



**June 2018**

### **Overview**

Winckworth Sherwood continues to maintain an active dialogue with various interested stakeholders, in respect of the Government's ongoing programme of leasehold reform.

In summary, since the last Bulletin:

- The Secretary of State for the Ministry of Housing, Communities and Local Government (MHCLG), Rt Hon James Brokenshire MP, hosted an industry roundtable to convene stakeholders to discuss solutions for the remediation of high-rise residential buildings with potentially unsafe cladding on 30 May.
- Officials from MHCLG's leasehold division, led by Claire Mathys, hosted an industry roundtable to discuss their proposed reforms to the leasehold sector on 4 June.
- The Secretary of State led a [debate](#) on the Government's response to the Grenfell Tower fire on 11 June, in which he referenced the aforementioned industry roundtables. He praised Barratt Developments, Legal & General and Taylor Wimpey for agreeing to pay for fire safety related costs in buildings they developed, and stated that they were "doing the right thing and taking responsibility" on fire safety costs, urging others to follow suit. He added that "the private sector must step up, and I'm not ruling anything out if they do not do so."
- The Law Commission held a meeting on 11 June for stakeholders to discuss the Law Commission's [call for evidence](#) on Commonhold and Enfranchisement process.
- On 18 June MHCLG published a consultation on banning the use of combustible materials in the external walls of high-rise residential buildings. The [consultation](#) closes on 14 August.

Winckworth Sherwood LLP will be hosting the Leasehold Reform Seminar, to convene stakeholders and experts from across the property sector to discuss reforms and solutions for bringing leasehold into the 21<sup>st</sup> Century. Amongst other presentations and a panel discussion, attendees will hear from MHCLG, who will outline the proposed reforms and the departments' current progress. If you would like to attend, please see below for sign up details.

June 2018



## **Defining a reasonable ground rent**

Last month's Bulletin explored the essential role ground rent income plays in enabling developers to secure funding for housebuilding, and the difficulties smaller developers would face without this resource, based on the [article](#) by Simon Allison for Estates Gazette - "A treatise in defence of ground rents". Moving forward from this, the industry has been considering the question around defining a reasonable ground rent.

The Government has proposed that ground rents on new long leases, for both houses and flats, are set to zero. However, a robust debate is required about what a reasonable ground rent is defined as to prevent adverse effects on housebuilding and house prices for consumers.

If the Government legislated that all future ground rents for leaseholds in apartment buildings be set at 0.1%, with a floor of £200, rising periodically in line with RPI, this would enshrine a culture of responsible management and enable freeholders to perform a valuable function in the sector.

Legislation for a reasonable ground rent would ensure that:

- Leaseholders would not be burdened by onerous leases
- More homes, and importantly more affordable homes, can be delivered each year
- Greater security for small and medium sized housebuilders as the sale of freeholds allows them to secure cheaper and more flexible funding
- Residents are protected if issues arise.

Based on discussions with industry and other stakeholders, it is clear that a more comprehensive debate on what defines a reasonable ground rent is essential. The key aim of the reforms, and thus abolishing ground rent, is to protect consumers. Abolishing ground rent entirely will likely have the opposite effect.



## **Evening Standard – “Cracks show for developers as ground rent proposals send tremors through industry”**

On Wednesday 27 June, the [Evening Standard](#) published a piece by Joanna Bourke, “Cracks show for developers as ground rent proposals send tremors through industry”.

The article assesses the impact of the Government’s proposal to set ground rents on new long leases to zero, on the housing sector. It sets out the views of a range of industry stakeholders – including investors, developers and property experts – capturing a general consensus around a need for a reasonable ground rent.

The article sets out the purpose of ground rents using the example of McCarthy & Stone, who state that “the company relies on ground rent income to help pay for the construction of expensive communal areas it provides for residents, such as lounges, hair salons and dining rooms.”

It quotes Spencer McCarthy, who runs Churchill Retirement Living, saying a “reasonable ground rent on fair terms” is vital for funding communal areas. “Without it we won’t be able to deliver the volume of new homes that are needed to meet the demands of our ageing population.”

McCarthy’s Clive Fenton says he supports government efforts to “eliminate bad practices” and that he’d be happy to offer residents the choice of paying more upfront instead of ground rents annually, but this would mean adding as much as £20,000 to price tags.

Simon Allison, property barrister at Hardwicke chambers, says freehold interests could become “commercially worthless”.

