective, applying to contracts predating the new legislation. Neither the FSA nor the government has defined 'fairness'. Two forthcoming European directives will also introduce additional duties of fairness into UK law – the Markets in Financial Instruments Directive and the Directive on Unfair Commercial Practices. The resulting uncertainty is potentially bad for business and consumers.

The English prefer a sense of fair play to legislating for it, or so it is often thought. Mainland European jurisdictions have over-arching legal principles of good faith; the English have cricket. In that light, the current initiatives look like an assault on the English approach to commercial relations that leaves the parties to a bargain free to choose the terms on which they deal.

But this is a caricature. Fairness is more prominent in English commercial law than is sometimes thought. A range of remedies has evolved, more rapidly in recent years, to deal with identifiable types of unfairness in

commercial relations, such as rules on duress and undue influence. These are supplemented by legislation outlawing unfair contractual terms. In providing his services a lawyer must also generally apply a standard of care that is reasonable (or dare one say, fair). All this rests on a judicial system the procedures of which are grounded on fairness. However, the courts have steadfastly refused to apply a general principle of good faith, considering it 'repugnant to the adversarial position of the parties involved in negotiations' and potentially dangerous because of the uncertainty it could cause.

That brings us back to the City, wrestling with the risks of acting unfairly. The disquiet may seem surprising. The City has long had to cope with the idea – company accounts have had to give a 'true and fair view' since 1947. As for TCF, the City is not without help: the FSA has given extensive guidance to firms, identifying areas to consider and examples of good and bad practice. And it is not as if businesses dispute the fact that well treated customers are more likely to be good customers, particularly in an increasingly consumer-activist environment.

Yet important questions remain, particularly over whether it is right to apply fairness to the basic commercial terms of credit agreements. Another question concerns how courts and regulators will enforce fairness. In the case of TCF, the FSA enforcement process looks fairer and more transparent following a recent overhaul, but it remains largely untested. It is easy to see, for example, how new arrangements for early settlement could result in firms cutting a deal with the FSA to avoid

reputational damage so creating a series of artificially customer-orientated precedents on what is fair. Uncertainty is also creating a system of 'regulation by speech' where, in the absence of formal rules, succeeding statements from the FSA are scrutinised for evidence of what it regards as fair. The Financial Ombudsman Service could complicate the situation further. It is not a court of law but has to decide cases based on what it considers fair and reasonable. How will its 'rough and ready' justice affect understandings of fairness?

There is also concern over how the courts might apply fairness under the Consumer Credit Bill, if enacted. Securitisations of consumer credit might be particularly vulnerable. Will institutions find it less easy to securitize their loan book because of the risk of unenforceable loans? The effects could be equally unpredictable for existing securitisation structures because the legislation is retrospective. Could lenders find the value of their loan book significantly reduced as a result of a single adverse finding with implications across the whole portfolio?

A definition of fairness covering every circumstance would probably be so vague as to be useless or so detailed as to be an impossibility. However, firms have a legitimate interest in knowing how courts and regulators are likely to go about deciding what is fair in a given case; commercial relationships need certainty.

The work of the English and Scottish Law Commissions on the UK unfair contract terms legislation may help. Their proposed Unfair Contract Terms Bill would create proper parameters for the courts in deciding what is unfair. Broadly, they would have to take into account how far a contract term is transparent, its substance and effect, and all the circumstances existing at the time it was agreed (ruling out hindsight). This sort of approach could provide a higher level of certainty in the context of the Consumer Credit Bill and TCF as well. Either way, in 2006 it is perhaps time for a new initiative: treating firms fairly.

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