



Financial Services Authority

# Fairness of terms in consumer contracts

Statement of Good Practice

May 2005

# Contents

1	Introduction	3
	(a) Scope	3
	(b) Status	5
2	The Regulations	7
3	Commentary on the Regulations	9
	(a) Reducing the risk of unfairness	9
	(i) ‘ <i>Valid reason</i> ’	10
	(ii) ‘ <i>Notice</i> ’	11
	(iii) ‘ <i>Free to dissolve the contract</i> ’	12
	(iv) ‘ <i>All the circumstances attending the conclusion of the contract</i> ’	12
	(v) ‘ <i>All the other terms of the contract</i> ’	13
4	Good practice applied to specific types of contract	14
	(a) Variation of interest rates	14
	(i) The Regulations	14
	(ii) Notification	15
	(iii) Withdrawal	16
	(b) Variation of long term insurance premiums	17
	(i) Valid reasons	17
	(ii) Notification	18
	(iii) Withdrawal	19

# 1 Introduction

- 1.1 This Statement<sup>1</sup> sets out the FSA's views on how firms may approach drafting fair variation clauses in their standard form consumer contracts. The need for firms to act fairly is central to an efficient retail financial services market and to the strengthening of consumers' confidence in it.
- 1.2 A variation clause gives a firm power to impose a level of change which the consumer has not explicitly agreed to in advance and which does not require the consumer's agreement at the time any change is made. As such, it directly affects the balance of power between the firm and the consumer with the risk that it weighs too far in favour of the firm.

## **(a) Scope**

- 1.3 This Statement is addressed only to firms authorised and regulated by the FSA in relation to products and services that are within the FSA's regulatory scope as set out in the Regulated Activities Order<sup>2</sup>. It will also be of interest to firms' professional advisers. It is particularly relevant for banks, building societies, residential mortgage lenders, insurers and friendly societies. It is also relevant to intermediaries.
- 1.4 This Statement takes into account the particular nature of financial services markets, the products firms sell and their consumers. It also takes into account the protection provided by the financial services regulatory system and industry self regulation<sup>3</sup>.

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1 This Statement is available on the FSA's website as a stand-alone document and can be found at [http://www.fsa.gov.uk/pubs/other/good\\_practice.pdf](http://www.fsa.gov.uk/pubs/other/good_practice.pdf). In addition to this we will (by mid-July) incorporate it into our web pages dealing with the Regulations so that firms will be able to see how this Statement and our work under the Regulations fit together.

2 Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001/544 (as amended)

3 For example, through the Banking Code (March 2005) and the ABI Advice on Non-investment Protection Policies with Reviewable Premiums and Practical Aspects of Unfair Contract Terms, published by the Association of British Insurers on 19 May 2005 as a consultation document.

- 1.5 The Unfair Terms in Consumer Contracts Regulations (the Regulations)<sup>4</sup> apply to standard form contract terms which have not been individually negotiated with consumers. ‘Consumer’ is defined in the Regulations as ‘*any natural person who, in contracts covered by these Regulations, is acting for purposes which are outside his trade, business or profession*’. The Regulations apply to contracts entered into since 1 July 1995 and make unfair terms unenforceable against the consumer. The Regulations implement the Council Directive<sup>5</sup> on unfair terms in consumer contracts which is a consumer protection measure.
- 1.6 Firms’ also have an obligation to act fairly under the Financial Services and Markets Act 2000 (FSMA) and through our own Principles for Businesses<sup>6</sup> (the Principles) which underpin the work that we are doing with firms as part of our *Treating Customers Fairly* initiative.
- 1.7 Principle 6 requires a firm to ‘*pay due regard to the interests of its customers and treat them fairly*’ and Principle 7 requires a firm to ‘*pay due regard to the information needs of its customers and communicate information to them in a way which is clear, fair and not misleading*’. Taken together, Principles 6 and 7 reflect the forerunner SIB Principle<sup>7</sup> that a firm ‘*should observe high standards of integrity and fair dealing*’.
- 1.8 There is an overlap between the Regulations and the Principles. The Principles, however, apply to the way that contract terms are used in practice, not just the way they are drafted, so a firm must not use an unfair term (or fair term) unfairly in practice. The Principles also apply to a ‘core term’ which is not subject to review under the Regulations.
- 1.9 A core term of a contract is not generally reviewable for fairness under the Regulations, provided it is written in ‘*plain, intelligible language*’ (Regulation 7). Core terms are generally those which define the main subject matter of the contract (such as the goods or services to be supplied) or which relate to the adequacy of the price or remuneration as against the goods or services supplied. Ultimately whether a term is a core term is a matter for the Courts. However, in our view, neither an interest rate variation clause nor a premium review clause is a core term within the meaning of the Regulations because each relates to varying the price rather than to setting the initial price. While the price of a product or service is not something that the FSA would

