



Financial Services Authority

Fairness of terms in consumer contracts

Statement of good practice on mortgage exit administration fees (MEAFs)

January 2007

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1 Introduction

(a) Purpose of this Statement

- 1.1 The main purpose of this Statement is to address the issue of recent increases to MEAFs. In it we indicate to lenders how we believe they should draft mortgage exit administration fees (MEAF or MEAFs) and MEAF variation terms and how to apply them fairly in practice. Section 4 – 'The Way Forward' sets out how we believe lenders will react to this Statement on MEAFs, and what our likely response to those reactions will be.

(b) Background

- 1.2 In our recent work on increases to MEAFs we asked some mortgage lenders who we considered to be representative of the industry to help us look at whether MEAF terms in this area might be unfair. And we asked them to give us evidence of how they decided to increase their MEAFs. We said that once we had reviewed those comments and the evidence provided, we would issue a follow-up Statement. This Statement follows on from our May 2005 Statement of Good Practice on the fairness of terms in consumer contracts ('the May 2005 Statement') and is based on the Unfair Terms in Consumer Contracts Regulations 1999 (the Regulations). The Council of Mortgage Lenders (CML) has helped us prepare this Statement and endorses Section 4 – 'The Way Forward' to its members.
- 1.3 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. We do not set prices for financial products, and firms can vary the amount they charge for services such as mortgage administration. However, the Regulations require MEAF terms and variation terms which enable lenders to vary MEAFs to be fair. If they are not fair they cannot be enforced against the consumer.
- 1.4 If a term in a standard form consumer contract is fair under the Regulations, then it is clear that a firm must act in accordance with the term as otherwise it will be in breach of contract. If a firm acts in breach of contract, this may also

involve a breach of Principle 6 of our Principles for Businesses, which underpins the work we are doing with firms as part of our *Treating Customers Fairly* (TCF) initiative. We think a firm is also likely to be in breach of Principle 6 if it relies on an unfair term in practice when it ought to know it was unfair.

- 1.5 The Mortgage Conduct of Business rules and the Principles for Businesses apply to regulated mortgage contracts entered into since 31 October 2004. Since then the Mortgage Conduct of Business rules have required lenders to disclose the original MEAF in the pre-sale Key Facts Illustration¹. While that rule may help improve transparency and fairness of MEAF terms, and we considered it (and Principle 6) when we drafted this Statement, this Statement deals with what we believe is required under the Regulations.

(c) Scope and status of this Statement

- 1.6 As with the May 2005 Statement, this Statement is addressed only to lenders we regulate for products and services that are within our regulatory scope, as set out in the Regulated Activities Order². However, as it represents our view of the standards required by the Regulations, the scope of the Statement is not limited to contracts entered into since we began regulating mortgage lenders. This is because the Regulations apply to contracts entered into since 1 July 1995, and we are a qualifying body with statutory responsibility for enforcing the Regulations in relation to financial services contracts.
- 1.7 This Statement has the same scope and status as the May 2005 Statement, so it is not Handbook text and does not constitute general guidance on rules under the Financial Services and Markets Act 2000 (FSMA). It is, however, disseminated with the agreement of the Office of Fair Trading under Regulation 15(3)³. In our view, this Statement does not place any new obligations on lenders. Lenders may find it helpful to refer to the Statement when drawing up new terms and conditions or applying existing ones.

(d) Definitions

- 1.8 For the purpose of this Statement, a 'MEAF term' is a provision in a contract between a lender and a customer that obliges the customer to pay a sum for the costs of administration services which a lender incurs when a customer exits a mortgage contract. The amount of this payment may not have been specified in a contract or associated documentation entered into before the Mortgage Conduct of Business Rules came into force. A 'MEAF' is a fee levied under a MEAF term.

1 See MCOB 5.6.66R and 5.6.67G.

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

3 Regulation 15 (3) provides that: 'The Director may arrange for the dissemination in such form and manner as he considers appropriate of such information and advice concerning the operation of these Regulations as may appear to him to be expedient to give to the public and to all persons likely to be affected by these Regulations.'

