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GOUGH SQUARE CHAMBERS' CONSUMER CREDIT COLUMN: AUGUST 2019

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In the August 2019 column, Ruth Bala considers the fairness of interest rate variation clauses in consumer credit agreements.

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INTEREST RATE VARIATION CLAUSES

In this month's column, the fairness of interest rate variation clauses in consumer credit agreements is considered.

Statutory provisions

The "Greylist" of terms which may be regarded as unfair is contained in schedule 2 to the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) (UTCCRs) for consumer contracts entered into before 1 October 2015, and in schedule 2 to the Consumer Rights Act 2015 (CRA) for consumer contracts entered on or after that date. Both schedules itemise the following indicatively unfair term (schedule 2 para 1(j), UTCCRs; schedule 2 para 11, CRA):

> "A term which has the object or effect of enabling the trader to alter the terms of the contract unilaterally without a valid reason which is specified in the contract."

Taken by itself, this indicates that interest rate variation clauses are likely to be unfair terms unless the clause specifies "valid reasons" for variations. However, this indicatively unfair term is subject to two derogations. The first derogation is specifically for interest rate variation clauses in contracts for the supply of financial services (schedule 2 para 2(b), first subpara, UTCCRs; para 22, CRA):

> "Paragraph [11] does not include a term by which a supplier of financial services reserves the right to alter the rate of interest payable by … the consumer … without notice **where there is a valid reason**, if (a) the supplier is required to inform the consumer of the alteration at the earliest opportunity and (b) the consumer is free to dissolve the contract immediately…" [emphasis added].

The existence of this derogation indicates that an interest variation clause in a credit agreement need not specify valid reasons for variations, provided that the creditor's ability to vary is premised on there being some (unspecified) valid reason. If the clause had to itemise potential valid reasons, then there would be no meaningful derogation.

The second derogation is for contracts of indefinite duration (schedule 2 para 2(b), second subpara, UTCCRs; para 23, CRA):

> "Paragraphs [11] …. do not include a term under which a trader reserves the right to alter unilaterally the conditions of a contract of indeterminate duration if (a) the trader is required to inform the consumer with reasonable notice, and (b) the consumer is free to dissolve the contract."

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This indicates not only that variation clauses in credit agreements of indefinite duration (for example, credit card agreements) need not specify valid reasons for variations, but also that the creditor's ability to vary need not even be premised on there being some (unspecified) valid reason. This is unsurprising, given that the creditor is entitled to terminate an indefinite term contract at any time anyway (that is, the creditor could just terminate and offer a new product at a higher rate, rather than exercising its power to vary).

Importantly, a term falling within one of these derogations is not necessarily fair; it is just not indicatively unfair (that is, it is not a Greylist term, but it may still be assessed for fairness in the usual way). This is now spelt out by section 63(2) of the CRA, no equivalent provision having been in the UTCCRs.

Caselaw

The early UK caselaw on the UTCCRs reflected the terms of these derogations. There was certainly no suggestion that variation clauses needed to specify valid reasons for variations. If the creditor exercised its discretion capriciously or unreasonably then it would run into trouble for another reason (breach of an implied term: *Paragon Finance plc v Nash & another [2002] 1 W.L.R. 685*).

Everything changed in April 2012, when the European Court of Justice (ECJ) considered the derogations in *Nemzeti Fogyasztovedelmi:*

> "In assessing the unfair nature of a term such as that at issue … the question whether the reasons for, or the method of, the variation of the fees connected with the service provided were specified and whether the consumer had the right to terminate the contract is particularly relevant.…
>
> … the possibility for the consumer to foresee, on the basis of clear, intelligible criteria, the amendments, by a seller or supplier, of the [supplier's terms] with regard to the fees … is of fundamental importance."

This puts something of a gloss on the statutory derogations, as it appears to add an additional requirement that the term specify the "reasons for, or the method of" the variation.

