



Unfair terms in consumer contracts: ignore them at your peril

This briefing comments on the legal and regulatory developments regarding the enforceability of certain standard terms in contracts for retail financial services.

Background

Following the decision of the Supreme Court in the long-running test case between the Office of Fair Trading (OFT) and financial institutions over charges to retail account customers, there may be a temptation to view the fairness and clarity of contractual terms with consumers as of less concern than previously. This would be a mistake. The Financial Services Authority (FSA) has obtained many undertakings from firms to change what it regards as unfair terms and has expressed a continued determination in its business plan for 2010/11, as part of its treating customers fairly (TCF) initiative, to ensure that firms do not rely on unfair terms. Consistent with this, the FSA has issued a statement about the use of declarations to be signed by consumers indicating that they have read and accepted an institution's standard terms. In addition, the Financial Services (Unfair Terms in Consumer Contracts) Bill was introduced in the House of Commons on 30 June 2010 with the intention of ensuring that ancillary pricing terms in consumer financial services contracts are assessable for fairness. The new legislation, if passed, will mean that greater care will need to be taken in drafting standard terms for consumer contracts.

The TCF initiative is now imbedded in the FSA's core supervisory work and the FSA now assesses firms' delivery of TCF compliance through ARROW visits. As part of its TCF initiative, the FSA has also been focusing attention on the assessment of terms for fairness under the Unfair Terms in Consumer Contracts Regulations 1999 (the Regulations). When the FSA finds unfair terms,

it can request an undertaking from the firm to stop using or to change unfair contract terms or it can seek an injunction from the court to prevent firms continuing to use unfair terms.

As part of the focus on unfair contract terms, the FSA has been carrying out thematic reviews of sectors in which a large number of complaints have been received (including PPI, mortgage exit administration fees and mortgage early repayment charges). Also, in June 2008 the FSA published a report following a review that was conducted to, among other things, measure firms' awareness of and compliance with the Regulations. In the course of that review, the FSA found that, despite it having published a large amount of information to help firms understand the need for fair contract terms, many of the firms reviewed still had unfair terms in their contracts, and that not all firms had systems and controls in place to monitor the fairness of standard form contracts. The FSA made clear that it expects firms to confront these issues.

Katherine Webster, the manager of the FSA's Unfair Contract Terms team, echoed these sentiments in a speech to the Council of Mortgage Lenders' Legal Issues for Mortgage Lenders Conference in January 2009, and emphasised that it is not enough for firms to monitor those undertakings that relate specifically to their industry sector. Firms must review all undertakings obtained by the FSA and consider whether the undertakings have any potential impact for the firm's own standard form contracts.

Recent undertakings published by the FSA further demonstrate the increased focus on this area, and highlight the importance for all firms to continually monitor standard form consumer contracts for compliance with the Regulations.

This briefing looks at the Supreme Court decision on bank charges and some recent undertakings given by firms in the areas of insurance, pensions, investment products and mortgages, and considers the possible consequences flowing from those undertakings.

Bank charges

On 25 November 2009, the Supreme Court unanimously allowed the banks' appeal in *Office of Fair Trading v Abbey National plc & others* on overdraft charges. The Supreme Court held that charges for unauthorised overdrafts are monetary consideration for the package of banking services supplied to personal current account customers. As a result, provided the terms are in plain intelligible language, no assessment of the fairness of those terms under the Regulations may relate to their adequacy for the services supplied.

Although the decision represents a victory for the banks, firms should not interpret the decision as relaxing the requirements of the Regulations. The case was won on a point of interpretation. The relevant terms still had to be drafted in plain intelligible language. Moreover, Lord Phillips commented that it would still be open to the OFT to attack the fairness of the charges, however any attack could not be founded on the allegation that the charges were excessive by comparison with the services that the consumer purchases.

The Supreme Court decision was followed by an announcement by the OFT on 22 December 2009 that it would not be continuing its investigation into the fairness of bank charges. The OFT expressed the view that, as a result of the judgment, the scope of any investigation would be very limited and would have low prospects of success.

Expressions with legal meanings

In 2008, the FSA published a statement on the use of the phrase 'consequential loss' in general insurance contracts. Many insurance contracts exclude liability for

consequential loss, and the FSA expressed a concern that, given this expression has a legal meaning, the average consumer would probably not understand it. In short, a term that excludes 'consequential loss' is not written in plain and intelligible language and therefore is vulnerable to being deemed unfair under the Regulations.

The FSA has also concluded that using the word 'indemnify' in a standard form letter signed by consumers to accept pension benefits on stated terms could be unfair, because most consumers would not understand the meaning of that term. In light of this, if a firm wishes to include an indemnity in a consumer contract, the firm must make the circumstances clear in which a consumer will be held responsible for losses or costs incurred by the firm.