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4 The Unfair Terms in Consumer Contracts Regulations SI 1999/2083 which revoked and replaced the Unfair Terms in Consumers Contract Regulations SI/1994/3159 which came into force on 1 July 1995. The 1994 Regulations were drawn to insurance and investment firms’ attention by the Personal Investment Authority in Regulatory Update 11, issued on 11 June 1994. The 1999 Regulations were amended by the Unfair Terms in Consumer Contracts (Amendment) Regulations SI 2001/1186 which added the FSA to the list of Qualifying Bodies.

5 Council Directive 93/13/EEC.

6 The Principles were effective from 1 December 2001 when FSMA came into force.

7 Made by the Securities and Investments Board and applying to members of the Personal Investment Authority with effect from 30 April 1990.

normally address<sup>8</sup>, as we are not an economic regulator, we will consider whether firms have met their wider obligations to treat consumers fairly with regard to the way in which price variation clauses are operated.

- 1.10 If we think a term is fair under the Regulations, then we will not challenge it under the Regulations. However, firms may consider issues arising under the Regulations along with their wider obligations to treat customers fairly. We expect firms not to rely on narrow and technical interpretations of the Regulations to seek to justify a contract term that may be, in the wider context, unfair and in which context it may be open to challenge.
- 1.11 Subscribers to the Banking Code will wish to consider this Statement alongside relevant provisions in the Code. The Code commits its subscribers to act '*fairly and reasonably*' in all dealings with consumers by meeting all the commitments and standards it sets down. Fairness is described by the Code guidance to include consideration of all relevant legislation, including the Regulations. Sponsors of the Code have agreed to review its provisions in light of the views expressed and the good practice indicated in this Statement. Where appropriate and in accordance with the established process for Code revision, amendments will be made to the Personal Banking Code.

## **(b) Status**

- 1.12 This Statement is not Handbook text and does not constitute general guidance on rules under FSMA. We do not, at this stage, propose any consequential changes to the Handbook. It reflects statutory obligations that have existed under the Regulations since 1995<sup>9</sup> and existing regulatory obligations rather than adding to them. It is not, of itself, enforceable against firms but we would expect to have regard to it in exercising our powers under the Regulations<sup>10</sup>.
- 1.13 If a firm has been observing any previous regulatory guidelines about the Regulations, then we would have regard to any representations made to us, when we consider exercising our powers under the Regulations, that the firm's contract terms were fair in the light of those guidelines.

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8 However, where applicable, we would remind firms of MCOB 12 which prevents a firm from levying excessive charges (which includes interest).

9 Where a contract, which was entered into before the Regulations came into force, is still in force and contains terms that would be unfair if the Regulations applied to them, firms must operate the contract fairly and may, in doing so, have regard to how they treat consumers with fair terms in post 1995 contracts.

10 As a Qualifying Body (enforcement authority) under the Regulations, the FSA may, for example, consider a complaint that a particular variation clause is unfair and take action, such as seeking an injunction against the firm. The Regulations provide that the FSA's functions shall be treated as functions under the FSMA. The FSA Handbook Enforcement manual (Chapter 20) sets out our approach to the use of our powers under the Regulations, including dealing with firms and taking enforcement action.