- 1.9 A 'MEAF variation term' is a provision in a contract between a lender and a customer that allows the lender to vary the MEAF term during the relationship between a lender and a customer. This will usually result in an increase in the MEAF. The customer will be informed of a variation to the MEAF typically through an update to the Tariff of Charges.
- 1.10 The 'original MEAF' will be the amount the customer was told when they entered into the contract, or the latest point at which the contract was lawfully and bilaterally varied by the lender and the customer (for example a further advance, or a product change). If no MEAF amount was given at either of those points, the original MEAF will be the amount that the lender would have charged an existing customer who was exiting their mortgage at whichever of the two points in time is relevant.

(e) Application of the Regulations

- 1.11 Our May 2005 Statement outlines the application of the Regulations, and provides some commentary on their application that we will not repeat here. However, some sections are of particular relevance⁴ for MEAFs. These are the passages on contract variables, valid reasons (and that only a court may decide what constitutes a 'valid reason'), notice, freedom to dissolve the contract, clarity of product literature, and that an unfair term is unenforceable against the consumer. We relied on those passages when we came to some of the basic principles we refer to below. Also of particular relevance is the fact that, under the Regulations, all written terms must be expressed in plain, intelligible language. If there is doubt about the meaning of a written term, the interpretation that favours the consumer should be used⁵.

(f) Basis for our assessment

- 1.12 In deciding whether a lender has met the standards we expect in this area, we will consider not only the MEAF term and MEAF variation term, but also whether the terms have been applied fairly in practice (see paragraphs 1.4 and 1.5 above).
- 1.13 However, it is important to note that consumers still have a right to challenge what they believe to be an unfair contract term either by a private action in the courts or through the Financial Ombudsman Service (FOS). Also, only a court can ultimately decide whether a term is unfair – and we have no power to determine what a court should decide. We hope this Statement will guide lenders by setting out our views of what is likely to be fair, and so reduce the risk that their terms will be challenged.

4 See the May 2005 Statement of Good Practice on the Fairness of terms in consumer contracts, in particular paragraphs 2.5, 3.6 et seq and 4.19 et seq, 3.11, 3.13, 3.17 and 1.5 respectively.

5 See Regulation 7(1) and (2).

2 Good practice – Basic principles for MEAF terms

2.1 The following paragraphs set out what we consider to be basic principles applicable to MEAFs as primarily derived from the Regulations. They should be read alongside the earlier part of this Statement and the May 2005 Statement.

2.2 The Regulations are concerned with the 'fairness' of standard terms decided between a supplier and a customer. To be enforceable, a standard term must be fair under the Regulations. The test of fairness is as follows⁶:

'A contractual term which has not been individually negotiated shall be regarded as 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.'

2.3 The Regulations also state '*...the unfairness of a contractual 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....*'⁷

2.4 Generally, terms which enable a lender to vary a MEAF term unilaterally are less likely to be unfair if the variation is based on:

- a valid reason stated in the contract⁸ (such as an increase in costs in respect to the administration services which a lender provides when a customer exits a mortgage contract, which we believe is the most likely valid reason); or
- a valid reason which is not stated in the contract, but where the consumer is given notice of the variation at the earliest opportunity and is free to dissolve the contract immediately⁹.

