

Answers to end of chapter Q&A

Question 1: Compare the regulatory regimes established by the FSMA 2002 and CCA 1974. Which regime do you think is most effective in protecting borrowers?

The different regulatory regimes established by the FSMA 2000 and the CCA 1974 are considered in sections 2.1 and 2.2. The principle is that the regimes should be mutually exclusive. The FSMA regime governs Regulated Mortgage Contracts being first legal mortgages over the borrower's home. The CCA regime largely governs second and equitable mortgages; the detailed rules are summarized in Section 2.2.1. The regulatory divide is thus governed by the type of loan and lender rather than the type of borrower. Both regimes are based upon the principles of decentered market regulation where the object of regulation is to create an open and competitive market in which borrowers can make informed choices best suited to their needs through the provision of standardized comparative information for instance regarding interest rates, repayment installments and penalty charges. Within this market borrowers are thus expected to be equipped to borrow responsibly and lenders to lend responsibly.

Lenders wishing to enter this market must be licensed and may be subject to disciplinary proceedings either by the FSA, if they conduct Regulated Mortgage Business, and by the OFT where their business is subject to regulation under the CCA. Thereafter both regimes adopt what has been called "cradle to grave" approach by setting out the steps and information that must be provided to the borrower throughout the course of the transaction from the lender's marketing of the loan and the borrower's first approach to the lender through to the mortgage offer and completion of the transactions. There are also requirements governing information that must be provided to the borrower during the course of the mortgage and provisions regulating the lender's actions should the borrower default.

However, the FSMA and CCA take different approaches. The FSMA looks to satisfy broad principles, including in particular to treat borrowers fairly, through the articulation of process based rules set out in the Conduct of Mortgage Business Handbook known as the MCOB. A breach of these rules may lead to an action for breach of statutory duty by the borrower or disciplinary action by the FSA. However, the enforceability of the mortgage itself is unaffected.

The CCA is somewhat more prescriptive in detailing the form and content of the loan agreement and mortgage and the process by which they must be completed. Furthermore the consequences of a breach of these requirements is more far-reaching; the mortgage is void and can only be enforced with the approval of the court, who may require a variation in the terms of the mortgage. There is no equivalent of the MCOB Handbook governing CCA regulated mortgages but the OFT does issue guidance on various matters for instance as to requirements lenders must satisfy to obtain and retain a license, default charges and on non-status lending.

A particularly important additional distinction between the two regimes is the provisions of sections 140A-C of the CCA 1974 which applies only to CCA regulated mortgages. These sections confer upon the court an important jurisdiction to reopen a mortgage where they determine that its terms create an unfair credit relationship between the lender and borrower, although it is still unclear exactly when a court will consider a particular credit relationship unfair. The OFT have offered their own guidelines.

Although the two regimes are distinct, it should be noted that the FSA and OFT do maintain a close collaboration in which the Financial Services Ombudsman also plays a part in its complaint and dispute resolution role to borrowers under both regimes. From a comparison of the legal forms of redress it is evident that the CCA regime affords great judicial protection to the borrower. This is perhaps not surprising given that CCA regulated lending is conducted mainly by secondary lenders, rather than high street banks and building societies, and is not primarily directed at home purchase loans but to secure loans to consolidate a borrower's debts or secure other expenditure. Nevertheless the OFT has been subject to criticism by consumer groups as failing to provide adequate, comprehensive and current guidance and to put in place an effective monitoring and compliance strategy.

The FSMA does provide a more coherent regime and various groups have suggested that all loans secured against a borrower's home should be regulated under by the FSA. However, the credit crunch has exposed the weakness of decentered market regulation, in particular lenders' failure to lend responsibly. The Turner Review (referred to in the additional web material) is critical of the FSA's past 'light touch' approach to its regulatory responsibilities and promises more intensive supervision focusing on responsible lending by considering the viability of regulated lenders business strategy, and not just their compliance with the MCOB. Also to come under greater scrutiny, will be the competence and probity of a lender's employees responsible for the conduct of the lender's business.