1.14 In publishing a Statement in this form, we are giving ourselves flexibility to keep the text up to date in light of experience and relevant case law. Detailed rules are not necessarily the answer to raising standards because they tend to set a single standard<sup>11</sup> and may not give firms the flexibility they need to deliver fairness to their consumers. This Statement gives firms an indication, rather than an instruction, as to how they may avoid the risk of terms which are unfair. This Statement sits alongside the industry's own good practice in interpreting and applying the Regulations in a way which is consistent with the Principles (and Handbook rules) and *Treating Customers Fairly*.

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11 As we said in *Treating Customers Fairly – Progress and Next Steps Report*, July 2004.

# 2 The Regulations

- 2.1 The overarching test of fairness is in Regulation 5 and provides that a term will be unfair 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’*<sup>12</sup>.
- 2.2 Regulation 6 provides that the fairness of a contract term *‘shall be assessed, taking into account the nature of the goods or services for which the contract was concluded and by referring, at the time of conclusion of the contract, to all the circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent’*.
- 2.3 Regulation 7 states that a firm *‘shall ensure that any written term of a contract is expressed in plain, intelligible language’* and *‘if there is doubt about the meaning of a written term, the interpretation which is most favourable to the consumer shall prevail..’*
- 2.4 Schedule 2 to the Regulations sets out an *‘indicative and non-exhaustive list of terms which may be regarded as unfair’*. An example in Schedule 2<sup>13</sup> of a term that may be unfair is one which enables the firm unilaterally to change the terms of the contract. Terms of this kind give firms significant power to alter their agreement with consumers by changing an element of the contract such as price, interest rate or insurance premium. In this Statement, we refer to such elements as ‘contract variables’.

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12 The House of Lords considered the meaning of this test in *Director-General of Fair Trading v First National Bank* [2001] All ER (D) 355. Lord Bingham said that the requirement of significant imbalance is met if a term is so weighted in favour of the supplier as to tilt the parties’ rights and obligations under the contract significantly in its favour. He also said that the requirement of good faith is one of fair and open dealing. Openness requires that the term should be expressed fully, clearly and legibly, containing no pitfalls or traps. Fair dealing requires that a supplier should not, whether deliberately or unconsciously, take advantage of the consumer’s necessity, indigence, lack of experience, unfamiliarity with the subject matter of the contract, weak bargaining position or similar factors. In the same judgment, Lord Steyn said that *‘any purely procedural or predominantly procedural interpretation of the requirement of good faith must be rejected’*.

13 Paragraph 1(j) of Schedule 2. There are other terms listed that firms may wish to have regard to in drafting terms that allow unilateral changes under a contract, for example, paragraphs (k) and (l).

- 2.5 Schedule 2 suggests that terms which enable a firm unilaterally to change contract variables are less likely to be unfair if:
- (i) the term enables the firm to change a contract variable only with a **valid reason which is specified in the contract**<sup>14</sup>; or
  - (ii) the term permits a change in the rate of interest or other charges for financial services under the contract and there is a **valid reason (which is not specified in the contract)** for that change and the contract provides for the firm to give the consumer **notice at the earliest opportunity** thereafter (rather than in advance) and the consumer is **free to dissolve the contract** immediately<sup>15</sup>; or
  - (iii) if, in a contract of indeterminate duration, the contract provides for the firm to give the consumer **reasonable notice in advance** of making the change and the consumer is **free to dissolve the contract**<sup>16</sup>.

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14 Paragraph 1(j) of Schedule 2

15 First sub-paragraph of 2(b) of Schedule 2

16 Second sub-paragraph of 2(b) of Schedule 2

# 3 Commentary on the Regulations

- 3.1 The Regulations apply generally across diverse business areas. They are written in general terms and, to a large extent, do not indicate how they are to be interpreted in any specific context. The terms listed in Schedule 2, are only *'indicative'* of what *'may be regarded as unfair'*. The Regulations do not define or explain what is meant by all the words and phrases used.
- 3.2 The interpretation of legislation is ultimately a matter for the Courts. However, given that the Regulations are generally worded and in the absence of specific case law addressing the issues, this commentary is intended to help firms interpret and apply the Regulations. It focuses on how firms might use the terms listed in Schedule 2 to assist them in reducing the risk that a particular variation term is unfair and how phrases such as *'valid reason'*, a consumer being *'free to dissolve the contract'* or *'all the circumstances attending the conclusion of the contract'* might be interpreted.