Richard Silva, who is a principal at fund management company Long Harbour, which manages numerous freeholds on behalf of UK pension funds is also quoted. He supports the drive for greater regulation of the industry but thinks a blanket ground rent ban “will reduce significant investment into the residential sector, and remove a much needed safety net provided by professional freeholders to homeowners”.

Donagh O’Sullivan, Chief Executive of Galliard Homes, thinks a zero rate would deter him and rivals from committing to certain developments, stating “It would be a daft move.”

The Home Builders Federation wants to ensure leasehold terms are fair and transparent. However, a spokesman adds: “Ultimately someone has to have responsibility for the building to ensure its sustainability — and responsibility comes at a price.”



## **Limitations to making Commonhold more accessible**

As many will be aware, the Law Commission is currently engaging with external stakeholders from across the industry, as well as consumer groups, to gain an understanding of the limitations to Commonhold and develop solutions for making it more accessible.

The Leasehold Reform Group (LRG), an informal group of stakeholders in the UK housing market, has held meetings with the Law Commission to offer views on Commonhold to put forward concerns held by industry.

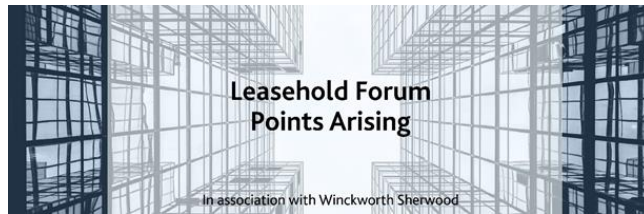
When considering the drive by Government to make Commonhold more accessible to consumers, one consideration should be how to define “consumers” in this context. Commonhold requires all residents within the block to participate in the Commonhold Association and be governed by the rules of the Commonhold Statement. The issue occurs in most larger developments as there are usually at least three separate cohorts of residential consumers, namely:

1. Owner occupiers
2. Buy to let owners – and therefore renters
3. Social housing landlords and their tenants

Catering for the needs of these different types of consumers is complex, and they will often have divergent views on what is important to them. Commonhold would make decision making and achieving consensus (on social and financial matters for example) problematic, often for no more complicated reasons than geographic location of the flat owners and the actual number of the flat owners. Leasehold, however, provides an overarching framework giving each type of consumer (and the freeholder) clarity on their rights and importantly their obligations.

Many of the objectives associated with making Commonhold more accessible can be achieved through effective reform of the leasehold sector. Firstly, Commonhold as a tenure may well work in smaller developments (up to 20 units) that are predominantly owner occupied. Secondly, absolute ownership through Commonhold can be achieved through collective enfranchisement, where a collective choice of sitting tenants can choose to take ownership if they should wish to. Similarly, standardisation, or professionalisation, of the industry can be achieved through a formal Freeholder Code of Conduct, which has been proposed to the Secretary of State by various members of the industry.

The clear view from industry – including developers, investors and advisors – is that the leasehold system, and professional freeholders, play an important role particularly in apartment buildings. The absence of an external, and professional, landlord can pose a raft of complex social challenges for residential led management under a Commonhold situation. Resident management, particularly in large apartment buildings, has led to a range of issues, including resident disputes, fraudulent dealings with collective funds, the scrapping of health and safety procedures and severely below par maintenance of buildings resulting in highly dangerous living situations.



Where resident directors may prioritise short term interests, or personal interests, responsible freeholders ensure that large residential properties are maintained in the long term interest of residents and the building.

The limitations of Commonhold mean that this system is unlikely to have the potential to benefit consumers. The industry as a whole supports wider reforms and acknowledges the importance of reforming the leasehold sector; these can be achieved, and will deliver the optimal outcomes for consumers, through effective reform of the current system, namely regulation adopted by the Secretary of State.



## **Retail Price Index (RPI) vs Consumer Price Index (CPI)**

The RPI vs CPI debate has come to light in the context of outlawing onerous doubling ground rents. Some doubling ground rents have been switched to increase in line with RPI over the preceding 10 year period. This proposal has come under fire due to complications with mortgage providers stating that they will not lend against such leases and that ground rent must not be increased during the first 21 years of a lease.

One of the main reasons behind the switch to the RPI linkage from onerous ground rents is that pension funds are generally linked to RPI. Pension funds often invest in ground rents as they offer a running yield that provides a reliable source of secure income. Linking to RPI is the only viable option for pension fund investors as it provides the best match for their liabilities.