6 See Regulation 5(1)

7 See Regulation 6(1)

8 See paragraph 1(j) of Schedule 2 to the Regulations

9 See paragraph 2(b) of Schedule 2 to the Regulations

- 2.5 If no valid reason is stated in the contract, the Regulations may allow unilateral variations where the lender has told a customer of the variation and the customer is free to dissolve the contract immediately if they do not think the proposed variation is acceptable¹⁰. In the context of MEAFs, we do not believe that in most circumstances there is 'freedom to dissolve the contract'. Freedom to dissolve may be affected by a number of contractual factors, such as early repayment charges. And in some cases there are other practical problems in replacing a mortgage contract with another provider. This increases the importance, when drafting a contract, of ensuring that enough valid reasons for any variation have been stated.
- 2.6 In our view, if a MEAF term is drafted to enable the lender to recover the cost of the administration services which a lender provides when a customer exits the mortgage, the lender should ensure that the MEAF represents **in fact** the cost of the lender's administration services. A failure to do so is also likely to be a breach of contract. You can find further guidance on administration costs in paragraphs 3.8 and 3.9 below. Under the Regulations, the MEAF term must also be expressed in plain and intelligible language. If there is doubt about the costs that the lender may recover under a MEAF term, the interpretation that favours the consumer must be used¹¹.
- 2.7 In our view, when increasing a MEAF on the basis of increased costs, the increase is unlikely to be fair unless it is proportionate to cost increases.
- 2.8 Any term or mechanism enabling the lender to vary the MEAF or MEAF term must be expressed in plain and intelligible language. There may be no specific contract term allowing the lender to vary a MEAF term or the existing variation term may be unenforceable because it is unfair. In these instances, the lender cannot introduce a variation term without complying with the Regulations in relation to unilateral variations (see in particular paragraph 2.5 of the May 2005 Statement).
- 2.9 In our view, MEAF variation terms (as defined in this Statement at paragraph 1.9) are not 'core terms' under the Regulations¹² and so can be reviewed for fairness under the Regulations.
- 2.10 This Statement does not deal with the issue of whether MEAF terms are 'core terms' under the Regulations. We acknowledge, however, that it may be possible for a MEAF term to be a 'core term', though only a court can ultimately decide whether a term is a 'core term'. A 'core term' would not be reviewable for fairness under the Regulations if it was written in plain and intelligible language.

10 See paragraph 2(b) of Schedule 2 to the Regulations.

11 See Regulation 7.

12 A core term of a contract is not generally reviewable for fairness under the Regulations, provided it is written in 'plain, intelligible language' (see Regulation 6 (2)). Core terms are 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 in exchange.

3 Practical application of the basic principles

- 3.1 The Financial Ombudsman Service (FOS) has raised the issue of MEAFs with us under the wider implications process. This is because it was concerned by the complaints it was receiving on the topic, and we decided that resolving these complaints would have wider implications for the industry and its customers. Regulatory action was the preferred route for resolving the issue given our powers under the Regulations. However, the FOS is required to consider complaints falling within its scope that are brought to it on the subject of MEAFs, and so clearly has an interest in both the fairness of MEAF terms and of any variation to them.
- 3.2 If the FOS receives a complaint on MEAFs (or any other issue) it will determine it by reference to what is, in its opinion, fair and reasonable in all the circumstances of the case. In considering what is fair and reasonable in all the circumstances of the case, the FOS will take into account the relevant law, regulations, regulators' rules and guidance and standards, relevant codes of practice and, where appropriate, what it considers to have been good industry practice at the relevant time.
- 3.3 We also have a duty to consider complaints about unfair contract terms under the Regulations, and can and do investigate matters that appear to give rise to concerns on our own initiative. When setting our policy for unfair contract terms we must do so in a way compatible with our FSMA objectives (including the protection of consumers). In so far as we believe it is appropriate to consider the fairness of any terms relating to MEAFs, whether under the Regulations or Principle 6, we would expect to apply the principles set out in this Statement when exercising our powers and deciding on the most suitable resolution of any case. However, this Statement is not, of itself, enforceable against lenders.
- 3.4 Given the above, if we receive a complaint about MEAFs we are likely to ask lenders to explain how the relevant terms are fair under the Regulations and, if necessary, how the lender considers that those terms meet the requirement

to be in plain and intelligible language. Even if the terms are fair under the Regulations, they must also be applied fairly in practice. Section 4 – The Way Forward outlines our likely regulatory approach in the case of the outcomes for past, current and future customers.

- 3.5 To help lenders decide whether this issue is one that might affect them, we outline below some examples of the practical application of these principles. Lenders may then wish to undertake a risk-management review to assess what impact, if any, this issue may have on their mortgage contracts.

(a) Clarity in contract terms

- 3.6 Our view is that if lenders wish to increase the MEAF amount because of a change to the level of their costs, the contract must contain a clear and fair term that allows the lender to do this.

(b) Evidence of justifiable increases and relevant costs

- 3.7 The contract terms may allow for an increase to a MEAF because of an increase in costs for the administration services which a lender provides when a customer exits a mortgage contract. If so, lenders should be able, if challenged, to show what those costs are and that the increase in the MEAF is justified by the increase in costs. An increase to a MEAF based on an increase to such costs will only be fair if it is demonstrably in proportion to the increase in those costs. If a lender cannot show this, then it is possible that any increase to the MEAF on this basis would be in breach of contract.