## **(a) Reducing the risk of unfairness**

- 3.3 In writing this commentary, we are conveying four key messages:
- Firms should take into account consumers' legitimate interests in relation to contracts over which they have had no influence but to which they will nonetheless be bound.
  - Fairness is not contrary to the prudent management of the business but part of it.
  - Dwelling on narrow technical arguments to justify a contract term that, in fact, may be unfair, risks future challenge.

- The fact that a variation clause does not offend any of the terms listed in Schedule 2 to the Regulations may not, of itself, remove the risk of unfairness. Firms need to assess whether a term is fair using the Regulations as a whole and in the context of the particular product or service.
- 3.4 The test of fairness includes the need for firms to take into account consumers' legitimate interests in the context of the inequality of bargaining power between a firm and its consumers. This is important, for example, to a firm in deciding on the extent of any discretion that it will reserve to itself at the time of drafting a standard form contract. If a firm retains extensive and/or open-ended discretion as to if, when and how it changes a contract variable, this may indicate a failure to take into account consumers' legitimate interests and so make the term(s) unfair.
- 3.5 We think that a term which provides that the firm may unilaterally change the wording of any other term in the contract which is found to be unfair, in order to remedy that unfairness, is not inherently unfair. However, in our view, any term of this kind which confers an unnecessarily broad discretion on the firm or could be used to the advantage of the firm, rather than the consumer, is likely to be unfair.

**(i) 'Valid reason'**

- 3.6 Schedule 2 indicates that a variation clause is less likely to be regarded as unfair if it can only be made with a valid reason specified in the contract. However, fairness should be assessed in light of the Regulations as a whole and, for example, just specifying a valid reason in the contract may not go far enough to satisfying the test of fairness. It may also be necessary, for example, to provide for notice to consumers that the change has been, or will be, made. Particular attention to the requirements of fairness is necessary where other factors, such as the consumer being locked-in to a contract (see paragraphs 4.12-4.15 below), may be to the advantage of the firm rather than the consumer.
- 3.7 Ultimately, only a Court may decide what constitutes a 'valid reason'. However, a general indication of what we might consider to be a valid reason is one which allows a firm to change contract variables to respond proportionately to changes in general law or to the decisions of the Financial Ombudsman Service, to meet regulatory requirements or to reflect new industry guidance and codes of practice which are there to raise standards of consumer protection. Likewise, a valid reason may be one which allows a firm to respond proportionately to changes in the Bank of England base rate, other specified market rates or indices or tax rates or to reflect other legitimate cost increases or reductions associated with providing the particular product or service.

- 3.8 If a contract contains a clause which provides that the firm may change a contract variable, for example: ‘for any reason we see fit’, ‘for any reason that we consider reasonable at the time of the change’ or ‘to cover unexpected costs’, in our view that firm is not specifying a valid reason in the contract but is, instead, leaving its options open. We would expect a ‘valid reason’ to be, amongst other things, clearly and unambiguously defined.
- 3.9 The greater the number of valid reasons given in the contract then, potentially, the less plain and intelligible the variation clause may be.
- 3.10 We take the view that the Regulations are intended to operate in a free-market economy and do not constrain a firm from managing its business prudently. Therefore we would not intend to enforce the Regulations in a way which impedes the legitimate commercial judgements that firms make having regard to the overall well-being of their business and of all their consumers. However, the Regulations are designed to give effect to a Directive whose purpose is to protect consumers on the assumption that there tends to be an inequality of bargaining power between firms and their consumers. Prudence and fairness are not mutually exclusive factors. Firms will have to make careful judgements when writing their consumer contracts to achieve the right balance.

