

# Leasehold Forum Points Arising

In association with Winckworth Sherwood

## Overview

On December 21<sup>st</sup> 2017, in response to their consultation on *Tackling unfair practices in the leasehold market*, the Ministry for Housing, Communities and Local Government (“**MHCLG**”) announced its intentions to ban long-term leasehold for newly built houses. There was also a concerted effort to prevent exploitation of leaseholders by stopping onerous leases with aggressively escalating ground rents, namely ten and fifteen-year doublers, by reducing all future ground rents to a peppercorn (zero financial value).

In the latter weeks of January and early February, Winckworth Sherwood LLP hosted a number of forums in London and Manchester to convene interested parties and discuss recent Government proposals to reform the leasehold market.

Stakeholders involved in these discussions included: managing agents, housebuilders, property developers, institutional investors, leading landlord and tenant barristers, planning and real estate investment lawyers and valuation experts. Overall there was a strong consensus arising that reform in the sector was required. For too long, unregulated behaviour has not benefitted leaseholders and residents. Specifically, many in attendance believed banning leaseholds on new build houses was a welcome and progressive move in the sector.

Nevertheless, there were a number of common themes raised around the unintended consequences of reducing all future ground rents on apartments to zero, particularly on large urban residential buildings where institutional freeholders play a critical role.

Also, it was interesting to note that the extent of the **10 yearly doubling lease issue** is significantly smaller than is often reported. Instead of the issue stretching to 100,000s of leaseholds as has been noted in the media, information gathered by the larger investors indicates that there are only about 20,000 of these leases in existence (or 0.47% of the total leaseholds in England & Wales).

Furthermore, it was noted that of those leases over half have the ability to be converted to an RPI linked review at no cost to the leaseholder under the Ground Rent Review Assistance Scheme by Taylor Wimpey and other schemes. There was a view that the remaining leases would be expected to be treated in a similar way by those professional participants in the industry.

## Key areas discussed

### 1. Complexities of resident controlled management boards

It is a widely held view that implementing a structure where residents are in full control of the management structure of a building – either through Right to Manage (RTM) or Residents’ Manage Companies (RMCs) – will not pose social or legal challenges.

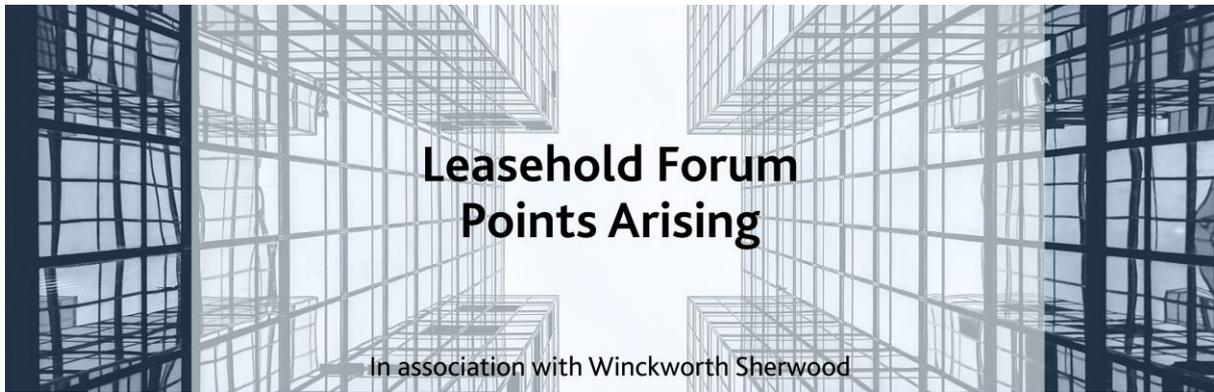


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However, whether it is in the form of RTM or a full commonhold structure, **managing agents** raised serious concerns in regards to shared management structures, particularly carrying out functions such as the management of communal areas for the long term, resolving resident's disputes and dealing with complex emergency situations:

