

## Finalised guidance

# Unfair contract terms: improving standards in consumer contracts

January 2012



## 1 Introduction

- 1.1 We are publishing this Statement as, despite the amount of information published about the Unfair Terms in Consumer Contracts Regulations 1999 ('the Regulations'), we still regularly see examples of terms which, in our view, are unclear or unfair.
- 1.2 To date, we have published a large amount of information about the fairness of contract terms, including: undertakings from individual firms; statements on specific types of unfair terms; outcomes from sector-wide projects; and guidance on how we will apply our powers under the Regulations in our Regulatory Guide.<sup>1</sup> Firms can also refer to guidance and undertakings published by the Office of Fair Trading and determinations by the Financial Ombudsman Service. We expect firms to consider this further Statement and to ensure terms in their consumer contracts are clear and not unfair.
- 1.3 This Statement is not a full legal explanation of the Regulations and does not set out an exhaustive list of all the terms that are likely to be unfair or unclear within a contract. This Statement provides a commentary on the types of contract term which we commonly find to be of concern under the Regulations. These are terms giving the firm :
  1. the right to unilaterally vary the contract;
  2. the right to terminate the contract;
  3. discretion to exercise contractual powers;
  4. the right to transfer its obligations under the contract; and
  5. terms that are not in plain and intelligible language.

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<sup>1</sup> Unfair Contract Terms Regulatory Guide at: <http://fsahandbook.info/FSA/html/handbook/UNFCOG> and FSA library on unfair contract terms at: [www.fsa.gov.uk/Pages/Doing/Regulated/uct/library/index.shtml](http://www.fsa.gov.uk/Pages/Doing/Regulated/uct/library/index.shtml)

- 1.4 Ultimately, only a court can determine the fairness of a term. We cannot approve terms for the purposes of the Regulations; it is for firms to ensure that their terms are clear and not unfair under the Regulations, in the context of the product or service in question. It is important to bear in mind that wording which is clear and not unfair in one particular agreement is not necessarily clear and not unfair in another. This commentary is intended to raise awareness of the types of issues that we commonly identify as being of concern under the Regulations and to restate our expectation that firms ensure they meet the requirements of the Regulations.

## 2 Scope and status of this Statement

- 2.1 This Statement constitutes general guidance but is not Handbook text. This Statement is addressed 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. Insofar as it represents our views under the Regulations, the scope of this Statement applies to contracts entered into since 1 July 1995.

### The Regulations and the FSA's Handbook

- 2.2 The Regulations apply to terms in standard-form contracts between a firm and a consumer. Under the Regulations a term is unfair if, contrary to the requirement of good faith, it causes a significant imbalance between the rights and obligations of the firm and the consumer, to the detriment of the consumer (Regulation 5(1)). Schedule 2 to the Regulations goes on to set out a non-exhaustive and indicative list of terms which may be regarded as unfair. However, the fact that a term does not offend any of the terms listed in Schedule 2 may not remove the risk of unfairness. The fairness of a term needs to be assessed by reference to the Regulations as a whole and in the context of the particular product or service. Terms should also be expressed in plain and intelligible language (Regulation 7).
- 2.3 A term will be exempt from the assessment for fairness under the Regulations to the extent that it falls within the exemption set out in Regulation 6(2). Regulation 6(2) provides: 'in so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate to the definition of the main subject matter of the contract or to the adequacy of the price or remuneration as against the goods or services supplied in exchange.'
- 2.4 In addition to assessing the fairness of contract terms under the Regulations, we have regard to the FSA's Handbook, including the Principles for Businesses, in relation to firms authorised by us. For example, Principle 6 requires that firms pay due regard to the interests of their customers and treat them fairly, and Principle 7 requires that information, including contracts, is communicated in a way that is clear, fair and not misleading.