**(ii) ‘Notice’**

- 3.11 The power to change a contract variable, especially price, is a sensitive one for consumers. This is not just because of any immediate financial impact but also because the change may lead to the consumer having to take substantive and difficult financial planning decisions for which there may have been little time to prepare. This underlines the value of firms giving their consumers notice of changes to contract variables.
- 3.12 Schedule 2 refers either to ‘*reasonable*’ notice being given in advance of a change to a contract variable or to notice being given ‘*at the earliest opportunity*’ after a change. What is sufficient to meet these requirements in practice will differ according to the particular product or service and the particular circumstances<sup>17</sup>. Firms may consider providing for notice when changes are made but also when consumers would expect a beneficial change but when one is not made. Firms may also consider whether their contractual notice periods give consumers sufficient time to review the impact of the change and determine whether they wish to respond to it.

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<sup>17</sup> With regard to any designated investment business, we would remind firms of COB 4.2.13R which requires a firm that has amended its contract without the consumer’s consent, to give at least 10 business days’ notice to the consumer before conducting any designated investment business with that consumer on any amended terms, unless it is impracticable in the circumstances to do so. There are also notice requirements in MCOB 7.

### **(iii) 'Free to dissolve the contract'**

- 3.13 Ultimately the meaning of being '*free to dissolve the contract*' is a matter for the Courts to decide. Our view is that, in the context of contracts for financial services, being '*free to dissolve the contract*' means that the consumer is able to withdraw from the contract without inhibition such as, for example, a requirement to make a payment or to give prior notice<sup>18</sup>. In our view, that is why the Regulations use the term 'free' rather than 'able' to dissolve the contract.
- 3.14 In the case of contracts intended to provide a benefit over a long period the ability of a consumer to dissolve the contract may not, in all instances, be the sole consideration when it comes to the wider fair treatment of consumers. Withdrawing from the contract may be particularly disadvantageous for some consumers. Firms should consider this in drafting contract terms. For example, in the case of some long term insurance contracts, the consumer may be technically free to dissolve but, in practice, may find it difficult to obtain alternative cover because of the need for fresh underwriting.
- 3.15 If a firm is aware that a contract variable, such as price or insurance premium, is likely to increase to such a level that it may become uneconomic or unaffordable for any particular class of consumers then it may be unfair to include a variation clause. Similarly, it may be unfair for a firm to include a variation clause if it intends, without fully informing the consumer, to adopt a low price strategy at the outset only to recover the cost of this low price strategy later.

### **(iv) 'All the circumstances attending the conclusion of the contract'**

- 3.16 In the case of financial services contracts, which can be complex, one of the '*circumstances attending the conclusion of the contract*' may be the consumer's relative lack of understanding of the financial system, how products work and the terminology used in relation to them. The Regulations require all terms to be written in '*plain, intelligible*' language and this gives consumers a better opportunity to understand the contract that they are entering into. However, a term that is plain and intelligible is not automatically a fair term and firms should comply with the Regulations as a whole.
- 3.17 If the contract is supported by product literature which is clear, fair and not misleading<sup>19</sup> then this may further help the consumer to understand how the product works. It also means that intermediaries will be better equipped to inform and advise their clients.

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18 COB 6.12, about treating with profits policyholders fairly, relating to the application of market value reductions and the calculation of surrender values will have effect from 30 June and 31 December 2005 respectively.

19 COB 2.1.3R, COB 3.8.4, ICOB 2.2.3R and MCOB 2.2.6R.

- 3.18 Changing a contract variable may benefit the firm or its consumers. If a firm were to draft its contracts so that a variation clause could only ever be used to its advantage and never to the advantage of its consumers, this is likely to be unfair. A term that only allows a change which is proportionate to the underlying reason for the change is more likely to be fair.
- 3.19 Another ‘*circumstance attending the conclusion of the contract*’ may be where a firm has a contract with a third party (for example, a re-insurer). The terms of that contract may, to some extent, drive the terms of the firm’s consumer contracts. This does not lessen the requirement for the firm’s consumer contracts to be fair under the Regulations. For example, a reference in the consumer’s contract to changes in reinsurance rates as a reason for an increase in price is only a valid reason if the corresponding terms in the reinsurance contract would be ‘valid reasons’ if they were written in the consumer contract and therefore assessed in light of the Regulations.