- 3.8 We also think that such costs may include deed release fees, Land Registry charges, staff processing cost, and a reasonable proportion of general overheads. However, we do not believe such costs could legitimately include the following (though this is not an exhaustive list):

- costs of arranging the mortgage;
- costs of running the mortgage account;
- initial costs not recovered if the loan does not run to full term, such as the marketing cost of obtaining new customers;
- loss of profit on lending;
- loss of interest while the loan is reassigned; and
- costs of marketing for customer retention.

- 3.9. The costs related to the MEAF may not have been made clear in the contract. If so, we think the MEAF can only be increased for costs that relate specifically to the administration the lender has to undertake when the customer exits the mortgage contract.

(c) Terms putting the 'burden of proof' on customers

- 3.10 Given the risk of an imbalance of power and knowledge between the lender and customer in this area, we believe that terms which require customers to prove that increases to MEAFs are not reasonable are unlikely to be fair in this context. It will be easier for lenders to show that their costs, and increases to them, which are passed on to customers, are reasonably incurred and reasonable in amount.

4 The way forward

4.1 If a term is unfair under the Regulations then it cannot be enforced against the consumer¹³. This section is intended to set out how we believe lenders will react to this Statement on MEAFs, and what our likely response will be. In considering whether to take action against any lender, we would consider the practical effect their approach would have on customers as a significant factor in that decision-making process. On how a lender treats its customers in the context of MEAFs, we see a lender's customers broken down into three categories – past, current and future.

(a) Past customers

4.2 We do not have the power under the Regulations to require lenders to pay compensation to customers who have suffered loss because of an unfair term. Customers may choose to complain to the lender and to seek compensation. We would expect any lender that receives a complaint from a past customer to treat that customer in the same way they would treat a current customer in the same situation. If the lender does not satisfy the customer's complaint, the customer may choose to refer the complaint to the FOS, if appropriate.

(b) Current customers

4.3 We believe that lenders will treat current customers in one of the following ways when they come to exit their mortgage:

- (i) no MEAF is charged (for example, if there was no MEAF term, or it was unclear and a customer could not reasonably have been aware that they would have to pay a MEAF);
- (ii) the original MEAF is charged (for example, if a lender accepts that any subsequent variation of the original MEAF would be deemed unfair on the basis of the principles in this Statement);

13 See regulation 8(1)

- (iii) a revised MEAF is charged (if the lender can vary the MEAF in accordance with the principles set out in this Statement) and it is equal to or lower than the original MEAF;
- (iv) a revised MEAF is charged (if the lender can vary the MEAF in accordance with the principles set out in this Statement) and it is higher than the original MEAF; or
- (v) the current MEAF is charged.

- 4.4 We allocate our resources to meet our objectives in a risk-based and proportionate way. One such objective is to secure the appropriate degree of protection for consumers. We believe that any real consumer detriment from potentially unfair MEAFs comes from some consumers being asked to pay a MEAF on exiting the mortgage that is more than the original MEAF that they agreed to. When we decide whether regulatory intervention is appropriate in relation to the way that a lender treats current customers who exit their mortgage, we are unlikely to investigate further any lender that reasonably adopts and implements one of the outcomes we outline in sub-paragraph 4.3(i) to (iii). If a lender adopts and implements outcomes 4.3 (iv) or (v) we may investigate further and ask lenders to demonstrate to us how they believe they have complied with the principles set out in this Statement. However, if they can adequately demonstrate this we would be unlikely to take action against them.
- 4.5 With the help of the CML, all lenders have had some time to consider this Statement before publication. So we are therefore less likely to take action against a lender that decides by 28 February 2007 which of the above five outcomes they will adopt for their current customers (though see paragraph 4.4 above in relation to outcomes 4.3 (iv) and (v)), makes that information available to customers, and applies that outcome in practice.

(c) Future customers

- 4.6 We expect lenders may wish to review their fees and their standard terms and conditions in the light of their intentions for charging fees in the future, and the principles contained in this Statement (including paragraphs 1.4 and 1.5). We are less likely to take action against a lender that has decided whether they will be amending their MEAF terms and MEAF amounts for future customers (and if so how) by 31 July 2007, and has applied those amended terms and amounts (if applicable) from then.

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