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

### 3 Issues

#### Issue 1: Terms providing the firm the right to unilaterally vary the contract

- 3.1 Terms which allow firms to unilaterally vary the contract unfairly are the most common type of unfair terms that we come across. Whether the variation is to the characteristics of the product, the price or the terms in general, unilateral variation terms have the potential to change the bargain the consumer entered into without the consumer's explicit consent.
- 3.2 Our experience shows that firms often reserve to themselves too much discretion as to if, when and how they will make changes to the contract. This raises the concern that some terms which allow firms to unilaterally vary the contract have the potential to be unfair.
- 3.3 Some of the terms listed in Schedule 2 to the Regulations point to specific types of unilateral variation terms which may, on an indicative basis, be regarded as being unfair. However, even where a unilateral variation term does not offend any of the terms listed in Schedule 2, this may not wholly remove the risk of unfairness under Regulation 5.
- 3.4 While variations to the characteristics of the product<sup>3</sup> and the price<sup>4</sup> have the potential to be unfair, this Statement focuses on issues around terms which enable the other terms of the contract to be varied, which is the most frequent type of unilateral variation term that we see.
- 3.5 Our interpretation of the Regulations and in particular the indicative terms of Schedule 2 is that terms which allow a firm to unilaterally vary the terms of its contract are less likely to be unfair if:
- (i) there is a **valid reason** which is specified in the contract<sup>5</sup>; or
  - (ii) for variations to interest rates or other charges, the term provides that the variation will be for a '**valid reason**' (which is not specified in the contract) 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>6</sup>; or
  - (iii) for 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>7</sup>.

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<sup>3</sup> Schedule 2, paragraph 1(k)

<sup>4</sup> Schedule 2, paragraph 1(l)

<sup>5</sup> Schedule 2, paragraph 1(j)

<sup>6</sup> Schedule 2, first paragraph of paragraph 2(b)

<sup>7</sup> Schedule 2, second paragraph of paragraph 2(b)

### Valid reasons

- 3.6 Many firms have failed to address the indication given in the Regulations that ‘valid reasons’ can help make a unilateral variation term less likely to be unfair. We often see no valid reasons specified in the contract which is of clear concern when assessing terms by reference to paragraph 1(j) of Schedule 2 to the Regulations. Valid reasons help consumers understand the circumstances in which their contracts may be varied.
- 3.7 We also see reasons that are not, in our view, valid. We consider that ‘valid reasons’ specified in a contract should be clearly and unambiguously defined, so a consumer can challenge a harmful variation that they have not clearly agreed to. In our view, a term should explain with sufficient clarity if, when and how a variation is likely to occur. What constitutes a ‘valid reason’ will depend upon the contract as a whole and the product in question.

Ultimately, only a court can decide what constitutes a ‘valid reason’. However, we are unlikely to object to a term that states that unilateral variations may be made:

- to respond proportionately to changes in general law or decisions of the Financial Ombudsman Service;
- to meet regulatory requirements;
- to reflect new industry guidance and codes of practice which raise standards of consumer protection;
- to respond proportionately to changes in the Bank of England base rate, other specified market rates or indices or tax rates; or
- to proportionately reflect other legitimate cost increases or reductions associated with providing the particular product or service.

Examples of reasons that we are likely to consider not to be valid include:

- to cover unexpected costs;
- for any reason a firm sees fit;
- for any reason a firm considers reasonable at the time of the change; or
- solely to increase profit margins.

- 3.8 Another concern we have in relation to ‘valid reasons’ is where the list of reasons specified in the contract is not exhaustive. We often see lists of reasons which conclude with ‘any other valid reason’. In our view, ‘any other valid reason’ is not an example of a valid reason in itself and therefore the reasons are not being ‘specified in the contract’ as indicated by paragraph 1(j) of Schedule 2 to the Regulations.

- 3.9 However, in circumstances where the term relates to the variation of interest rates or charges specifically, paragraph 2(b) of Schedule 2 indicates that the variation term is less likely to be unfair if the variation is made for a ‘valid reason’ (and notice is given at the earliest opportunity after the variation and the consumer is free to dissolve the contract immediately). In our view, the risk of unfairness may be mitigated in relation to such terms if the term explicitly states that the variation can only be made for a ‘valid reason’, for example, a term which states ‘We can vary these charges if we have a valid reason for doing so.’<sup>8</sup> This helps to redress any potential for imbalance by giving the consumer the knowledge that they can challenge the firm if they do not believe that the reason for variation is valid.