**(v) ‘All the other terms of the contract’**

- 3.20 In assessing whether a variation term is fair, the Regulations require consideration of ‘*all the other terms of the contract*’. Terms in a contract for financial services which deserve particular consideration may, for example, be those requiring notice of the variation and any terms about if, when and how the consumer may dissolve the contract (such as a requirement for the consumer to pay a charge or give a specified period of notice before the contract is dissolved).
- 3.21 Where a term in a standard form consumer contract is unfair, the Regulations make it unenforceable against the consumer. If a firm attempts to rely on an unfair term it is at risk of challenge. Firms will wish to take into account the legal, reputational and operational risks of a Court finding a term to be unfair and then striking it out of the contract. In some cases, this could have prudential implications for the firm because a Court may not necessarily void the entire contract (so that the effect on the firm could be, for example, that the reviewable premium payable on a long term insurance contract becomes fixed).
- 3.22 In deciding whether to take enforcement action, for example whether to seek an injunction against a firm, the FSA will consider not only the contract term itself but also any undertakings from the firm about the way in which the contract is operated in practice. We will consider whether existing consumers are treated as fairly as new consumers whose contracts contain terms which are fair. It is possible that a Court may also take a pragmatic approach, rather than simply striking out the unfair term, but this would be a matter for the Court.

# 4 Good practice applied to specific types of contract

- 4.1 The following paragraphs set out what we consider to be good practice in the case of two specific types of contract – those with an interest rate variation clause or a premium review clause. They should be read in the context of the preceding part of this Statement.
- 4.2 The examples given in the following paragraphs are generic and serve only to illustrate a particular aspect of fairness. They are not product specific and are not intended to cover all types or variations of products.

## **(a) Variation of interest rates**

- 4.3 Interest rate clauses operate in a variety of ways. For example, they may provide for a fixed interest rate, a variable interest rate, a tracker rate (which varies in line with an external benchmark, such as the Bank of England base rate) or a rate which is fixed for a defined period at the end of which it will change to a variable rate.
- 4.4 In our view, the power to vary interest rates during the lifetime of a contract is not inherently unfair. Indeed, a variable rate may be the most attractive for many consumers. It may also give firms the flexibility they need to manage their business prudently and remain competitive. However, the contract terms should not be drafted in a way which allows the firm, in varying these rates, to take unfair advantage of the consumer. It is likely to contribute to the fairness of a term if it sets out if, when and how the interest rate may change.

## **(i) The Regulations**

- 4.5 Ultimately, whether a term is a core term is a matter for the Courts. In our view, an interest rate variation clause is not a core term within the meaning of the Regulations because it relates to varying the price, rather than setting the initial price. So, for example, where a contract provides for an interest rate to be fixed for a certain period, at the end of which it changes to a variable rate

or where a savings account provides for different fixed interest rates to apply depending on the amount maintained in the account and includes a power to alter the thresholds, then the drafting of the variation clause is, in our view, subject to the test of fairness. However, a term which provides for a fixed interest rate and no more would generally not be within the scope of the Regulations because the price has been set for the duration of the contract.