In *RWE Vertrieb AG v Verbraucherzentrale Nordrhein-Westfalen eV (C-92/11) March 2013*, the ECJ followed its approach in Invitel, stating:

> "As regards the assessment of a term that allowed a supplier to alter unilaterally the charges for the service to be supplied, it followed from arts 3 and 5 of and points 1(j) and (l) and 2(b) and (d) of the annex to Directive 93/13 that it was of fundamental importance for that purpose, first, whether the contract set out in transparent fashion the reason for and method of the variation of the charges for the service to be provided, so that the consumer could foresee, on the basis of clear, intelligible criteria, the alterations that might be made to those charges.…
>
> While from the point of view of point 2(b) of the annex to Directive 93/13 and point (b) of Annex A to Directive 2003/55 it was indeed for the supply undertaking to notify consumers in good time of any increase in tariffs and of their right to terminate the contract, that obligation, laid down for cases in which the undertaking actually wished to exercise the right reserved to it to amend the tariffs, was in addition to the obligation to inform the consumer, before conclusion of the contract and in clear and intelligible terms, of the principal conditions of the exercise of that right of unilateral variation…"

FCA guidance

In December 2018, the FCA published its finalised guidance (FG18/7) about the fairness of variation terms in financial services consumer contracts. The FCA rationalises the divergence between the statutory derogations and ECJ caselaw by reminding us that variation clauses which are not within the Greylist nonetheless need to be "transparent" to pass the fairness assessment. Transparency, it is said, requires a specification of the grounds for variation.

When considering the fairness of variation clauses, any specified grounds should now be checked against the FCA's comments on example grounds in FG18/7. In essence, the FCA's approach is that any specified grounds for a rate increase should:

- Relate to events outside the firm's direct control.
- Be tied to the costs of providing the particular product which the customer has purchased.

This is because the function of a variation clause is to transfer risk to the customer. Where the increase in costs is within the creditor's control, or relates to its general operating costs, then it is not fair for the risk of that increase to be passed on.

The FCA implicitly recognises in FG18/7 that there is a lower threshold for the fairness of variation clauses in longer-term loans and credit card agreements. For instance, the FCA considers that the sweeping up ground "any other valid reason" is more likely to be acceptable in this context. However, the FCA makes it clear that the inclusion of a sweeping up ground in a longer-term agreement is only likely to be valid where the principal conditions for variation have already been specified (in line with the extract from Vertrieb cited above). The FCA says that the inclusion of the sweeping up ground is only justified if, at execution, the creditor reasonably considers that it cannot foresee all the circumstances justifying variation. Whether inclusion of this ground is justified in individual cases is likely to be a future battleground.

Early repayment charges

The relevance of the level of any early repayment charge (ERC) remains unclear. There is no indication either in the caselaw or the FCA guidance that ERCs cannot be imposed upon settlement by the customer following variation. The FCA merely comments, rather opaquely, that when drafting variation clauses, firms should "consider" ERCs. Since an ERC represents a barrier to shopping around, it appears that the higher the ERC, the more important it is that the specified grounds for variation be fair and transparent.

Quantum

Issues surrounding quantum are potentially complex. The consequence of a variation clause being unfair under the UTCCRs or CRA is that it is "not binding" on the customer, so that the creditor is unable to obtain judgment for any element of the outstanding balance referable to the rate increase. If the customer alleges an "unfair relationship" under section 140A of the Consumer Credit Act 1974 (CCA), they will be able to reclaim the element of any "overpayment" they have made directly, so as to put them in the position they would have been in had the increase not been made.

If the variation clause is severable, such that only parts of it are struck down as unfair, there may be evidential questions as to which historic variations were made in reliance upon which specified grounds.

Omission to reduce

It is sometimes alleged that the creditor ought to have reduced the interest rate in the light of falls in the Bank of England base rate. In truth this is not an "unfair term" allegation, but rather an allegation of an omission by the creditor giving rise to an "unfair relationship". In order to determine whether this omission was unfair, the court would require evidence as to whether the creditor's own costs of funding had indeed decreased over the relevant period, in line with falls in the base rate. The court would also need to consider whether the creditor had given the customer any legitimate expectation that it would track, or reflect, falls in the base rate.

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