### Notice

- 3.10 What is sufficient in relation to notice will differ according to the product in question and the type of variation.
- 3.11 In the circumstances of unilateral variations to contracts of indeterminate duration, the potential for unfairness that we often observe arising from such terms is where the notice does not provide consumers with enough time to consider the variation in advance of it being made, in order to decide whether or not to dissolve the contract, i.e. the notice provided is not reasonable. The Regulations indicate that such terms are less likely to be unfair if the contract provides for consumers to receive reasonable notice in advance (in addition to freedom to dissolve the contract<sup>9</sup> as explained below).
- 3.12 The Regulations indicate that advance notice of variations to interest rates and charges may not be required where there is a valid reason, so long as the consumer is given notice at the earliest opportunity thereafter and the consumer is free to dissolve the contract immediately.<sup>10</sup> For example, if a term in a savings or investment contract were to allow the firm to make variations to reflect Bank of England base rate changes, we would be concerned if consumers were not informed of the reduction in the interest rate as soon as possible after the variation taking effect.
- 3.13 For the avoidance of doubt, we would be unlikely to object to a term that goes beyond the indication in Schedule 2, paragraph 2(b), by providing that, for unilateral variations to interest rates and charges, notice is to be given in advance rather than after the event, as long as the terms still provided that the variation would be made for a valid reason and gave consumers freedom to dissolve the contract immediately.
- 3.14 Firms should ensure contracts are clear and not unfair in relation to how notice of unilateral variations will be given to consumers. Personal notification is likely to contribute to fairness as it is most likely to ensure consumers are aware of the variation. In some cases, for example, a minor variation to bank

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<sup>8</sup> As long as the contract provides for the firm to give the consumer notice at the earliest opportunity thereafter and the consumer is free to dissolve the contract immediately.

<sup>9</sup> Schedule 2, second paragraph of paragraph 2(b)

<sup>10</sup> Schedule 2, first paragraph of paragraph 2(b)

accounts which have low balances, media or branch notification may be appropriate. However, we would be concerned if consumers were informed of significant variations in this way.<sup>11</sup>

#### Freedom to dissolve the contract

- 3.15 The Regulations indicate that the consumer's freedom to dissolve the contract may be a factor in a unilateral variation term being less likely to be unfair<sup>12</sup> and our experience is that firms sometimes fail to consider this. In our view, firms should bear in mind both the financial and the practical barriers which may prevent a consumer from exiting the contract if they object to a particular variation of a term.
- 3.16 For example, we would not regard consumers as being free to dissolve the contract if the terms did not provide that any exit charges would be waived to remove financial barriers to exiting the contract. Even if exit charges were waived, while a consumer may be financially free to exit the contract, there may also be practical barriers that we often find firms fail to consider. These concerns apply in many sectors. For example, in the case of some long-term insurance contracts, the consumer may, in practice, find it difficult to obtain alternative insurance because of the need for fresh underwriting. The same can also apply to mortgage products, where a consumer may be unable to find an affordable interest rate with an alternative provider, and so would be unable to exit their contract in practice.
- 3.17 It should be noted that where firms unilaterally vary the rate of interest or charges, the Regulations indicate that the term is less likely to be unfair if the consumer is free to dissolve the contract immediately.<sup>13</sup> Where a firm wishes to unilaterally vary a contract term in a contract of indeterminate duration, the Regulations indicate that a term is less likely to be unfair if a consumer is free to dissolve the contract.<sup>14</sup> Firms need to ensure they reflect this distinction when considering the drafting of their variation terms.