- There is evidence of decisions being made by simple reference to cost rather than safety, deliverability and long-term value for money;
- Most RMC/RTM directors are volunteers without the management skills necessary to discharge their duties to residents and the estate. This may lead to a proliferation of outsourced suppliers and advisers which will increase service charge costs dramatically as economies of scale and expertise is reduced;
- Tenants have recourse to the implied “insurance” contractually provided by professional freehold managers (known as “PFMs”) in the possible event of negligence affecting tenants’ and the estates long-term interests. In the event of RMC/RTM management oversight or negligence to the detriment of tenants and the estate, tenants have little recourse other to pursue the RMC/RTM directors personally as otherwise recourse to the RMC/RTM will only result in increased service charge,
- The need for individual director insurance costs of the RMC/RTM will be expensive in the context of voluntary management considering potential large liabilities;
- Many schemes include complex M&E components including CHP, power distribution, fire safety and ventilation plants requiring expert maintenance and management beyond the expertise of RMC/RTM volunteer;
- There is no “responsible person” (such as a PFM) to step-in the event of RMC/RTM failure or inability to act;
- The RMC/RTM market could be flooded with opportunistic and unregulated service suppliers to meet the demand should PFMs currently responsible and overseeing management of more than 4.3 million long-leasehold properties leave the market due to reputational risk;
- The Grenfell tragedy also highlighted another weakness in the RMC/RTM structure – namely, post Grenfell hundreds of RMC directors resigned once the true obligations and liabilities the RMC stood behind came to light;
- Lack of oversight – RMC/RTM directors have limited reporting obligations, redress and oversight. One major institutional investor undertook a detailed audit of its estate post Grenfell. Within 4 weeks, 99.9% of developments that are under 2 party leases had provided up to date detailed health and safety and fire risk assessment information. Upon receipt of this information the freeholder was able to constructively engage with residents and other stakeholders to manage blocks where issues had arisen. However, as at the end of January 2018 (7 months post Grenfell) only 56% of RMC/RTM controlled developments had responded. As there is no obligation on these entities to provide this information to the freeholder it is uncertain whether these (unreported) developments are either compliant or indeed safe.



A survey undertaken by one PFM revealed interesting statistics of those RMC/RTMs which have been dissolved following their establishment due to technical failure. These findings are set out in the annex to this document. Please note in this annex that “*Manco Right to Appoint*” refers to circumstances where there has been an independent management company appointed but not owned by residents or the landlord. ‘Tenant to Repair’ refers to clauses relating to flats where the tenants must insure with landlords consent. This is a similar structure to RMCs.

## **2. Impact on affordable housing**

A number of **housebuilders** expressed concerns about the impact the elimination of ground rents would have on a secure pipeline of affordable homes through Section 106 Agreements, including:

- Reduction in supply of social and intermediate housing following the re-negotiation of Section 106 Agreements/CIL contribution – attendees indicated re-negotiations had already begun following the MHCLG’s announcement in December;
- Immediate stagnation in the supply of housing as Section 106 Agreements are renegotiated with local authorities decreasing viability; and
- Increased sale prices as housebuilders seek to redress the loss of revenue that could result from the elimination of ground rents. This means housing is less affordable – consumers will need larger deposits or increased borrowing (higher consumer debt).

## **3. Impact on development finance and land supply**

During the course of the forums, it emerged there were concerns that the Government’s proposals could have an impact on the viability of future projects to be undertaken by a housebuilder. Similarly, concerns were expressed that there has been limited debate about the impact of these reforms on housing supply and the cost of land itself:

To that end, **investors** raised pertinent concerns, including:

- Reassessment of the development viability and affordability of residential and, in particular, mixed use schemes; and
- Increased premiums of plot sales to account for lost ground rent revenue.

**Developers** raised concerns, including:

- Investors/lenders less likely to provide forward funding for housing developments if not guaranteed the future receipts provided by ground rents;
- Ground rent on residential land provides long term index linked income that provides an attractive yield for institutional investors, which allows housebuilders to bid higher on brownfield sites;



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- That they would be reluctant to construct complex developments with intricate M&E, as RMC/RTMs do not have the experience or ability to take responsibility for managing such schemes over the long-term.

## 4. Role of the freeholder

In various discussions over the past month, representations have been made in regards to the role of a freeholder as a responsible steward of the long-term and objective interests of tenants (including successor tenants) and the estate. This has been discussed in relation to recent issues around cladding and fire safety for high-rise residential apartment blocks. Investors and managing agents expressed a view on this, including:

- Emergency free interest loans for appropriate arrangements to maintain resident's safety, i.e. re-cladding or permanent presence of fire marshals;
- References were made to several buildings where the intervention of the freeholder has kept home owners safe in their own homes, rather than evacuation as directed by emergency services -this has considerable benefits for leaseholders;
- Freeholders are able to make quick and informed decisions on critical safety issues - concern was expressed (particularly on larger and complex schemes) in the ability for 100 or so leaseholders being able to make these decisions; and
- Freeholders have the resources and professional relationship to pursue the original property developers, and enforce under warranties and insurance policies the costs for remedial work, i.e. cladding.

## 5. Impact on pension funds

The level of investments in ground rents, as a secured and lower risk investment grade matched liability for pension and life insurance companies, is significant enough to cause a potential knock-on effect. Investors raised a number of concerns along these lines, including:

- Less safe and secure lower risk investments will be sought by institutional investors for investment of pension/life insurance contributions currently allocated to ground rents; and
- A significant pension fund deficit could arise if compensation is not provided for the removal of ground rent in the event of retrospective action from the Government.

***We welcome your feedback and thoughts on our roundup of the points arising and concerns expressed over the last two weeks. Any of your comments will inform the next bulletin to be issued shortly when we will also provide details of the forthcoming Leasehold Reform Seminar scheduled to take place in April.***

For further information please contact [jduncan@wslaw.co.uk](mailto:jduncan@wslaw.co.uk)