Feature

KEY POINTS

- The requirement of transparency which the CJEU has discerned in the Directive on unfair terms in consumer contracts has created particular uncertainty about the fairness of variation terms in contracts for the supply of financial services to consumers.
- Recent guidance from the FCA provides welcome clarification of its views on this difficult topic, including a list of factors which the FCA regards as relevant when assessing the fairness of variation terms and a discussion of the likely validity of five reasons for exercising powers of variation which are commonly included in consumer contracts.
- There remains a degree of uncertainty on whether some aspects of the guidance are compatible with the CJEU's requirement of transparency.

Author Malcolm Waters QC

New guidance from the FCA on the fairness of variation terms in consumer contracts

In this article, Malcolm Waters QC analyses recent guidance from the FCA on the fairness of variation terms in financial services consumer contracts, which FCA-regulated firms should consider when reviewing existing contracts and drafting new ones.

Council Directive 93/13/EEC on unfair terms in consumer contracts (the Directive) is currently implemented in the UK by Pt 2 of the Consumer Rights Act 2015 (CRA), which applies to consumer contracts made on or after 1 October 2015. The Directive was previously implemented by the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs), which continue to apply to consumer contracts made before 1 October 2015.

A topic of particular concern to firms providing financial services to consumers is the application of the legislation to terms enabling the firm to vary the contract, eg a term in a mortgage or savings contract conferring power on the firm to vary the interest rate. The approach taken by the Directive and the UK implementing legislation is that the fairness of a term must be assessed by reference to the circumstances at the conclusion of the contract. An assessment of the fairness of a variation term therefore requires a focus on the term's potential to cause detriment to the consumer during the lifetime of the contract, not on whether the term has been exercised fairly in practice. If the term is found unfair, it will not be binding on the consumer, with the *prima facie* consequence that the consumer will not be bound by any changes which the supplier has made in reliance on the term since the date of the contract.

The FSA previously published guidance on the fairness of variation terms in financial services consumer contracts in 2005 and 2012.[1] That guidance was, however, withdrawn by the FCA in March 2015 in the light of: (i) the forthcoming enactment of the CRA; (ii) the expected publication by the CMA of its guidance on the CRA (the *CMA Guidance*[2]); and (iii) the caselaw of the Court of Justice of the EU (CJEU) on the Directive. The relevant CJEU caselaw consists of a series of decisions starting in 2012, in which the court has held that, in assessing the fairness of a variation term, two factors (neither of them explicitly articulated in the Directive) are of "fundamental importance". The first is a far-reaching requirement for transparency, which, in *RWE Vertrieb*,[3] the CJEU (at [49]) formulated as follows:

> "... whether the contract sets out in transparent fashion the reason for and method of the variation of the charges for the service to be provided, so that the consumer can foresee, on the basis of clear, intelligible criteria, the alterations that may be made to these charges."

The second factor is whether the consumer has an effective right to terminate the contract if the power of variation is actually exercised – that is to say, a right which is not purely formal but can actually be exercised, having regard (among other things) to:

> "... whether the market concerned is competitive, the possible cost to the consumer of terminating the contract, the time between the notification and the coming into force of the new tariffs, the information provided at the time of that communication, and the cost to be borne and the time taken to change supplier."[4]

The above developments resulted in the previous FSA guidance becoming seriously outdated and left the FCA with little alternative to withdrawing it. Nonetheless, the withdrawal of the guidance left a gap which was not adequately filled by the *CMA Guidance* – not surprisingly, given that the *CMA Guidance* covers a much wider range of terms and contracts. However, the relatively scant coverage of variation terms in the *CMA Guidance* highlighted the need for more focused guidance on such terms in financial services contracts.

That need has now been met by the publication on 19 December 2018 of the FCA's Finalised guidance, FG18/7, Fairness of variation terms in financial services consumer contracts under the Consumer Rights Act 2015.

The FCA states in chapter 1 of the guidance that it expects firms to which the guidance applies (namely, FCA-authorised persons and their appointed representatives, electronic money issuers and payment service providers) to consider the guidance when they review their existing contracts and when they draft new ones. Firms within the Senior Managers Regime should also ensure that responsibility for fair consumer contracts is clear from the relevant Statements of Responsibilities.

While the title to the guidance might suggest that it is relevant only to the fairness of variation terms under the CRA, chapter 2 makes it clear that it is equally relevant to the fairness of such terms under the corresponding provisions of the UTCCRs. This chapter also contains a summary of the relevant legislative provisions, supplemented by helpful citations of key passages from the CJEU and UK caselaw.