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<sup>11</sup> In addition to the Regulations, firms should also consider any other relevant legislation relating to contract terms. Payment service providers, for example, should ensure that their terms and conditions comply with the conduct of business provisions of the Payment Services Regulations 2009, where one such requirement is that generally a firm should provide at least two months notice to be given of any changes to the existing terms of the framework contract (Regulation 42).

<sup>12</sup> Schedule 2, paragraph 2(b)

<sup>13</sup> In addition, Schedule 2, first paragraph of paragraph 2(b) provides that the variation will be for a 'valid reason' and indicates that the contract should provide for the firm to give the consumer notice of the variation at the earliest opportunity thereafter.

<sup>14</sup> In addition, Schedule 2, second paragraph of paragraph 2(b) indicates that the firm should give the consumer reasonable notice of the variation in advance.

#### **Issue 2: Terms providing the firm the right to terminate the contract**

- 3.18 Unfair cancellation terms are one of the most frequently occurring types of unfair contract terms that we observe.
- 3.19 In assessing the fairness of a cancellation term under the Regulations, a key consideration is the effect on the consumer if the firm cancels the contract. Cancellation terms have the potential to be unfair if they create substantial inconvenience or cost to a consumer, for example in mortgage contracts where a consumer would need to seek a new mortgage from an alternative provider and pay any associated arrangement fees. Also, when a consumer is subject to cancellation of an insurance contract by a firm, they may need to declare that they have previously had insurance cancelled when seeking new insurance, even where the cancellation was through no fault of their own. This could lead to the consumer experiencing difficulties in obtaining insurance in future or paying higher premiums. In the meantime, the consumer may find themselves without important – perhaps statutory – insurance cover.
- 3.20 It is therefore important that firms consider the effect of cancellation terms, taking into account the nature of the product in question. We consider further issues with cancellation terms in relation to contracts of determinate duration and contracts of indeterminate duration below.

#### **Contracts of determinate duration**

- 3.21 In the case of contracts of determinate duration, such as annual insurance contracts and mortgage contracts, we take the view that a term which affords a firm a wide discretion to cancel the contract has the potential to be unfair. For example, we have seen terms in mortgage contracts which allow the firm to terminate the mortgage for any breach of the contract, including minor breaches. Our concern here is to ensure that such powers can only be exercised in commensurately serious circumstances. We have also seen terms in insurance contracts which allow the firm to cancel the contract for any reason – i.e. they do not specify the grounds on which the firm can cancel. Terms which reserve to the firm the right to cancel the contract only if there are serious grounds to do so reduce this risk of unfairness. Even then, in order to further mitigate the risk of unfairness, we encourage firms to consider whether the breach can be remedied by the consumer and only reserve the right to cancel the contract where the consumer has failed to provide a remedy when asked to do so.

#### Contracts of indeterminate duration

- 3.22 Terms which allow the firm to cancel a contract of indeterminate duration also pose the risk of being unfair to a consumer. However, the Regulations recognise that for contracts of indeterminate duration, there may be circumstances in which a firm may need to terminate a contract either:
- when giving reasonable advance notice<sup>15</sup>;
  - without notice where there are serious grounds<sup>16</sup>; or
  - without notice where there is a ‘valid reason’ to do so, provided that the supplier is required to inform the consumer immediately.<sup>17</sup>
- 3.23 Where a firm chooses to provide reasonable notice in advance, in our view this means that a consumer is provided with sufficient time to act. For example, if a consumer has an insurance contract and is not advised with adequate notice in advance that the firm is intending to cancel this cover, then the consumer may not have time to organise alternative insurance cover and therefore may find themselves uninsured.
- 3.24 The Regulations indicate that there is no requirement for ‘valid reasons’ for cancellation to be specified in the contract, provided that the cancellation only occurs for a ‘valid reason’. In our view, and as with valid reasons for unilaterally varying the contract, a term is less likely to be unfair if it is clearly specified in the contract that the cancellation will be for a valid reason. This is because it helps to redress any potential for imbalance by providing the consumer with the knowledge that he can challenge the firm if the consumer does not believe the reason is valid.