Question 2: How does a wife prove she has been unduly influenced by her husband?

Section 3.3 of this chapter considers the effect of undue influence upon the creation of mortgages which has been thrown into sharp focus in recent years where a lender makes a loan secured upon the jointly owned family's home to provide finance to the husband's business. A wife, as joint owner, will be required to consent to the creation of this mortgage and subsequently may allege that the mortgage should be set aside against her interest because her consent was obtained as a result of her husband's undue influence.

In these circumstances the wife must prove undue influence, which we consider in section 3.3.1. The wife will have to bring evidence either that she has been subject to the actual undue influence of her husband, for instance in *CIBC v Pitt* the wife was able to prove that the pressure of constant arguments with her husband constituted actual undue influence which robbed of her ability to make her own decision to enter into the mortgage.

Alternatively, the wife may establish that the undue influence of her husband should be presumed. A presumption of undue influence will throw the burden of proof upon her husband, or more likely the bank, to convince the court that the wife entered into the mortgage of her independent and free will. Usually the fact that the wife entered into the mortgage after the receipt of independent advice will suffice to rebut a presumption of undue influence.

A presumption of undue influence may be raised upon proof that the wife's relationship with her husband was one in which she reposed trust and confidence in her husband in the conduct of their financial affairs and furthermore that the mortgage was a transaction which called for an explanation because the wife's entry into it was not explicable as the exercise of her independent and free will. Following the House of Lords guidance upon the proof of undue influence outlined in *Royal Bank of Scotland plc v Etridge*, it is clear that the court now takes a more rigorous approach in the common case outlined than was the practice after the earlier case of *Barclays Bank plc v O'Brien*. In particular, the wife's entry into a mortgage over the family home to secure an advance made to the family's business is not necessarily a transaction which calls for an explanation. It may be explicable because the wife is interested in the business or is concerned to support the family's main source of income.

Question 3: When will a bank be 'on notice' that a wife may have been unduly influenced by her husband and what steps should a bank take to minimize this risk.

There is no suggestion in the case of a mortgage over the family home to support a business loan to the husband that the lender has been unduly influenced by the wife, the undue influence (if any) is that of the husband. However, in *Barclays Bank plc v O'Brien* the House of Lords decided that a bank, as party to a mortgage granted by the wife, could be infected by undue influence exerted by the husband where the bank should have been aware of the risk of undue influence. If the husband has unduly influenced the wife, the bank may be 'on notice' of this risk and the mortgage against the wife's interest may be set aside unless the bank can prove that they took adequate steps to address that risk by trying to ensure that, so far as they were aware, the wife's consent to the mortgage was freely obtained.

In *Barclays Bank v O'Brien* the circumstances necessary to establish undue influence and to put the lender 'on notice' tended to converge. However in *Royal Bank of Scotland v Etridge* the House of Lords drew a distinction between the two tests. Whilst we have noted that the facts required to establish a presumption of undue influence were more rigorously articulated, the circumstances when a lender is put 'on notice' are easier to identify. Following *Etridge* a lender will be 'on notice' whenever a wife stands surety for her husband's debts.

Where a lender is on notice of the risk of undue influence, they must then satisfy themselves that the wife has entered into the mortgage of her own free and independent will. The House of Lords in *Etridge* outlined the steps that lenders should take. A lender must establish that the wife is separately represented by an adviser who can provide her with independent advice and they must receive confirmation that the wife has been independently advised by that party.

A lender does not need to be satisfied as to the content of that advice, merely that it has been given. These steps differ from those recommended by the House of Lords in *Barclays Bank v O'Brien* where their Lordships had recommended that the bank interview the wife separately. This course of action proved unpopular with lenders. The revised guidance advocated in *Etridge* is intended to provide an alternative process that can be implemented by banks without great difficulty.

These second and third stages in the process of setting aside a mortgage for undue influence are more fully explored in Sections 3.3.2 and 3.3.3.

