Chapter 27

Question 1: In the context of mortgage lending, how does the FCA meet its statutory obligation to provide an appropriate level of protection to consumers?

Following a change in regulatory responsibilities prompted by the Mortgage Credit Directive, the FCA is responsible, pursuant to the FSMA 2000, for the regulation of most legal mortgages over dwelling houses. Regulated Mortgage Contracts include first and subsequent legal charges by way of mortgage over dwelling house that are occupied by the borrower and some buy-to let mortgages. This regulatory regime is considered in section 27.2.1.

It is 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 instalments and penalty charges. This decentred regulatory approach which is reflected in the statutory strategic objectives of the FCA which is to ensure that financial markets function well which is reinforced by the FCA statutory operational objectives which are to provide consumers with the appropriate degree of protection, to protect and enhance the integrity of the market and to promote effective competition in the interests of consumers.

Within the mortgage market borrowers are thus expected to be equipped to borrow responsibly and lenders to lend responsibly. However, the credit crunch exposed the weakness of decentered market regulation, particularly lenders' failure to lend responsibly which triggered a wave of activity amongst regulators, both at national and European level, to ensure that lenders take greater care when deciding to lend. In the UK the Mortgage Market Review triggered changes requiring lenders to take greater responsibility for their lending decisions for instance by undertaking affordability checks and providing advice to borrowers on the suitability of their mortgage. Mortgage Credit Directive has reinforced this shift of responsibility and introduced other technical changes to the way in which lenders are required to behave to provide greater borrower protection. The FCA constantly monitor the regulated mortgage market and will introduce changes to regulatory rules in response to changes in the market and economic conditions. For example, during the COVID pandemic rules were introduced to require mortgage lenders to show forbearance to borrowers facing repayment difficulties for instance by granting repayment holidays.

This regulatory agenda is delivered through the control lenders within the market through licencing of those permitted to lend and a 'cradle to grave' approach in setting expected standards of behaviour required of lenders throughout the mortgage transaction and most notably through the sales process. The FSMA 2000 lays down a two-tiered level of behavioural norms with which lenders are required to comply. There are broad Principles, for example to treat borrowers fairly, and also more detailed process-based rules and guidance set out in the Conduct of Mortgage Business Handbook known as the MCOB. A breach of the Principles or MCOB may trigger disciplinary action by the FCA and a breach of MCOB also may lead to an action for breach of statutory duty by the borrower or or found a borrower's complaint to the Financial Ombudsman Service. However, the enforceability of the mortgage itself is unaffected.

Whether this regulatory frame provides an appropriate degree of consumer protection is a matter of debate. The tools are there but their effective enforcement largely rests with the FCA who too often have responded to financial scandals rather too late. Their preferred approach is one of persuasion rather than enforcement and accordingly it can take some time for a complaint to work its way through the dispute resolution process and then for the culprit to be sanctioned, most commonly through the payment of a fine, and the regulatory lacuna to be addressed. Notably examples of such financial scandals include the miss-selling of endowment mortgages and payment (including mortgage) protection insurance as well as the miss-selling interest rate hedging products to small and medium size businesses. The latter highlighted the vulnerable position of certain small businesses who lacked the expertise and knowledge to appreciate the full implications of the products they were 'persuaded' to buy. The dividing line between 'a consumer' and a 'business' borrower can be difficult to

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draw when the key is whether they have the experience and expertise, or can buy the necessary expertise, to make informed and responsible decisions which take account of the financial risks. By contrast, financial institutions are experienced and well-resourced players and accordingly the inequality of bargaining power can be stark.

Question 2: Does the alternative dispute resolution facility provided by the Financial Ombudsman Service provide sufficient and effective redress to consumer borrowers?

The jurisdiction of the Financial Ombudsman Service (FOS) is considered in section 27.2.3**.** The FOS provides an accessible, cheap and efficient means by which a borrower can resolve disputes with their lender on the basis of what is fair and reasonable rather than by looking solely to the strict legal effect of the parties' relationship. The FOS has provided a route through which recent miss-selling scandals have been addressed for instance the miss-selling of endowment mortgages and payment protection insurance.

Whether their undoubted good work is sufficient and effective is limited by the financial cap on the monetary awards the FOS can make and the FOS' reluctance and limited ability to affect the proprietary relationship created by the mortgage. The cap has recently been raised and the reach of the FOS extended to certain small businesses.

Question 3: How does a wife prove that her husband has unduly influenced her and when will a bank be 'on notice' that a wife may have been unduly influenced by her husband?

Section 27.3.3 of this chapter considers the effect of undue influence upon the creation of mortgages which has been thrown into sharp focus 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 27.3.3.1. 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 under influence which robbed her 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 resided 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's 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.

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 unduly influenced the wife, that 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

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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 27.3.3.2 and 27.3.3.3.

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.' Has it succeeded?

The House of Lords in these two leading authorities were clearly 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 26 Section 26.2) 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 27.3.3.

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 a rising number of cases 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* sought 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 centres 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 section 27.3.3.3.

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

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husband. This difficult choice is one that is not confined to wives but to others in an emotionally dependent relationship for instance cohabiting hetero 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 section 27.3.1. 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 27.3.2.

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 27.4.1.2. 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 26 section 26.5). 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 sections 27.4.2 and 27.4.3. 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, particularly the Consumer Rights Act 2015. 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 Consumer Rights Act 2015 (CRA 2015)?

The statutory control of terms in consumer mortgages is considered in section 27.4.1.3. An unfair term is not binding upon the borrower and the FCA and Consumer Markets Authority (CMA) 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.

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The definition of when a term is unfair is found in section 62 of the CRA 2015 which provides that a term is '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'. 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* and *Aziz v Caixa d'Estalvis de Catalunya*. It is supplemented by a non-exhaustive 'grey list' of terms which potentially may be regarded as unfair– see section 63. In addition the FCA and CMA have issued guidance on their view of the test.

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 27.4.1 and the particular measures effecting interest rates in section 27.4.4.

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 some regulatory oversight. . The statutory control of unfair terms operating through the CRA 2015 only applies 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 FOS may provide some satisfaction. The CRA 2015 is unlikely to be of assistance as the initial interest rate is likely to be a core term.

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*. 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*.

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