The vast majority of indexed corporate bonds and all government indexed bonds have RPI linkage. One of the reasons for this is that there is no reliable public source of CPI pricing and, due to the lack of pricing comparables and the lower risk matching, CPI linkage is more challenging for investment. Outside of residential ground rents, it is common for long term commercial leases to use RPI indexation, (a technique to connect prices and asset values to inflation).

Private pension funds typically have a 0 per cent floor and a 5 per cent cap on uplifts. As a consequence, to impose this on ground rents would not affect pension fund investment and would limit increases in a high inflation environment for the leaseholder.

According to the Department of Work and Pensions, about 75 per cent of pension funds have RPI written into their pension scheme rules. However, the figure (based on assets under management, AUM) is likely to be significantly higher, as only newer schemes could possibly have CPI liabilities. Whilst public sector pension schemes are CPI linked, most are unfunded.

Currently, the public debate around RPI vs CPI is one-sided and fails to take into consideration the complex reasons behind the benefits of RPI linkage.



## **Centre for Economic Business Research report**

The Leasehold Reform Group, in association with Winckworth Sherwood, has formally commissioned the Centre for Business and Economics Research (CEBR) to assess the economic contribution of ground rents and the impact of leasehold reform. The report considers the impact of the Government's proposed leasehold reforms; the economic contribution of residential ground rents; and recommended areas of future research.

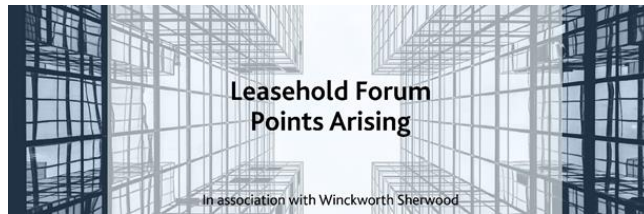
In order to assess the impact on the housing market and specifically construction sector, the CEBR surveyed a sample of UK housebuilders. It is understood that ground rents have come to form a critical part of development appraisals for new developments and investment pipelines and the abolition of ground rents could have a profound impact on the number of homes built every year. Moreover, there is a concern this will carry-over to developer's Section 106 negotiations with local authorities that identify a share of affordable homes for new developments.

The CEBR's findings pointed to a strong consensus amongst housebuilders that ground rents not only form a critical part of development appraisals but a segment of them also agreed they would have to re-visit live negotiations to reduce the share of affordable housing or equivalent, if ground rents were to be reduced to zero financial value.

The CEBR's research also considered the broader impact on the UK economy. In 2017, residential ground rent directly contributed £304.1m in cash flow into the UK economy and in the past 10 years the sector directly generated £2.0bn worth of investment, of which £1.6bn has come from the ground rent revenue streams of apartments.

Given the knock-on impact the reforms will have on the housing market, the CEBR have also highlighted recommended areas of future research. One of these that warrants the attention of policymakers and economists alike, is the potential impact on pensions. Institutional investment in the sector, from pension's funds and insurers, has channelled a significant source of revenue into housebuilding. The proposed reforms pose an immediate challenge: market participants may anticipate that this reform may be the first of several, with future reforms posing a threat to those ground rent revenue streams already in existence. This would see those ground rents trading in secondary markets deteriorate in value, damaging the returns of pensioner's whose pension funds are invested in ground rents.

The principal economist from the CEBR will be presenting their research in detail at the forthcoming Leasehold Reform Seminar.



### **Leasehold Reform Seminar**

Leasehold reform is a key priority for this Government. Winckworth Sherwood is hosting the Leasehold Reform Seminar in association with the Leasehold Reform Group to bring together policy makers, experts from across the property sector, and industry stakeholders, for a private and discursive half-day forum. The seminar will consider the challenges for the current leasehold market and explore the solutions that have been proposed over the past few months. Many attendees will have been working to identify much needed solutions to reform the market in the interest of homeowners and residents.

The seminar will include a presentation by a representative from MHCLG, updating on the departments current progress and thinking with regard to the leasehold reform proposals. Following this, attendees will hear from a representative from the CEBR who will present the top line findings of the economic research into the economic contribution of ground rents and the impact of leasehold reform, sharing exclusive insights. Finally, there will be a panel discussion with a range of industry experts on solutions for bringing the leasehold system into the 21<sup>st</sup> century, examining a range of topics.

We have a limited number of places still available so if you would like to attend the seminar, please register [here](#).

### **Diary of forthcoming industry events**

- Leasehold Reform Group seminar - half-day conference taking place 4 July