## **(ii) Notification**

- 4.6 Setting interest rates is a commercial, not a regulatory, decision. When firms design product literature they must ensure that any information about what the interest rate is and if, when and how it may change and how notification of any such change will be given is clear, fair and not misleading.
- 4.7 In the case of variable interest rate accounts, one of the factors in deciding whether rates are changed may be the Bank of England base rate or some other external index. With tracker accounts there is a strict correlation between the two but in other cases the link may be more implicit and a separate decision about if, when and how to pass interest rate changes on to consumers must be made by the firm. Variation clauses must be drafted in a way which is fair having regard to, amongst other things, the power to change rates and the power to decline to change rates, or to delay a change.
- 4.8 Interest rate variation terms should be plain and intelligible about whether they track an external rate or not. In addition, firms must ensure that product literature is clear, fair and not misleading, including as to whether the interest rate will track an external rate.
- 4.9 A tracker account contains a variation clause which provides for interest to be paid at a rate which follows, by a defined amount and within a defined period, Bank of England base rate or some other external index. In our view, such a variation clause is likely to be fair provided it has been drafted in '*plain, intelligible*' language. Any product literature which describes the clause should do so in a way which is clear, fair and not misleading. So long as the clause governing the rate for a tracker account provides only for changes by the defined amount<sup>20</sup>, it is likely to be fair. However, if a term of the contract for a tracker account allows the firm to change the relationship between the external rate and the rate applicable to the consumer, then that term will need closer consideration as to whether it is fair.
- 4.10 Terms which govern notifying consumers of interest rate changes should be fair. These terms also affect the fairness of interest rate variation terms. Whether a term is fair takes into account the respective costs and benefits of different forms of notification including, for example, personal notification. In our view,

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20 However, where applicable, we would remind firms of MCOB 12 which prevents a firm from levying excessive charges (which includes interest).

personal notification is likely to contribute to fairness. Personal notification is likely to be less important in relation to a term which only allows changes to the interest rate which reflect changes in an external benchmark. There may be circumstances in which a term may fairly provide exceptions to the general position on notifying consumers personally. A different form of notification, for example in media and branch notices, may be appropriate, for example, for accounts which contain only a small amount of money. Subscribers will wish to refer to provisions of the Banking Code.

- 4.11 In deciding on how to notify consumers in practice, firms should consider all terms in the contract as well as any expectations that they may have created in product literature or other communications. It may be that, having considered the costs and benefits of giving personal notification, firms wish to specify a threshold (for example, by reference to the size of the change) below which they would not normally expect to give personal notification. Subscribers will wish to refer to provisions of the Banking Code.

### **(iii) Withdrawal**

- 4.12 A contract ‘locks-in’ a consumer where, in order to withdraw from the contract, the consumer is required to give advance notice and/or pay a cost and/or give up a benefit (such as accrued interest). Firms should take particular care to ensure that interest rate variation terms that apply to locked-in consumers are fair. It is likely to contribute to the fairness of an interest rate variation term in a contract for a locked-in consumer if there is some connection between interest rate changes that apply to locked-in consumers and those which apply to non locked-in consumers.
- 4.13 The constraints of a lock-in clause may weigh the balance of rights and obligations between a firm and its consumers in favour of the firm. Therefore, where a firm wishes to have flexibility to change a contract variable, such as the interest rate, it may consider drafting the contract to permit the change to be made only where any lock-in clause is not exercised. A term that provides that the consumer will be given advance notice of the change is more likely to be fair and it may not be necessary for the contract to specify one or more valid reasons for the change. However, in each case, fairness should be assessed in light of the Regulations as a whole.
- 4.14 A firm may wish to be able to change a contract variable and exercise the lock-in. In these circumstances, we are more likely to regard the variation term as fair where the change is made with a valid reason specified in the contract. However, as with all terms to which the Regulations apply, fairness should be assessed in light of the Regulations as a whole.
- 4.15 In all cases, there is a balance to be struck between the rights and obligations of the firm and the consumer under the contract. In exchange for the

constraints of a lock-in clause, the consumer often benefits from other more attractive terms. Equally, there are financial and competition benefits to the firm from the certainty that contracts with lock-in terms give them. Firms must balance their interests with consumers' interests in drafting contract terms to ensure they are fair under the Regulations. Subscribers will wish to refer to provisions of the Banking Code.