Question 4: In *Barclays Bank v O'Brien* and *Royal Bank of Scotland v Etridge* the House of Lords tried to ensure that “a law designed to protect the vulnerable does not render the matrimonial home unacceptable security to financial institutions.” Have they succeeded?

The House of Lords in these two leading authorities have clearly been concerned to try and strike a balance between the sanctity of the family home and the commercial support for small and medium size businesses. The latter are often unable to obtain adequate financial support from banks and other lenders unless they can offer security (see Chapter 29 Section 2) and the only feasible security is usually the business proprietor's family home. Lord Browne Wilkinson in *O'Brien* outlined this delicate balance – see extract in section 3.3.

The decision in *O'Brien* heralded a significant and innovative development in the application of the concept of notice that was utilized by many wives to try and save the family home in the event of the family business' insolvency. Lenders became worried as they struggled to address the risk that a wife may be unduly influenced by her husband in these circumstances. As a result there was a rising number of cases that were coming before the courts, the decision in *Etridge* was in fact a co-joined appeal of a number of cases. In light of pressure from lenders that the balance had swung too far in favour of the wife, the House of Lords in *Etridge* sort to recast the balance and to articulate a practical and cost efficient process that could be implemented by lenders whilst providing a measure of protection to the wife.

That process centers upon the provision of independent advice to the wife to try and ensure that she enters into the mortgage aware of the risks. A wife who has received inadequate or negligent advice would have a personal cause of action against her adviser, usually a solicitor, rather than a proprietary protection of her interest in the family home. The House of Lords in *Etridge* also gave guidance as to who qualified as a sufficiently independent adviser and the content of the advice they should provide –see sections 3.3.1. and 3.3.3.

Nevertheless, concerns still remain over the independence of advisers where that adviser is a solicitor who also represents the husband as well as the competence of solicitors to give adequate advice of the commercial, as opposed to the legal, risks of this type of mortgage. Feminist legal scholars have also highlighted the dangers of what has been called 'sexually transmitted debt' when wives face the dilemma of making the often very

difficult and emotionally challenging choice between the risks to family home and the business aspirations of their husband. This difficult choice is one that is not confined to wives but to others in an emotionally dependent relationship for instance cohabiting heterosexual or same sex partners and parents and their children.

Question 5: What is the relationship between undue influence and unconscionable bargains? Would it be helpful to assimilate the two doctrines?

The concepts of undue influence and unconscionable bargains (as well as other vitiating factors) are explored in sections 3.1. Both concepts seek to protect the vulnerable in an unequal relationship and as such have close similarities and the same circumstances may be addressed by both doctrines. The English courts have tended to rely on undue influence whilst the Australian courts have made greater use of the unconscionable bargain doctrine. Distinctions may however be drawn between the essential focus of the two concepts. Undue influence looks to the quality of consent of the vulnerable party whilst a plea of unconscionable bargain casts the spot light on the abuse of the dominant party's position.

There have been calls for the doctrines to be assimilated and extensive academic debate on the conceptual underpinnings of the two doctrines. This debate is considered in section 3.2.

Question 6: Does the clogs and fetters doctrine continue to have any utility?

The clogs and fetters doctrine refers to the equitable jurisdiction to strike down a term which may bar or inhibit the borrower's right to redeem and thus their equity of redemption – see section 4.1.2. The doctrine was developed by the chancery courts in hand with the development of the equity of redemption which we considered in our last chapter (see Chapter 29 section 5). Particular targets for attack were terms which had the effect of excluding the equitable right to redeem, for instance the grant of an option to purchase to the lender, terms which postpone the right to redeem and collateral advantages – see section 4.2 and 4.3. However, the doctrine has itself been the object of criticism since the 19th century when it came to be considered as an unwarranted intrusion into the freedom of parties to agree contractual terms. Examples of this criticism can be seen in a number of the cases that we examine in particular *G&K Kreglinger v New Patagonia Meat and Cold Storage Co Ltd*, *Knightsbridge Estates v Byrne* and the option cases including *Samuel v Jarrah Timber & Wood Paving Corporation Ltd* and more recently *Jones v Morgan*. As a result the courts have been alert to limit the doctrine by careful construction of the transaction, a term will only be struck down if it is part of the mortgage transaction rather than being independent of it see *G&K Kreglinger v New Patagonia Meat and Cold Storage Co Ltd*, *Reeve v Lisle*, *Lewis v Frank Love* and *Warnborough v Garmite*. The courts have also looked to their alternative jurisdiction over penalties and to strike down oppressive and unconscionable terms to control collateral advantages and terms which postpone, as opposed to bar, the equitable right to redeem – see *G&K Kreglinger v New Patagonia Meat and Cold Storage Co Ltd*, *Knightsbridge Estates v Byrne* but note *Jones v Morgan*.