The heart of the guidance is contained in chapter 3. The chapter begins by acknowledging that fair variation terms in financial services contracts benefit both firms and consumers because the firm's ability to make changes during the lifetime of the contract enables it to provide a wider range of products to consumers, so offering them greater choice. It then goes on to draw attention to those provisions in the so-called "greylist" of indicatively unfair terms in Sch 2 to the CRA which are relevant to assessing the fairness of variation terms (or terms which are similar to variation terms, such as price escalation clauses). In contrast to the earlier FSA guidance, the new guidance (wisely in the light of the CJEU caselaw) does not treat the provisions of the "greylist" as directly signposting possible routes for achieving fairness in variation terms. Instead, the FCA collects together a broader range of factors which it considers to be relevant when assessing the fairness of variation terms.[5] The listed factors may be summarised as follows:

PURPOSE

(1) Has the firm included the variation term to achieve a legitimate purpose?

SCOPE

(2) Are the reasons (ie any reasons entitling the firm to exercise its power to vary the contract) no wider than is reasonably necessary to achieve a legitimate objective?
(3) Is the extent of the change permitted by the variation term no wider than is reasonably necessary to achieve a legitimate purpose?
(4) Are the reasons objective?
(5) Would it would be possible for the firm to demonstrate whether or not the reasons entitling it to vary the contract have arisen?

ABILITY TO FAVOUR THE CONSUMER

(6) Does the term:
- give reasons which allow variations in favour of the consumer as well as the firm, (eg price decreases as well as increases); or
- allow variations which only favour of the consumer?

TRANSPARENCY

(7) Are the reasons clearly expressed?
(8) Will the average consumer understand, at the time of contracting, the consequences that a change might have for them in the future? In particular, for a term enabling the firm to vary the price:
- if practicable, does the contract (or other information provided to the consumer before the contract is concluded) explain in general terms the method for determining the new price, and
- will the average consumer understand the economic consequences for them of the variation term?

NOTICE

(9) What, if any, notice of a variation does the contract require the firm to give to the consumer?

FREEDOM TO EXIT

(10) Does the contract give the consumer the right to terminate the contract before or shortly after any variation takes effect?
(11) Judged at the time the contract is concluded, is it likely that the consumer would be able to exercise the right in practice?

BALANCE

(12) Does the term strike a fair balance overall between the legitimate interests of the firm and the legitimate interests of the consumer?

Factor 8 reflects the requirement of transparency evolved by the CJEU. As will be apparent from the extract from *RWE Vertrieb* quoted above, the CJEU's formulation of the requirement in the context of price variation terms emphasises the importance of setting out in transparent fashion both the reason for and the "method" of varying the price. The specific treatment which the FCA gives to price variation terms under factor 8 appears to recognise that, in relation to the method of varying the price, it may not be "practicable" to explain how the new price will be determined (an obvious example being where the firm has power to vary the interest rate for reasons specified in the contract, but no formula or methodology for quantifying the variation has been agreed as part of the contract). Later in the guidance, however, the FCA says that firms should consider whether it is practicable to give the consumer a simple explanation of the firm's likely approach to changing prices covering:
- the circumstances in which prices may change;
- in general terms how the new price would be determined; and
- the potential size of any price increases.

While an explanation of that kind could well be helpful in meeting the requirement of transparency, the explanation would need to be drafted with some care to avoid imprudently fettering the firm's freedom to exercise the power of variation in circumstance which may not have been foreseen (or foreseeable) at the date of contracting – especially bearing in mind that, if the consumer takes account of the explanation when deciding whether to enter into the contract (and the whole point of giving the explanation would be that the consumer should take account of it), the firm is likely to be contractually bound by it under s 50 of the CRA. Moreover, as the FCA itself points out, a firm giving an explanation of its approach to changing prices would need to be careful to avoid breaching competition law by sharing commercially sensitive information with competitors.

Several of the factors listed by the FCA are directed at cases in which the firm's power to vary the contract is dependent on reasons entitling the firm to exercise the power. The presence of such reasons may contribute to the fairness of the variation term in two ways:
- specifying valid reasons in the contract for the exercise of the power will avoid the term being subject to an indication of

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unfairness under para 11 of the "greylist" in Sch 2 to the CRA; and

- more generally, setting out reasons for the exercise of the power in the contract, or in any relevant pre-contractual material,[6] is likely to help the consumer to foresee the kinds of circumstances in which changes will be made and thus go at least some way towards satisfying the CJEU's requirement of transparency.