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<sup>15</sup> Schedule 2, paragraph 1(g)

<sup>16</sup> Schedule 2, paragraph 1(g)

<sup>17</sup> Schedule 2, paragraph 2(a)

#### **Issue 3: Terms giving firms discretion to exercise contractual powers**

- 3.25 Another issue that we commonly come across is where firms reserve to themselves excessive levels of discretion over the circumstances in which they will exercise their contractual powers. In principle, there are no objections to terms which give firms an element of discretion in order to operate efficiently. However, we are concerned about terms which give excessive discretion to firms as to if, when or how they will be able to exercise their contractual powers. In our view, such discretion can cause a term to be unfair.
- 3.26 We recognise a firm's right to fairly and legitimately protect itself against problems beyond its control and/or from serious misconduct by a consumer. However, the potential effect of excessive discretion goes beyond this and is open to abuse by the firm. In our view, terms are less likely to be unfair under the Regulations if they define the scope of a firm's discretion in a clearly defined and balanced way.
- 3.27 For example, we have accepted undertakings from firms agreeing to change terms in mortgage contracts which gave the firm the power to demand immediate repayment of the mortgage in a wide range of circumstances. We have also published a statement about terms in bank and building society accounts which gave firms power to restrict consumers' access to their savings accounts, which were drafted in a wider way than was necessary to protect the legitimate interests of the firm (by providing that the firm could limit at any time without notice the amount that a consumer could withdraw in respect of any account). We considered that a firm's ability to exercise some of the powers in some of the circumstances may have been unfair. In our view, legitimate circumstances in which a firm may have wished to limit consumers' access to savings accounts could have included, for example, financial crime and/or complying with law, regulations or a court order. We consider firms should determine whether reserving the ability to exercise a power is in line with the Regulations in each and every circumstance and to ensure that the power can only be exercised when there are commensurately serious grounds for doing so.
- 3.28 In addition to our concerns about terms that provide a firm with discretion to exercise contractual powers, we also have concerns about terms which are drafted in a vague way, such that the interpretation of the term is subject to the firm's discretion (whether deliberately or inadvertently).
- 3.29 For example, if a firm writes a term in a way that is vague, there may be ambiguity when interpreting the term. This has the potential to cause detriment to consumers by giving the firm the scope to interpret the term in a way that is most favourable to it and, as a consequence, we consider that such terms have the potential to be unfair under the Regulations. For example, we have observed terms that are vague about the circumstances in which the firm may levy charges upon cancellation of the contract by the consumer.

#### **Issue 4: Terms giving the firm the right to transfer its obligations under the contract**

- 3.30 Terms which reserve the right for a firm to transfer its rights and obligations to a third party often cause us concern under the Regulations where the transfer may serve to reduce the guarantees<sup>18</sup> for the consumer, without the latter's agreement.<sup>19</sup>
- 3.31 In our experience, there are several ways of addressing the potential unfairness caused by such terms.
- 3.32 In our view, terms which permit a firm to transfer its rights and obligations to a third party, where such a transfer results in the same, or better, guarantees for a consumer are less likely to be unfair under the Regulations. As such, terms should be clearly drafted to indicate that this will be the case.
- 3.33 Terms which would result in a reduction of a consumer's guarantees in the event that the firm transfers its rights and obligations to a third party are of concern because they have the potential to cause significant detriment to consumers. The Regulations indicate that consumer consent should be sought in these circumstances<sup>20</sup>. In such cases, we take the view that seeking informed consent, so that the consumer is made fully aware of the impact of the changes to their contract, is more likely to reduce the potential for unfairness. Nonetheless, there is a risk of consumer detriment being caused by such a term as a consumer may consent to an amendment in circumstances where they consider that there is not a viable alternative product in the market, or through inertia.

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<sup>18</sup> The OFT describe 'guarantees' in these circumstances as being the consumer's rights under the contract. See Unfair Contract Terms Guidance, September 2008, paragraph 16.2.