## **(b) Variation of long term insurance premiums**

- 4.16 Where an insurance contract is intended to provide a benefit over a long period and is not subject to renewal (at which point fresh cover may be put in place as well as a new premium being set), a premium review clause gives a right to the firm to review and, if it believes it necessary, to change the price of the contract. The fairness of such clauses is considered here with particular reference to life and long term health insurance contracts such as critical illness, whole of life, permanent health insurance (otherwise known as income protection) and long term care.
- 4.17 Premiums may be calculated, in part, on assumptions relating to various contingencies. Where a premium is guaranteed, the risk that assumptions may change is retained by the firm but premiums are often higher to allow for the risk that those assumptions may change during the life of the contract, even though they may not. A reviewable premium generally provides for the risk of assumptions changing to be shared between the firm and the consumer. We recognise that without this sharing of risk, some products may not be commercially viable and consumers could be faced with less choice and less protection. However, care needs to be taken to ensure that premium review clauses are not significantly one-sided or that they may operate only to the benefit of the firm.
- 4.18 It may be unfair for a review clause to give the firm the opportunity, but not the obligation, to review premiums because this would allow the firm to only review premiums where the outcome would be to the firm's advantage. Where a contract contains a obligation for a firm to carry out a review then the firm must ensure that the review is carried out.

### **(i) Valid reasons**

- 4.19 A valid reason may be one that allows firms to review premiums in the light of changes in assumptions about the future, for example, assumptions relating to the expected future number and timing of claims. However, a valid reason is, for example and in our view, unlikely to be one which, in a pure protection contract, allows the firm to recoup its investment losses on the contract incurred up to the date of the review or one which gives it the discretion to increase profitability margins beyond those assumed at the outset of the

contract. Similarly, a valid reason is unlikely, in our view, to be one which allows the firm unfairly to target a particular group of policyholders for an increase in premium or one which seeks to cover losses/higher costs incurred elsewhere in the firm's business.

- 4.20 If a firm does not base its original pricing decisions on a carefully considered estimate of cost variables such as the cost of providing the benefits under the contract and expected investment returns over the long term, then, in our view, it may be unfair for the firm to include a premium review clause.
- 4.21 Similarly, if a contract has a low initial price consciously based on overly optimistic assumptions about investment performance it is, in our view, likely to be unfair for the firm to include a premium review clause.
- 4.22 In the case of contracts with an investment element, it is important for consumers to understand what they are paying for<sup>21</sup>. The premium should be described in a way that is clear, fair and not misleading. It will be made up of various amounts, for example an amount in respect of the protection afforded by the product (the risk charge) and management and/or investment fund charges. A fair term is unlikely to be one which, for example, allows management and/or fund charges to be increased in order to disguise the fact that the cost of protection has increased but this cost has not actually been reflected in the risk charge.

## **(ii) Notification**

- 4.23 Notification terms must be fair. They can also affect the fairness of premium review clauses. Notification terms include terms which deal with: how consumers will be notified of an impending premium review; the time by which consumers can expect to be advised of the outcome of the review; and whether they will be told what their options are at that time<sup>22</sup>.
- 4.24 It may be unfair for firms to alter premiums using a power that is only triggered when an assumption changes, if their records do not indicate what the initial assumptions were. Generally<sup>23</sup>, if assumptions remain the same then it should not be necessary for a firm to change the risk based elements of the premium pursuant to a review clause.

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21 We would remind firms of ICOB 4.2.15R and 5.5.14R about disclosure requirements for fees, premiums and other costs and ICOB 4.5 on excessive charges.

22 See also ICOB 5.3.24R which relates to mid term changes and applies to changes in premiums (unless the change conforms to a previously disclosed formula).

23 Unless a definite future change in premium was part of the design of the product and was made known to and accepted by consumers taking up the product.

### **(iii) Withdrawal**

- 4.25 Where the consumer is not free to dissolve the contract, firms will wish to consider the impact this may have on the overall fairness of the contract. In addition, any terms concerning surrender must themselves be fair. Fairness suggests that where the product has a surrender value, the consumer should be able to withdraw from the contract without disproportionate cost and to claim the surrender value. However, withdrawal is, in many cases, just one of the options to be considered. In some cases the consumer may be technically free to dissolve but, in practice, may not be able to obtain alternative cover because of the need for fresh underwriting.

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