The doctrine has also been sidelined by other developments that we have examined for instance consumer borrowing is now much more effectively protected by market regulation and by the statutory controls, in particular the Unfair Terms in Consumer Contract Regulations. Even within the commercial sphere, modern competition law is likely to be a more effective control over collateral advantages.

Accordingly the utility of the doctrine is in considerable doubt and indeed there have been calls by the Law Commission for its abolition.

Question 7: When is a mortgage term “unfair” within the meaning of the Unfair Terms in Consumer Contract Regulations 1999?

The statutory control of terms in consumer mortgages through the Unfair Terms in Consumer Contract Regulations is considered in section 4.1.3. Under the regulations an unfair term is not binding upon the borrower and the OFT may exercise its powers to try and ensure that unfair terms are not employed. However, it is only the standard terms of the mortgage, which are not individually negotiated, that must satisfy the need for fairness.

The definition of when a term is unfair is found in regulations 5 and 6. Regulation 5 provides “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.” Whilst regulation 6 provides that the unfairness of a term is to be determined, taking into account the nature of the mortgage and all the circumstances, including the other mortgage terms. This test of unfairness encompasses both a lack of good faith and a significant imbalance in the rights and liabilities of the parties which operates to the detriment of the borrower – see *Director General of Fair Trading v First National Bank Plc*. It is supplemented by Schedule 2 of the Regulations which sets out a non-exhaustive ‘grey list’ of terms which potentially may be regarded as unfair. In addition the OFT have issued guidance on their view of the test, which is currently being reviewed.

Question 8: What legal controls can a borrower use to challenge the interest he has agreed to pay his lender?

We consider the legal sources by which mortgage terms in section 4.1. and the particular measures effecting interest rates in section 4.4.

The application of these controls will differ according to whether the borrower is a commercial or consumer borrower. For instance market regulation is largely limited to consumer loans, although loans to small and medium size business may fall within either FSMA or CCA regulation, and the statutory control operating through the Unfair Terms in Consumer Contract Regulations will only apply to consumers. In addition the courts evaluation of whether or not a term may be struck down in equity, because it is oppressive and unconscionable, will in part be measured according to the status of the borrower – see *Multiservice Bookbinding Ltd v Marden* and *Cityland & Properties (Holdings) Ltd v Dabrah*.

The most appropriate means by which the interest charged by the lender may be questioned will depend on the nature of the complaint. If the complaint is that the initially agreed interest rate is excessive then the equitable control of oppressive and unconscionable terms might provide some redress or where the borrowing is regulated under the FSMA or the CCA a complaint to the FSO may provide some satisfaction. The Unfair Terms in Consumer Contract Regulations are unlikely to be of assistance as the initial interest rate is likely to be a core term. Where the borrowing is regulated under the CCA, s140A-C may be of assistance.

Where the complaint concerns a change in the rate of interest following default the unfair terms regulations may be of assistance – see *Falco Finance Ltd v Gough* - and s140A-C may also provide redress where the borrowing is CCA regulated. Where the change in the rate of interest results from other circumstances, for instance a change in the base rate, the change may also be questioned on the grounds of Wednesday unreasonableness or because the rate change is improper, arbitrary or capricious – see *Paragon Finance Plc v Nash*.