<sup>19</sup> Schedule 2, paragraph 1(p)

<sup>20</sup> Schedule 2, paragraph 1(p)

#### Issue 5: Terms that are not in plain and intelligible language

- 3.34 Regulation 7 provides that contract terms should be expressed in plain and intelligible language. Unclear terms are of particular concern because they leave consumers unable to fully understand the terms of the contract they have entered into.
- 3.35 We often see firms using technical or legal language in their contracts which consumers may not be able to understand. For example, words and expressions such as ‘indemnify’, ‘tort’, ‘lien’, ‘consequential loss’, ‘force majeure’ and ‘time is of the essence’ have specific legal or technical meanings which are not readily understood by the average consumer.
- 3.36 Regulation 7 is clear that where there is any ambiguity about the interpretation of a term, a court would construe the term in favour of the consumer. As a consequence, a firm may find itself either unable to apply certain terms or charges, or liable for losses it had intended to exclude. For example, we have seen terms in insurance contracts which are unclear or are contradictory as to what is covered. In those cases, the firms agreed to clarify the wording in new contracts and to apply the terms in existing contracts in such a way as to ensure that no consumers were disadvantaged as a result of the ambiguity of the wording.
- 3.37 On occasion, we see terms which are so unclear that we believe they have the potential to cause a significant imbalance to the detriment of consumers. Such terms can also be contrary to the requirement of good faith and we consider that they are, therefore, likely to be unfair under Regulation 5(1). While terms which are not in plain intelligible language are interpreted in favour of the consumer, unfair terms are unenforceable. For example, in our view, terms which exclude liability for ‘consequential loss’ without explanation are likely to be unfair. We take this view because ‘consequential loss’ is legal terminology which is so unclear that it leaves consumers unable to understand what they are covered for. As such, it has the potential to cause a significant imbalance to the detriment of consumers, contrary to good faith. In court, there is a risk that this lack of clarity would mean that rather than construing the term in favour of the consumer, the court could determine that the term would instead be unenforceable and would be struck out of the contract entirely.
- 3.38 Regulation 7 applies to all categories of terms, including terms which are excluded from an assessment of fairness under the Regulations.<sup>21</sup> It is, therefore, very important that all of the terms of the contract are clearly drafted to meet the requirements of Regulation 7.
- 3.39 A further concern with the clarity of terms arises in relation to terms which do not reflect how the firm will act in practice. Consumers rely on the terms of the contract to understand their rights and obligations and those of the firm. When we approach firms about potentially unfair terms, firms often indicate that they do not rely on the term in an unfair way or in some cases that they do not rely on the

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<sup>21</sup> Regulation 6(2) excludes from an assessment of fairness terms which deal with the definition of the main subject matter of the contract and the price or remuneration. Regulation 6(2) only exempts terms from an assessment for fairness if such terms are drafted in plain and intelligible language.

term at all. We see this in relation to both potentially unfair terms and also unclear terms. In our view, terms should fully reflect how the firm intends to operate the product or service in practice.

## 4 Summary

- 4.1 Firms need to ensure that their contract terms are clear and not unfair under the Regulations and meet their obligations to treat their customers fairly. As stated at the outset, we have published a large amount of information about the fairness of contract terms, and firms can also refer to guidance and undertakings published by the Office of Fair Trading and determinations by the Financial Ombudsman Service.
- 4.2 Unfair terms, unclear terms, contradictory terms and terms that do not reflect how the firm will act in practice are all issues which indicate poor systems and controls in relation to consumer contracts. Factors such as how contracts are signed-off at the product development stage and to what extent contracts remain in compliance with developments in law and regulation throughout the lifetime of a product are also indicative of the robustness of systems and controls in this area. We are conducting increasing amounts of work on firms' systems and controls in relation to the fairness and clarity of their contract terms, to identify the root causes of why some firms are failing in this area.
- 4.3 With the publication of this Statement, we expect to see all firms taking positive and proactive action to ensure that their contract terms are clear and fair under the Regulations, including ensuring that they have adequate systems and controls in place to achieve this.