It is important for firms to monitor undertakings such as these, and to carefully review any standard form consumer contracts, to ensure that any phrases with legal meanings are written in a clear and unambiguous way, and in a way that clearly enables consumers to understand what terms mean.

Consumers' statutory rights

The FSA has recently conducted a review of statutory rights clauses in standard form consumer contracts and has concluded that 'clauses which just refer to "statutory rights" without providing any further information may not be plain and intelligible and are therefore potentially unfair'.

On its website, the FSA notes that the OFT has already obtained an undertaking from a firm on this issue, to require a firm to amend a term to provide details on what statutory rights the consumer has, and where the consumer can obtain more information about those statutory rights.

The FSA has warned that, when relying on terms that refer to statutory rights, firms need to consider including wording that explains to consumers how they can find out more information about their statutory rights.

Declaration that the customer has read and understood the terms

In January 2009, the FSA published an undertaking given by the On-line Partnership concerning its standard

terms, which were headed ‘About Us, Our Fees, Services and Client Agreement terms of business 2007 version’. The term in question stated: ‘I confirm that I have received, read and understood this agreement and agree to the terms set out within.’ The FSA determined this term was unfair under the Regulations, because, among other things, it binds customers to terms that they may not have any real awareness of.

The firm agreed to revise the term, which now reads: ‘This is our standard client agreement upon which we intend to rely. For your own benefit and protection you should read these terms carefully before signing them. If you do not understand any point please ask for further information.’

The FSA published a statement on 16 June 2010 providing further explanation about its view on similar declarations in standard term contracts for consumers and the approach that firms should take when drafting or relying on consumer declarations of this type. The FSA will assess the fairness of a declaration based on how it is drafted and how it is used in practice. The June 2010 statement contains examples of declarations the FSA may regard as fair as well as declarations the FSA may regard as unfair and proposes action that firms should take in this respect.

Discretion, and variation of terms and conditions

The FSA has also expressed concern over the right of a firm to vary its terms and conditions.

One firm that has given an undertaking in this regard is Jarvis Investment Management plc (Jarvis). The FSA was concerned with two terms in some of its standard terms and conditions, namely: (a) a clause that gave Jarvis sole discretion to amend the rates of account charges, and (b) a clause that said Jarvis may vary the terms and conditions by giving reasonable notice to the consumer. In summary, the FSA’s concerns were that:

- Jarvis had sole discretion to vary account charges without having to give valid reasons for making these changes; and
- Jarvis was not obliged to notify consumers of the variation and consumers were not free to leave the contract if they did not accept the variation.

As a result, Jarvis agreed to amend its terms to address these concerns. The FSA has identified similar issues with a lender’s discretion to vary the terms of a mortgage and it obtained an undertaking from Chesham Building Society in May 2010 to vary the terms only once 30 days’ notice has been given, to convert the mortgage to its standard variable terms only if the borrower is in arrears and, in that case, to refrain from charging the higher rate of interest retrospectively.

Tracker mortgages with collars

Financial institutions offering mortgages with ‘collars’ (ie a point at which a firm will not pass on any further reduction in the Bank of England Base Rate) need to consider the risk that any such terms may fall foul of the Regulations. Aside from the disclosure obligations firms have regarding collars, firms must take care to ensure that terms explaining the collar are drafted in clear and intelligible language. In the FSA’s June 2009 Mortgage Lender Briefing, it was reported that a firm had included a term that enabled them to change the up-front tracker margin in certain circumstances, including if the Base Rate dropped below 3 per cent. In short, the term gave the firm the discretion to change the tracker margin by any amount it wished. The FSA felt that this term was unfair.

The basis on which the FSA felt that this term was unfair is not apparent from the briefing. It was presumably because the FSA felt it gave the firm too much discretion over the margin, and it was not sufficiently clear to consumers how that discretion could be exercised. Perhaps the FSA also considered that a change to the margin could result in a disproportionate cost to the consumer, creating a significant imbalance in the parties’ rights to the detriment of the consumer.

Lessons for firms

As the examples above indicate, the FSA is continually reviewing and monitoring consumer contracts for fairness, and challenging firms if it does not believe the standards set in the Regulations are being met.

Firms must continue to review any standard form consumer contracts and, in particular, be alert to the following issues:

- ensuring that any discretion given to the firm is clearly explained to the consumer and is not excessive so as to create a significant imbalance between the parties to the detriment of the consumer;
- ensuring that the contract provides valid reasons as to how and why the firm may vary terms and conditions; and
- avoiding 'legalese', particularly with exclusions, and making sure that a consumer can understand what his rights and obligations are under the contract.

Firms should adopt a careful approach to this area and bear in mind, at all times, that if a term is considered by the FSA to be unfair it will be construed in favour of the consumer.

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