As part of its commentary on factors 2 to 5, the FCA addresses the first of these points by giving its views on whether five commonly used reasons for making changes under a variation term are likely to be accepted as valid. The FCA states that three of the five are likely to make the grade. The "approved" reasons are those which allow the firm:

(a) to change charges because the firm has made changes to its technology;
(b) to make changes to reflect changes to legislation, regulatory requirements or case law; and
(c) to change rates because of changes in the firm's costs of funding.

In the case of reasons (a) and (c), the guidance proceeds on the basis that the reasons are likely to be valid because they relate to changes which are part of the cost of providing the product.[7] Consistently with that approach, the FCA says that the costs must either be specific to the product or fairly allocated to the product. That limitation seems right in principle, though it may not be easy in practice to draft the reason in a way which embodies this limitation in the "plain intelligible language" required by s 68 of the CRA.

The two reasons which the FCA regards as unlikely to be valid are those which allow the firm:

(d) to make changes to remain competitive; or
(e) to make changes for any other reason (ie reasons other than those listed).

Two points may be made with regard to reason (e).

- First, it is common in practice to find that a variation term which allows changes to be made for an open-ended category of unspecified reasons nonetheless limits the firm's discretion by requiring those reasons to be valid, eg by stating that changes may be made for a list of specified reasons "or any other reason *which is valid*". Where the term takes that form, it would reduce the force of the FCA's criticism that a term allowing the firm to make changes for unspecified reasons "would allow the firm to make changes for reasons that do not strike a fair balance between the legitimate interests of the firm and the consumer".[8]
- Second, the FCA itself makes two important qualifications to its view that reason (e) is unlikely to be valid, namely:
  - that, in longer term contracts of fixed duration, a term entitling the firm to vary for any reason may be justified if, at the time of contracting, the firm reasonably considers that it cannot foresee all the circumstances that could justify a variation; and
  - that, in contracts of indeterminate duration, a power to vary for any reason may be acceptable if it enables the firm to do no more than it could lawfully achieve by giving the consumer notice to terminate the contract and offering to enter into a new contract.
- The FCA is careful to state that, before seeking to rely on either qualification, the firm would need to consider all the circumstances, including the terms regarding notice, freedom to exit, practical barriers to termination and the information provided to the consumer about the variation term. Even so, it is doubtful whether the FCA's qualifications are compatible with the CJEU's requirement of transparency, with its emphasis on the need for the consumer to be able to foresee the changes that may be made on the basis of clear, intelligible criteria. Thus, while the FCA's qualifications may provide a degree of comfort to firms with existing contracts containing variation terms which permit changes for unspecified reasons, considerable caution would be needed before drafting a term in this form for inclusion in a new contract. ■

1 *Fairness of terms in consumer contracts, Statement of Good Practice*, May 2005; *Unfair contract terms: improving standards in consumer contracts*, January 2012.
2 *Unfair contract terms guidance*, CMA37, 31 July 2015.
3 *RWE Vertrieb AG v Verbraucherzentrale Nordrhein-Westfalen e.V* Case C-92/11. For other cases in the series, see in particular *Nemzeti Fogyasztóvédelmi Hatóság v Invitel Távközlési Zrt* Case C-472/10 at [24]-[31] and *Matei v SC Volksbank România SA* Case C-143/13 at [74].
4 See *RWE Vertrieb* at [54].
5 The FCA is, however, careful to preface the list with a warning that it is not a substitute for the application of the general law on unfair terms.
6 See *Van Hove v CNP Assurance SA* (C-96/14) at [47].
7 The same applies to reason (b) in those cases in which changes to the contract are prompted by changes in legislation etc which cause the firm to incur increased costs.
8 Moreover, para 22 of Sch 2 to the CRA suggests that a term in a financial services contract which enables the firm to change interest rates or charges for unspecified *valid* reasons will not be indicatively unfair under para 11 provided that the contract requires the firm to inform the consumer of changes at the earliest opportunity and that the consumer is free to dissolve the contract immediately. Para 22 is, however, difficult to reconcile with the CJEU's requirement of transparency, so it is currently unclear how much reliance may be placed on it: compare note 41 to the FCA guidance.

Further Reading:

- The requirement of transparency under the Directive on unfair terms in consumer contracts: some problems (2017) 11 JIBFL 697.
- Implementing the Unfair Terms Directive in accessible language: an impossible challenge? (2012) 10 JIBFL 605.
- LexisPSL: Financial Services Practice note: Consumer Rights Act 2015 – application to unfair terms in consumer contracts.